

# The American Economy: A Structural Geography

# Contents

<b>The American Economy: A Structural Geography</b>	<b>12</b>
What This Book Is About . . . . .	12
What You'll Find Here . . . . .	12
Who This Book Is For . . . . .	13
A Note on Data . . . . .	13
Acknowledgments . . . . .	13
<b>How to Use This Book</b>	<b>15</b>
Structure . . . . .	15
Conventions . . . . .	15
Reading Paths . . . . .	16
Interactive Visualizations . . . . .	16
Technical Appendices . . . . .	16
<b>Part I: The Shape of the Economy</b>	<b>18</b>
<b>1. The American Economy in Numbers</b>	<b>19</b>
The Big Picture . . . . .	19
What Gets Produced: GDP by Industry . . . . .	20
Who Works: Employment by Sector . . . . .	23
The Structure of Business . . . . .	25
How We Measure: The Statistical Infrastructure . . . . .	27
Reading the Numbers . . . . .	29
What the Numbers Don't Show . . . . .	29
Key Takeaways . . . . .	30
Data Sources and Further Reading . . . . .	30
Exercises . . . . .	31
<b>2. How It All Fits Together</b>	<b>33</b>
The Input-Output Framework . . . . .	33
Following the Money: Circular Flow . . . . .	36
The Sectoral Balance Identity . . . . .	37
The Flow of Funds . . . . .	38
Value Chains: Three Examples . . . . .	40
Where Households Spend . . . . .	41
Interdependence and Vulnerability . . . . .	43
Shock Propagation Through I-O Linkages . . . . .	44

Key Takeaways . . . . .	47
Data Sources and Further Reading . . . . .	47
Exercises . . . . .	48
<b>3. The Geography of Production</b>	<b>50</b>
The State-Level Picture . . . . .	50
Metropolitan Dominance . . . . .	52
Industry Location Patterns . . . . .	57
Urban vs. Rural . . . . .	58
The Cost of Geography . . . . .	60
The Political Economy of Place . . . . .	61
Key Takeaways . . . . .	61
Data Sources and Further Reading . . . . .	62
Exercises . . . . .	62
<b>Interlude: Who Benefits — Distribution and Inequality</b>	<b>64</b>
Income Distribution: The Basic Facts . . . . .	64
Wealth Distribution: The Deeper Divide . . . . .	67
The Racial Wealth Gap . . . . .	68
Geographic Inequality . . . . .	69
The Gender Pay Gap . . . . .	69
Intergenerational Mobility . . . . .	70
How Distribution Connects to Structure . . . . .	71
Key Takeaways . . . . .	71
Data Sources and Further Reading . . . . .	72
Exercises . . . . .	72
<b>Part II: The Sectors</b>	<b>74</b>
<b>Chapter 4. Government at All Levels</b>	<b>75</b>
How Government Works as an Economic Actor . . . . .	75
Geographic Distribution . . . . .	81
Industry Structure . . . . .	82
The Regulatory State . . . . .	84
The Budget Process (Abridged) . . . . .	85
Recent Trends . . . . .	86
Profiles . . . . .	87
Data Sources and Further Reading . . . . .	88
Exercises . . . . .	89
<b>Chapter 5. Real Estate, Rental, and Leasing</b>	<b>91</b>
Overview . . . . .	91
How the Industry Works . . . . .	92
Industry Structure . . . . .	94
Geographic Distribution . . . . .	97
The Workforce . . . . .	98
Regulation and Policy . . . . .	99
Trade Associations and Lobbying . . . . .	100

When Housing Prices Collapse: The 2006-2012 Crisis . . . . .	101
Recent Trends . . . . .	104
Firm Profiles . . . . .	107
Data Sources and Further Reading . . . . .	108
Exercises . . . . .	109
<b>6. Healthcare . . . . .</b>	<b>112</b>
Overview . . . . .	112
How the Industry Works . . . . .	113
Industry Structure . . . . .	119
Geographic Distribution . . . . .	121
The Workforce . . . . .	122
Regulation and Policy . . . . .	122
Trade Associations and Lobbying . . . . .	123
Recent Trends . . . . .	123
Firm Profiles . . . . .	124
Data Sources and Further Reading . . . . .	125
Exercises . . . . .	125
<b>7. Professional and Business Services . . . . .</b>	<b>128</b>
Overview . . . . .	128
How the Industry Works . . . . .	129
Industry Structure . . . . .	132
Geographic Distribution . . . . .	137
The Workforce . . . . .	138
Regulation and Policy . . . . .	139
Trade Associations and Lobbying . . . . .	139
Recent Trends . . . . .	140
Firm Profiles . . . . .	141
Data Sources and Further Reading . . . . .	142
Exercises . . . . .	143
<b>Chapter 8. Finance and Insurance . . . . .</b>	<b>145</b>
Overview . . . . .	145
How the Industry Works . . . . .	147
Industry Structure . . . . .	148
Geographic Distribution . . . . .	153
The Workforce . . . . .	154
Regulation and Policy . . . . .	155
Trade Associations and Lobbying . . . . .	156
Recent Trends . . . . .	157
Firm Profiles . . . . .	158
Data Sources and Further Reading . . . . .	159
Exercises . . . . .	160
<b>Chapter 9: Manufacturing . . . . .</b>	<b>163</b>
Overview: Size and Scope . . . . .	163
How the Industry Works . . . . .	164

Industry Structure . . . . .	166
Geographic Distribution . . . . .	171
The Workforce . . . . .	173
Regulation and Trade . . . . .	177
Industrial Policy and Strategic Investment . . . . .	178
Recent Trends . . . . .	179
Firm Profiles . . . . .	180
Data Sources and Further Reading . . . . .	182
Exercises . . . . .	183
<b>Chapter 10. Retail and Wholesale Trade</b>	<b>185</b>
Overview . . . . .	185
How the Industry Works . . . . .	186
Industry Structure . . . . .	188
Geographic Distribution . . . . .	190
The Workforce . . . . .	191
Regulation and Policy . . . . .	192
Trade Associations and Lobbying . . . . .	193
Recent Trends . . . . .	194
Firm Profiles . . . . .	196
Data Sources and Further Reading . . . . .	197
Exercises . . . . .	198
<b>Chapter 11: Information, Technology, and Media</b>	<b>201</b>
Overview: Size and Scope . . . . .	201
How the Industry Works: Business Models . . . . .	202
Industry Structure: The Giants and the Rest . . . . .	205
Geographic Distribution . . . . .	208
The Workforce . . . . .	209
Regulation and Policy . . . . .	210
Trade Associations and Lobbying . . . . .	212
Platform Economics and Network Effects . . . . .	213
Recent Trends . . . . .	216
Firm Profiles . . . . .	219
Data Sources and Further Reading . . . . .	221
Exercises . . . . .	222
<b>12. Transportation and Logistics</b>	<b>224</b>
Overview . . . . .	224
How the Industry Works . . . . .	226
Trucking: The Dominant Mode . . . . .	226
Freight Rail: The Duopoly . . . . .	228
Airlines: Consolidated Skies . . . . .	232
Ports and Maritime Shipping . . . . .	235
Logistics and Warehousing . . . . .	238
Geographic Patterns . . . . .	239
Regulation and Policy . . . . .	240
Trade Associations and Lobbying . . . . .	241

Recent Trends . . . . .	242
Firm Profiles . . . . .	245
Data Sources and Further Reading . . . . .	247
Exercises . . . . .	247
<b>Chapter 13. Construction</b>	<b>250</b>
Overview . . . . .	250
How the Industry Works . . . . .	251
Industry Structure . . . . .	252
Geographic Distribution . . . . .	255
The Workforce . . . . .	257
Regulation and Policy . . . . .	258
Trade Associations and Lobbying . . . . .	259
Recent Trends . . . . .	260
Firm Profiles . . . . .	262
Data Sources and Further Reading . . . . .	264
Exercises . . . . .	265
<b>Chapter 14. Energy</b>	<b>267</b>
Overview . . . . .	267
How the Industry Works . . . . .	268
Industry Structure . . . . .	271
Geographic Distribution . . . . .	274
The Workforce . . . . .	275
Regulation and Policy . . . . .	276
Trade Associations and Lobbying . . . . .	277
Beyond Electricity: Water, Gas, and Broadband Utilities . . . . .	277
Oil Price Volatility and Regional Economies . . . . .	280
Environmental Economics and the Energy Transition . . . . .	283
Recent Trends . . . . .	288
Firm Profiles . . . . .	290
Data Sources and Further Reading . . . . .	291
Exercises . . . . .	292
<b>Chapter 15. Education</b>	<b>295</b>
Overview . . . . .	295
How the Industry Works . . . . .	295
Industry Structure . . . . .	298
Geographic Distribution . . . . .	299
The Workforce . . . . .	304
Regulation and Policy . . . . .	305
Trade Associations and Lobbying . . . . .	306
Returns to Education . . . . .	307
Recent Trends . . . . .	308
Firm Profiles . . . . .	309
Data Sources and Further Reading . . . . .	311
Exercises . . . . .	312

<b>Chapter 16. Agriculture and Food Production</b>	<b>315</b>
Overview . . . . .	315
How the Industry Works . . . . .	317
Industry Structure . . . . .	319
Geographic Distribution . . . . .	321
The Workforce . . . . .	322
Regulation and Policy . . . . .	324
Trade Associations and Lobbying . . . . .	325
Recent Trends . . . . .	326
Firm Profiles . . . . .	327
Key Takeaways . . . . .	329
Data Sources and Further Reading . . . . .	329
Exercises . . . . .	330
<b>Chapter 17. Leisure and Hospitality</b>	<b>333</b>
Overview . . . . .	333
How the Industry Works . . . . .	334
Industry Structure . . . . .	337
Geographic Distribution . . . . .	339
The Workforce . . . . .	340
Regulation and Policy . . . . .	341
Trade Associations and Lobbying . . . . .	342
Recent Trends . . . . .	343
Firm Profiles . . . . .	345
Key Takeaways . . . . .	346
Data Sources and Further Reading . . . . .	347
Exercises . . . . .	348
<b>Part III: The Financial Architecture</b>	<b>351</b>
<b>Chapter 18: How American Finance Works</b>	<b>352</b>
The Hierarchy of Money . . . . .	352
How Banks Actually Work . . . . .	355
The Payments System . . . . .	358
Shadow Banking . . . . .	360
The Federal Reserve's Operational Framework . . . . .	362
The Credit Channel: How Finance Affects the Real Economy . . . . .	363
Monetary Policy Transmission: The 2022-2023 Tightening Cycle . . . . .	364
The Regulatory Architecture . . . . .	368
March 2023: Runs in the Modern Era . . . . .	369
Recent Trends . . . . .	369
Firm Profile: Fedwire and CHIPS . . . . .	370
Firm Profile: JPMorgan Chase . . . . .	370
Firm Profile: The Federal Reserve System . . . . .	371
Firm Profile: BlackRock . . . . .	372
Data Sources and Further Reading . . . . .	372
Exercises . . . . .	373

<b>Chapter 19: Capital Markets</b>	<b>376</b>
Size and Scope . . . . .	376
Equity Markets . . . . .	378
Bond Markets . . . . .	382
Derivatives Markets . . . . .	384
Private Markets . . . . .	386
The Geography of Capital Markets . . . . .	387
Regulation and Infrastructure . . . . .	388
Recent Trends . . . . .	389
Firm Profiles . . . . .	391
Firm Profile: Vanguard Group . . . . .	392
Conclusion . . . . .	393
Data Sources and Further Reading . . . . .	393
Exercises . . . . .	394
<b>Chapter 20: Corporate Finance in Practice</b>	<b>397</b>
The Pecking Order in Practice . . . . .	397
The Corporate Bond Market . . . . .	400
Investment Banking and Deal-Making . . . . .	401
Private Equity's Role . . . . .	403
Corporate Governance . . . . .	404
Capital Allocation Decisions . . . . .	407
The Geography of Corporate Finance . . . . .	408
Recent Trends . . . . .	409
Firm Profiles . . . . .	410
Conclusion . . . . .	413
Data Sources and Further Reading . . . . .	413
Exercises . . . . .	414
<b>Part IV: Trade and Global Linkages</b>	<b>417</b>
<b>Chapter 21: America's Trading Relationships</b>	<b>418</b>
The Scale of American Trade . . . . .	418
What America Trades . . . . .	420
Trade Agreements . . . . .	423
Trade Enforcement Agencies . . . . .	425
The New Trade Policy . . . . .	426
The Political Economy of Trade . . . . .	430
Firm Profiles . . . . .	431
Conclusion . . . . .	433
Data Sources and Further Reading . . . . .	434
Exercises . . . . .	434
<b>Chapter 22: Global Supply Chains</b>	<b>437</b>
The Structure of Modern Trade . . . . .	437
Major Trade Corridors . . . . .	438
Semiconductor Supply Chains . . . . .	439
Automotive Supply Chains . . . . .	442

Pharmaceutical Supply Chains . . . . .	444
The 2021-22 Supply Chain Crisis . . . . .	445
Reshoring and Nearshoring . . . . .	447
Firm Profiles . . . . .	448
Conclusion . . . . .	450
Data Sources and Further Reading . . . . .	450
Exercises . . . . .	451
<b>Part V: Regional Economies</b>	<b>454</b>
<b>23. The Northeast Corridor</b>	<b>455</b>
A Unified Economic Region . . . . .	455
The Four Pillars . . . . .	456
The Acela Economy . . . . .	462
Housing and Talent Competition . . . . .	464
Recent Trends . . . . .	465
Regional Profiles . . . . .	466
Data Sources and Further Reading . . . . .	468
Exercises . . . . .	468
<b>24. The Sunbelt</b>	<b>471</b>
The Great Shift . . . . .	471
Key Metropolitan Economies . . . . .	474
Cost Advantages and Their Limits . . . . .	478
Infrastructure Challenges . . . . .	479
Labor and Workforce . . . . .	481
The Battery Belt . . . . .	481
Political Economy . . . . .	482
Regional Profiles . . . . .	482
Data Sources and Further Reading . . . . .	484
Exercises . . . . .	484
<b>25. The Midwest</b>	<b>487</b>
The Industrial Heartland . . . . .	487
Metropolitan Economies . . . . .	488
The Manufacturing Revival . . . . .	493
Workforce and Skills . . . . .	494
The Farm Economy . . . . .	495
Demographics and Talent . . . . .	495
Regional Profiles . . . . .	496
Data Sources and Further Reading . . . . .	497
Exercises . . . . .	498
<b>26. The West</b>	<b>501</b>
California: The Colossus . . . . .	501
Metropolitan Economies . . . . .	503
Housing and the Affordability Crisis . . . . .	508
Water: The Existential Constraint . . . . .	508

Policy Laboratories . . . . .	509
Workforce and Immigration . . . . .	509
Recent Trends . . . . .	510
Regional Profiles . . . . .	511
Data Sources and Further Reading . . . . .	512
Exercises . . . . .	512
<b>27. Rural America</b>	<b>515</b>
Defining Rural . . . . .	515
The Rural Economies . . . . .	516
The Rural-Urban Divide . . . . .	518
Infrastructure Gaps . . . . .	521
Federal Transfers . . . . .	522
The Political Economy of Rural America . . . . .	523
Success Stories . . . . .	523
Recent Trends . . . . .	524
Regional Profiles . . . . .	525
Data Sources and Further Reading . . . . .	526
Exercises . . . . .	527
<b>Part VI: Institutions and Governance</b>	<b>530</b>
<b>28. Federal Economic Governance</b>	<b>531</b>
The Policy-Making Core . . . . .	531
The Independent Fed . . . . .	532
Data and Statistics . . . . .	532
Regulatory Agencies . . . . .	533
The Budget Process . . . . .	536
The Scorekeepers . . . . .	536
Recent Institutional Developments . . . . .	537
Institutional Profiles . . . . .	538
Data Sources and Further Reading . . . . .	539
Exercises . . . . .	539
<b>29. Trade Associations and Business Organization</b>	<b>542</b>
The Business of Influence . . . . .	542
The Big Four Business Associations . . . . .	542
Industry-Specific Associations . . . . .	545
How Trade Associations Function . . . . .	546
Political Spending . . . . .	548
The Policy Infrastructure . . . . .	548
Association Profiles . . . . .	549
Data Sources and Further Reading . . . . .	550
Exercises . . . . .	551
<b>30. Labor Markets and the Workforce</b>	<b>554</b>
The State of Organized Labor . . . . .	554
The Major Unions . . . . .	554

Union Federations . . . . .	557
How Unions Function . . . . .	558
Recent Labor Actions . . . . .	559
Alt-Labor and Worker Centers . . . . .	560
The Gig Economy and Worker Misclassification . . . . .	560
Political Activity . . . . .	562
Union Profiles . . . . .	562
The Changing Nature of Work . . . . .	563
Labor Market Power: Monopsony . . . . .	566
Immigration and the Labor Market . . . . .	567
Childcare, Eldercare, and Labor Force Participation . . . . .	570
Key Takeaways . . . . .	572
Data Sources and Further Reading . . . . .	573
Exercises . . . . .	574
<b>Part VII: Conclusion</b>	<b>578</b>
<b>31. The American Economy in Perspective</b>	<b>579</b>
The View from 2026 . . . . .	579
Distinctive Features . . . . .	580
Ongoing Transformations . . . . .	585
Persistent Tensions . . . . .	587
Conclusion . . . . .	589
Exercises . . . . .	590
<b>Chapter 32: How Shocks Move Through the Economy</b>	<b>593</b>
The Propagation Framework . . . . .	593
Case Study: The 2014-2016 Oil Price Collapse . . . . .	596
Comparative Analysis: Other Major Shocks . . . . .	599
Policy Responses and Their Transmission . . . . .	601
What Structure Tells Us About Vulnerability . . . . .	602
Conclusion: Structure as Destiny . . . . .	603
Data Sources and Further Reading . . . . .	604
Exercises . . . . .	605
<b>Appendices</b>	<b>608</b>
<b>Appendix A: Data Sources Guide</b>	<b>609</b>
Bureau of Economic Analysis (BEA) . . . . .	609
Bureau of Labor Statistics (BLS) . . . . .	609
Census Bureau . . . . .	610
Federal Reserve . . . . .	611
Agency-Specific Sources . . . . .	611
International and Comparative Data . . . . .	612
Tips for Using Government Data . . . . .	612
Further Resources . . . . .	612
<b>Appendix B: BEA Industry Accounts Reference</b>	<b>614</b>
GDP by Industry (2023) . . . . .	614

Manufacturing Subsectors . . . . .	615
State GDP Rankings (2023) . . . . .	615
Metropolitan Area GDP (Top 20, 2023) . . . . .	615
How to Read BEA Industry Tables . . . . .	616
Input-Output Tables . . . . .	617
Data Vintage Notes . . . . .	617
<b>Appendix C: NAICS Codes Quick Reference</b>	<b>618</b>
Two-Digit NAICS Sectors . . . . .	618
Key Three-Digit Subsectors . . . . .	619
NAICS vs. SIC . . . . .	621
NAICS Revisions . . . . .	621
Using NAICS for Research . . . . .	621
<b>Appendix D: Glossary of Key Terms</b>	<b>623</b>
A . . . . .	623
B . . . . .	623
C . . . . .	624
D . . . . .	625
E . . . . .	626
F . . . . .	626
G . . . . .	627
H . . . . .	628
I . . . . .	628
J . . . . .	629
K . . . . .	629
L . . . . .	629
M . . . . .	630
N . . . . .	631
O . . . . .	631
P . . . . .	632
Q . . . . .	632
R . . . . .	632
S . . . . .	633
T . . . . .	635
U . . . . .	635
V . . . . .	635
W . . . . .	636
X . . . . .	636
Y . . . . .	636
Z . . . . .	636

# The American Economy: A Structural Geography

## What This Book Is About

This book offers a concrete, institutional guide to how the American economy actually works. Not abstract theory, but the real ecosystem: which industries dominate, where they're located, who the major players are, how money flows, what the government does with 40% of GDP, how trade works with neighbors, what people buy, and how it all connects.

The United States has a \$27 trillion economy—the largest in the world. But what does that actually mean? Where does the money come from and where does it go? Who works in what industries, and where? How do the pieces fit together?

These are surprisingly difficult questions to answer. Economics courses teach models and theory. Business schools focus on strategy and finance from the firm's perspective. Neither provides a systematic map of the economic terrain—the kind of concrete knowledge that a regional planner, a journalist covering business, or an informed citizen might want.

This book attempts to fill that gap. It draws on the tradition of regional economics, institutional economics, and economic geography to provide a structural portrait of the American economy as it exists today.

## What You'll Find Here

**Part I** establishes the framework: how we measure the economy, how different sectors connect through input-output relationships, and how economic activity is distributed geographically.

**Part II** examines the major sectors of the economy—from government (the largest) through healthcare, finance, manufacturing, retail, technology, energy, and more. Each chapter follows a consistent template: size and scope, how the industry actually works, who the major players are, where it's concentrated geographically, how it's regulated, and who lobbies for it.

**Part III** dives deeper into the financial architecture: how the banking system works, how capital markets function, and how companies are actually financed.

**Part IV** covers America's trading relationships and global supply chains, with particular attention to the integrated North American economy.

**Part V** offers regional portraits: the Northeast corridor, the Sunbelt, the Midwest, the West, and rural America.

**Part VI** examines the institutional landscape: federal economic governance, trade associations and business lobbying, and labor organizations.

**Part VII** concludes with a synthesis: what makes the American economy distinctive, how shocks propagate through the system, and the tensions that will shape its future.

## Who This Book Is For

This book is written for a mixed audience:

- **General readers** who want to understand how the economy actually works
- **Undergraduate students** in economics, public policy, or business who need institutional context
- **Graduate students and researchers** who need a reference on industry structure
- **Journalists and policy professionals** who need background on specific sectors

The main text is accessible and avoids unnecessary jargon. Technical details and data methods are relegated to appendices for those who want to dig deeper.

## A Note on Data

This book was written in late 2025 and early 2026. The primary reference year for statistical data is 2022-2023, reflecting the lag in official economic statistics from the Bureau of Economic Analysis (BEA), Bureau of Labor Statistics (BLS), and Census Bureau. However, the narrative and policy context is current through January 2026, incorporating major developments in antitrust enforcement, industrial policy, and market events through 2024 and 2025.

Economic statistics are released with varying lags—GDP data may be one to two years old, while employment data is more current. Where possible, I've updated figures to reflect the most recent releases, but readers should check primary sources for the latest numbers. The goal is to capture the structure of the economy as it exists in the mid-2020s, not to provide a real-time snapshot that would be outdated upon publication.

## Acknowledgments

This book was written with substantial assistance from Claude, an AI assistant developed by Anthropic. Claude helped with research, drafting, data analysis, figure generation, and editing across all chapters. The author directed the overall structure, made editorial judgments, and takes responsibility for the final content. All

factual claims should be verified against the primary sources cited throughout the text.

The interactive visualizations were built using Plotly.js. Figures were generated using Python with matplotlib, seaborn, and plotnine. Data comes from public sources including the Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, and Census Bureau.

# How to Use This Book

## Structure

Each sector chapter in Part II follows a consistent template:

1. **Overview:** Size of the sector (GDP contribution, employment), basic structure
2. **How the Industry Works:** Business models, revenue streams, how money flows
3. **Industry Structure:** Market concentration, major firms, competitive dynamics
4. **Geographic Distribution:** Where the industry is concentrated, regional patterns
5. **The Workforce:** Who works in this sector, occupations, wages
6. **Regulation and Policy:** Key regulatory agencies, major policy frameworks
7. **Trade Associations and Lobbying:** How the industry organizes politically
8. **Recent Trends:** Structural changes underway
9. **Firm Profiles:** Brief profiles of 2-3 exemplary firms
10. **Data Sources and Further Reading:** Where to learn more

## Conventions

### Data Sources

Throughout the book, I cite data from standard government sources:

- **BEA:** Bureau of Economic Analysis (GDP, industry accounts)
- **BLS:** Bureau of Labor Statistics (employment, wages)
- **Census:** Census Bureau (business establishments, trade)
- **Fed:** Federal Reserve (financial data, flow of funds)

### Industry Classification

Industries are classified using the North American Industry Classification System (NAICS). See Appendix C for a reference guide.

### Dollar Figures

Unless otherwise noted, dollar figures are nominal (not adjusted for inflation) and refer to the 2022-2023 period.

## Firm Data

When discussing specific companies, data typically comes from SEC filings (10-K annual reports) for public companies, or from industry sources for private companies.

## Reading Paths

You don't need to read this book front-to-back. Here are some suggested paths:

**For a broad overview:** Read Part I (Chapters 1-3) to understand the overall structure, then dip into specific sectors of interest.

**For regional analysis:** Start with Chapter 3 (Geography), then read the relevant regional chapter in Part V.

**For policy context:** Focus on Part VI (Institutions and Governance) and the regulation sections within sector chapters.

**For financial analysis:** Read Part III (Financial Architecture) and Chapter 8 (Finance and Insurance).

## Interactive Visualizations

Throughout this book, you'll find interactive visualizations that let you explore the data yourself. These include:

- **GDP Treemap** (Chapter 1): Explore GDP composition by industry with hover details and multiple view modes
- **Employment Chart** (Chapter 1): Compare sectors by employment, GDP share, and productivity
- **Circular Flow Diagram** (Chapter 2): Animated visualization of how money flows through the economy
- **Regional Map** (Chapter 23): Interactive map of America's top 20 metro economies
- **Shock Propagation** (Chapter 32): Explore how economic shocks cascade through industries and regions
- **Data Explorer**: A full dashboard for comparing any sectors across all metrics

### ☐ Key Point:

**Data Explorer Dashboard:** For comprehensive sector comparisons and custom analysis, use our [interactive data explorer](#).

## Technical Appendices

The appendices provide more detail on:

- Data sources and how to access them
- How to read BEA industry tables
- NAICS codes and what they mean

These are designed for readers who want to do their own analysis or verify the numbers in the text.

# **Part I: The Shape of the Economy**

# 1. The American Economy in Numbers

The United States generates \$27 trillion in annual output. New York's metropolitan area alone outproduces Canada. California exceeds India, Texas, Russia. Four percent of the world's population, one-quarter of its GDP.

What does a \$27 trillion economy look like from the inside—who works in it, what they make, and where? The statistics that follow answer these questions and frame the chapters ahead.

## The Big Picture

**Gross Domestic Product (2023):** \$27.4 trillion

**Info:**

**Gross Domestic Product (GDP)** measures the total market value of all final goods and services produced within a country's borders during a specific period. "Final" means goods sold to end users—not intermediate inputs that will be processed further.

GDP measures the total value of goods and services produced within U.S. borders over a year—the standard benchmark for economic size, though an imperfect one (it misses unpaid labor, ignores environmental costs, and conflates activity with welfare).

The daily output runs to \$75 billion. Hourly, \$3 billion. At any moment, the American economy produces wealth at a rate no other nation matches.

**Employment:** 157 million nonfarm workers

**Info:**

**Nonfarm Payroll Employment** counts workers on the payrolls of non-agricultural businesses. It excludes self-employed individuals, unpaid family workers, farm workers, and military personnel. This is the headline number in the monthly "jobs report."

These are people on payrolls—employees who show up to a workplace (or log on remotely) and receive a wage or salary. It doesn't include the self-employed, agricultural workers, or the military, but it captures the vast majority of the workforce.

## **Establishments:** 8 million businesses with employees

From corner stores to corporate headquarters, the American economy comprises about 8 million distinct places of business that employ at least one person. Add in businesses without employees (solo proprietorships, freelancers), and the count rises to over 30 million.

## **How America Compares**

The United States remains the world's largest economy by conventional measures, though China has closed the gap dramatically:

**Table 1.0: Global GDP Comparison (2023)**

Rank	Economy	GDP (2023)
1	<b>United States</b>	<b>\$27.4T</b>
2	European Union	\$18.6T
3	China	\$18.0T
4	Germany	\$4.5T
5	Japan	\$4.2T
6	India	\$3.7T

Source: IMF World Economic Outlook, October 2023

What makes America distinctive isn't just size but productivity. American workers produce about \$175,000 in output per year on average—among the highest in the world. This reflects a combination of capital investment, technology, skills, and the sectoral mix of the economy.

## **What Gets Produced: GDP by Industry**

Where does \$27 trillion come from? The answer may surprise you: the largest industries aren't the ones that dominate headlines.

## **The Composition of Output**

**Table 1.1: GDP by Major Industry (2023)**

Industry	Share of GDP	Value Added
Professional & Business Services	13%	\$3.6T
Real Estate	12%	\$3.3T
Government	11%	\$3.0T
Manufacturing	11%	\$3.0T
Healthcare & Social Services	9%	\$2.5T
Finance & Insurance	8%	\$2.2T
Information (Tech/Media)	6%	\$1.6T

Industry	Share of GDP	Value Added
Retail Trade	6%	\$1.6T
Wholesale Trade	6%	\$1.6T
Construction	4%	\$1.1T
Transportation & Warehousing	3.5%	\$960B
Other	~10.5%	~\$2.9T

Source: Bureau of Economic Analysis, GDP by Industry (Table 1.5.5, 2023 annual data). Note: Shares sum to more than 100% due to rounding and the exclusion of some smaller sectors from the “Other” residual.

Several patterns stand out:

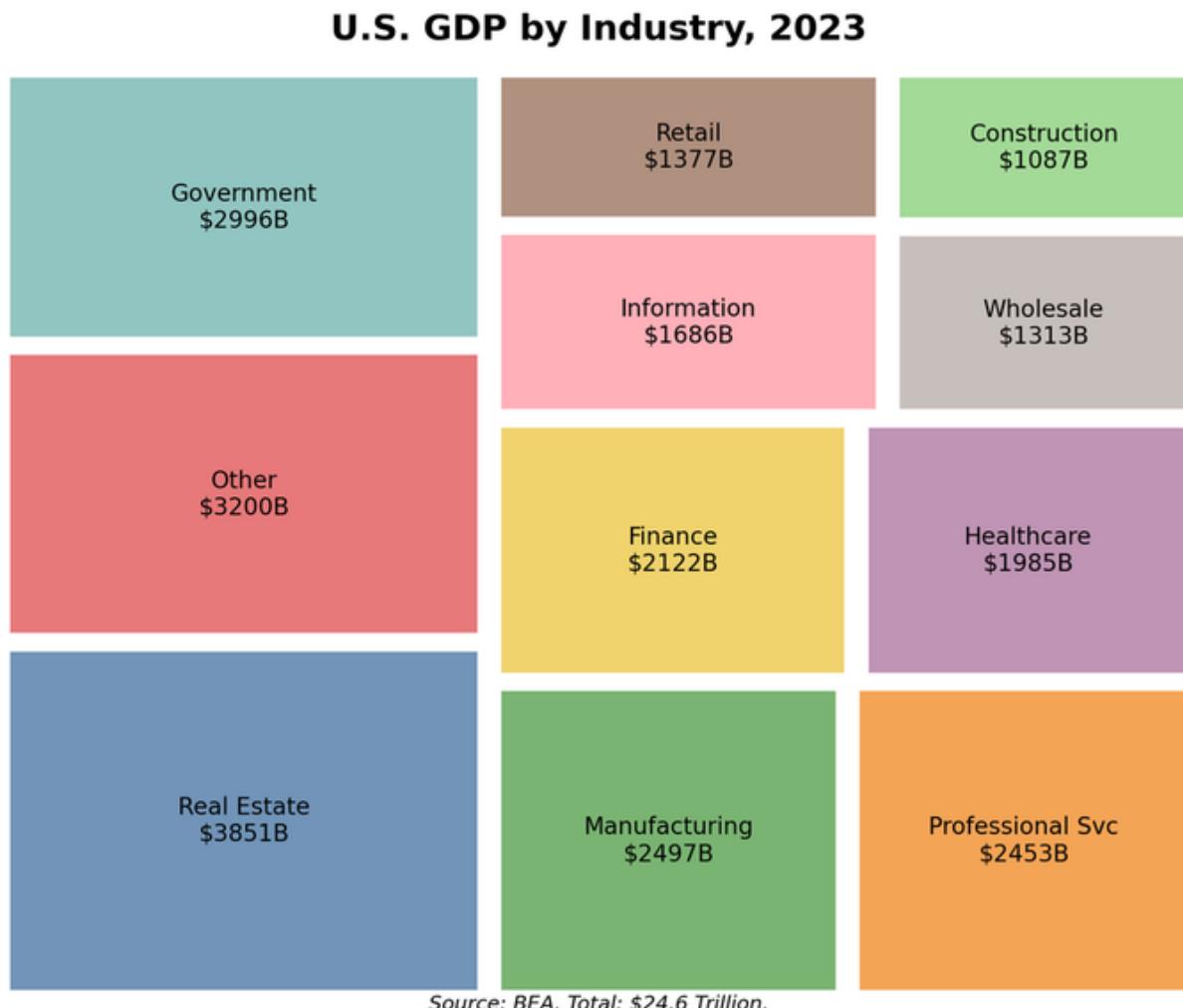


Figure 1: Figure 1.1: U.S. GDP composition by industry (2023). Services dominate, with professional services, real estate, and government each exceeding manufacturing. View interactive version. Source: BEA

**Services dominate.** The goods-producing sectors—manufacturing, construction, mining, agriculture—together account for less than 20% of GDP. The remaining 80%+ comes from services: professional services, healthcare, finance, retail, government, real estate. This is sometimes called the “post-industrial” economy, though it’s more accurate to say we’ve shifted what we produce rather than stopped producing.

**Real estate is huge.** The real estate sector’s 12% share includes the imputed rent that homeowners “pay” themselves, but it also reflects genuine economic activity: property management, real estate services, and the housing market’s central role in the economy.

**Professional services lead.** The largest private-sector contributor isn’t manufacturing or tech—it’s the sprawling category of professional and business services: law firms, accounting practices, consulting, engineering, advertising, staffing agencies, and corporate headquarters functions.

**Manufacturing still matters.** Despite decades of relative decline, manufacturing produces \$3 trillion in value—more than the entire GDP of the United Kingdom. The sector has become more capital-intensive: it produces more output with fewer workers than ever before.

## What GDP Measures (and Doesn’t)

GDP counts market production—goods and services exchanged for money. This creates some well-known quirks:

- If you hire a housekeeper, their work counts toward GDP. If you clean your own house, it doesn’t.
- Pollution cleanup adds to GDP; the pollution itself doesn’t subtract.
- The illegal economy (drugs, off-the-books work) is mostly excluded.
- Unpaid caregiving—raising children, caring for elderly parents—doesn’t appear.

GDP is also a flow, not a stock. It measures what’s produced each year, not the accumulated wealth of the nation. A country could have enormous GDP while running down its natural resources, degrading its infrastructure, or accumulating unsustainable debt.

### □ Note:

**Common Misconception:** GDP growth does not equal prosperity growth. A country can report rising GDP while depleting natural resources, accumulating debt, or concentrating gains among a small elite. GDP measures production, not well-being.

Despite these limitations, GDP remains the standard measure because it’s comprehensive, consistent, and comparable across time and countries. Just remember what it captures: the market value of final goods and services produced within a country’s borders in a given period.

## Who Works: Employment by Sector

Employment tells a different story than GDP. Some industries are labor-intensive (lots of workers per dollar of output); others are capital-intensive (lots of machinery and technology per worker).

### Where Americans Work (2023)

**Table 1.2: Employment by Sector**

Sector	Employment	Share
Education & Health Services	26.4M	17%
Government	23.1M	15%
Professional & Business Services	22.9M	15%
Leisure & Hospitality	16.8M	11%
Retail Trade	15.6M	10%
Manufacturing	12.6M	8%
Financial Activities	9.1M	6%
Construction	8.1M	5%
Transportation & Warehousing	6.2M	4%
Wholesale Trade	6.1M	4%
Other Services	5.9M	4%
Information	2.9M	2%
Mining & Utilities	1.2M	1%

Source: Bureau of Labor Statistics, Current Employment Statistics (CES), December 2023

## The GDP-Employment Gap

Compare these rankings with GDP share, and you'll notice striking divergences:

**Healthcare and education** employ more people than any other sector (17% of the workforce) but produce 9% of GDP as measured by value added in the BEA industry accounts. (Note: total national health expenditure, a broader measure tracked by CMS, is roughly 18% of GDP—the difference reflects how healthcare spending flows through insurance, government programs, and employer contributions that appear in other sectors' value added.) These are labor-intensive services where productivity gains are difficult. You can't automate a nursing home visit or a kindergarten class the way you can automate a factory.

**Manufacturing** contributes 11% of GDP but employs only 8% of workers. Each manufacturing worker produces about \$240,000 in value annually—far above the economy-wide average. Automation, technology, and capital investment have made factories extraordinarily productive.

**Leisure and hospitality** employs 11% of workers but produces only about 4% of GDP. Restaurants, hotels, and entertainment venues pay relatively low wages for work

## **U.S. Employment by Industry, 2023**

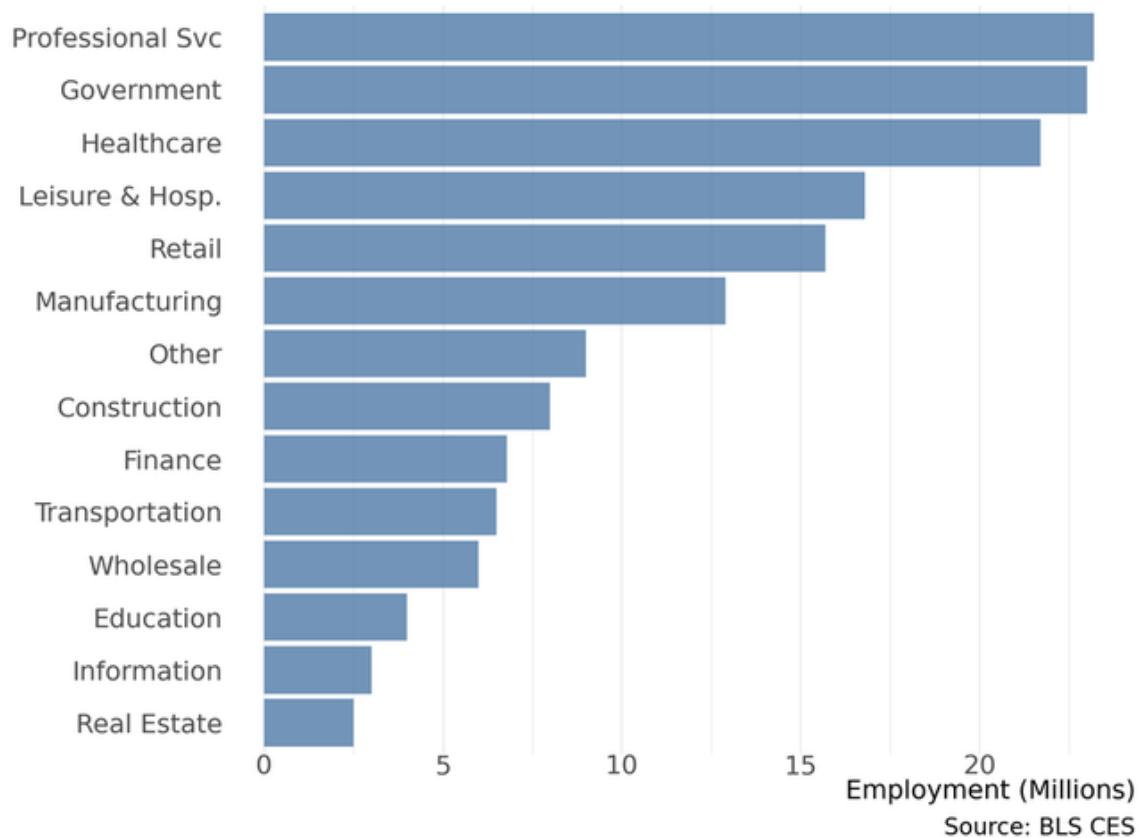


Figure 2: Figure 1.2: Employment by sector. Education and healthcare employ the most Americans, followed by government and professional services. View interactive version. Source: BLS CES (2023)

that's hard to automate.

**Information/tech** shows the reverse: 2% of employment but 6% of GDP. Tech workers are among the most productive (and highly paid) in the economy.

These gaps explain much about wage inequality, regional divergence, and the political economy of trade and automation. Industries that can substitute capital for labor tend to have rising productivity, higher wages, and falling employment shares. Industries that can't—healthcare, education, personal services—absorb more workers but face persistent cost pressures.

#### □ Key Point:

#### **Deep Dive: The Baumol Effect**

Why do healthcare and education costs rise faster than inflation? Economist William Baumol identified a structural problem: some services resist productivity gains. A string quartet in 1850 required four musicians playing for 40 minutes. In 2024, it still does. Meanwhile, manufacturing productivity has increased 100-fold. Service sectors must raise wages to compete for workers, but can't offset costs with productivity—so prices rise. This explains much about the modern economy's cost structure.

## The Structure of Business

### Size Distribution

American business spans an enormous range of scales. At one extreme, a Fortune 500 company like Walmart employs 2.1 million people and generates \$570 billion in revenue. At the other, millions of self-employed individuals—freelancers, consultants, gig workers—operate as one-person businesses.

The distribution is highly skewed:

**Table 1.3: Firm Size Distribution**

Firm Size	Share of Firms	Share of Employment
Under 20 employees	90%	17%
20-499 employees	9.7%	29%
<b>500+ employees</b>	<b>0.3%</b>	<b>54%</b>

Source: Census Bureau, Statistics of U.S. Businesses (SUSB), 2021

Read that again: 0.3% of firms—about 20,000 large enterprises—employ more than half of all American workers. The American economy is, in an important sense, an economy of large corporations surrounded by millions of small businesses.

#### □ Note:

**Common Misconception:** “Small businesses create most jobs.” This is true only for gross job creation. Small businesses also destroy many jobs

## GDP Share vs. Employment Share by Industry, 2023

Industries sorted by capital intensity (GDP/worker)

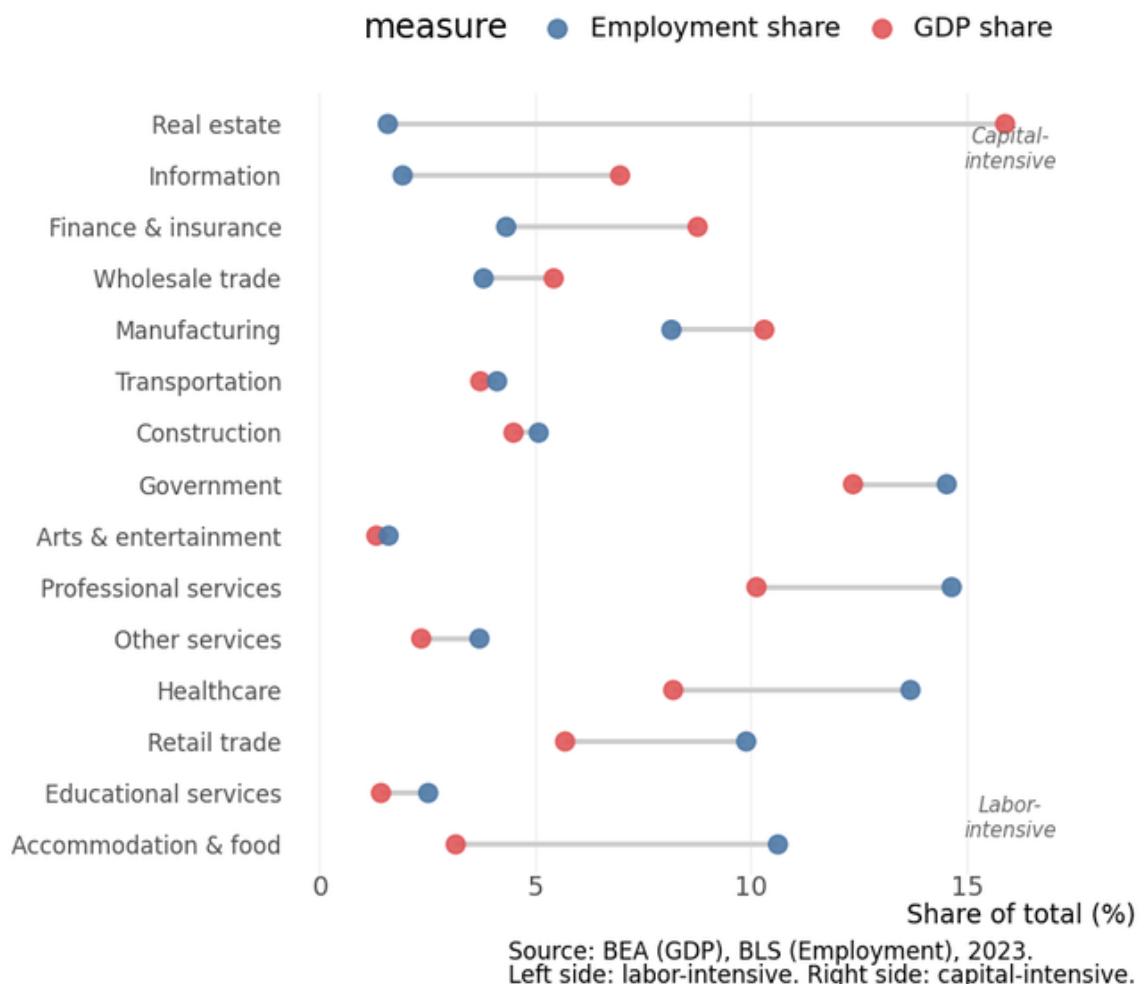


Figure 3: Figure 1.3: The GDP-employment gap by sector. Manufacturing and tech produce far more output per worker than healthcare or leisure services. This divergence drives wage inequality and shapes automation's impact. Source: BEA, BLS (2023)

through failure. At any given time, most Americans work for large, established firms—not startups or small businesses.

## The Fortune 500

The largest American corporations are staggeringly large. The Fortune 500's combined revenues approach \$20 trillion—about 70% of GDP (though revenue and value-added aren't directly comparable). These 500 companies employ over 30 million people.

The composition of the Fortune 500 has shifted dramatically over decades:

- In 1955, the top 10 were dominated by industrial giants: GM, Exxon, U.S. Steel, GE.
- In 2024, the top 10 include Walmart (retail), Amazon (tech/retail), Apple (tech), and health insurers (UnitedHealth, CVS).
- Tech companies now dominate by market value, even if not always by revenue.

## Establishments vs. Firms

A distinction that matters: **firms** are legal entities (companies); **establishments** are physical locations (stores, factories, offices). A single firm may operate thousands of establishments. Walmart is one firm but operates over 4,700 U.S. stores. Understanding this distinction matters when interpreting data: establishment counts tell you about the geographic footprint of business; firm counts tell you about corporate structure and concentration.

### □ Info:

**Firm vs. Establishment:** A **firm** is a legal business entity (a company). An **establishment** is a single physical location where business is conducted. Always check which measure your data uses—the numbers can differ dramatically.

## How We Measure: The Statistical Infrastructure

The numbers in this chapter come from an elaborate statistical infrastructure built over more than a century. Three agencies do most of the heavy lifting:

### Bureau of Economic Analysis (BEA)

The BEA, part of the Commerce Department, produces the National Income and Product Accounts (NIPA)—the official measure of GDP and its components. Key products include:

- **GDP and components** (quarterly and annual)
- **GDP by industry** (value added by sector)
- **GDP by state and metro area** (regional accounts)
- **Input-output tables** (how industries buy from each other)

- **International transactions** (balance of payments)

When you hear that GDP grew 2.5% last year, that number comes from BEA.

## Bureau of Labor Statistics (BLS)

The BLS, part of the Labor Department, measures employment, unemployment, wages, and prices. Key products include:

- **Current Employment Statistics (CES)**: The monthly jobs report that moves markets, based on a survey of 670,000 establishments
- **Current Population Survey (CPS)**: The source of the unemployment rate, based on a household survey

### Key Point:

### Deep Dive: Why Economic Data Gets Revised

The BLS publishes employment data 3 weeks after each month ends. How? Surveys. The initial estimate samples 670,000 establishments. Over subsequent months, more responses arrive and benchmarks are applied. The "final" number may differ from the initial release by 100,000+ jobs. Markets react to the first number, but researchers should use revised data.

- **Consumer Price Index (CPI)**: The main measure of inflation
- **Occupational Employment Statistics (OES)**: Detailed wage and employment data by occupation
- **Productivity statistics**: Output per hour worked

## Census Bureau

The Census Bureau, also part of Commerce, conducts the decennial population census but also produces detailed business statistics:

- **Economic Census** (every 5 years): A comprehensive count of all businesses, the foundation for industry statistics
- **County Business Patterns**: Annual data on establishments and employment by county
- **Statistics of U.S. Businesses (SUSB)**: Firm-level data by size and industry

## The NAICS System

All these agencies organize data using the North American Industry Classification System (NAICS), which categorizes every business establishment into a hierarchical code:

- 2-digit: Major sector (e.g., 31-33 = Manufacturing)
- 3-digit: Subsector (e.g., 336 = Transportation Equipment)
- 4-digit: Industry group (e.g., 3361 = Motor Vehicles)
- 5-digit: Industry (e.g., 33611 = Automobile Manufacturing)
- 6-digit: National industry (e.g., 336111 = Automobile Manufacturing)

Understanding NAICS codes matters for anyone working with economic data. The system replaced the older SIC codes in 1997 and is updated periodically to reflect economic change.

#### □ Info:

**Reading NAICS Codes:** The more digits, the more specific. Code 31-33 covers all Manufacturing; 336 is Transportation Equipment; 336111 is specifically Automobile Manufacturing. When researching industries, start broad (2-digit) then narrow down.

## Reading the Numbers

Statistics are only as useful as your ability to interpret them. A few principles:

**Levels vs. changes.** GDP of \$27 trillion is a level; GDP growth of 2.5% is a change. Both matter, but they answer different questions. Levels tell you about size and scale; changes tell you about dynamics and momentum.

**Nominal vs. real.** Nominal figures are in current dollars; real figures adjust for inflation. A nominal GDP increase could reflect more production, higher prices, or both. Real GDP strips out the price effect to measure actual output growth. For comparing over time, always use real figures.

**Stocks vs. flows.** GDP is a flow (production per year); wealth is a stock (accumulated assets). Employment is a stock (people employed at a point in time); job creation is a flow (new jobs over a period).

**Seasonality.** Many economic series have regular seasonal patterns—retail sales spike in December, construction slows in winter. Seasonally adjusted figures remove these patterns to reveal underlying trends.

**Revisions.** Economic statistics are revised, sometimes substantially. The first estimate of GDP growth is often revised in subsequent months as more data arrives. Don't over-interpret preliminary numbers.

#### □ Note:

**Data Caution:** Initial GDP and employment estimates are frequently revised—sometimes by full percentage points. The “advance” GDP estimate uses incomplete data. Wait for the “final” release (3 months later) before drawing firm conclusions.

## What the Numbers Don't Show

This statistical portrait captures the formal, measured economy. It misses several important dimensions:

**The informal economy.** Cash transactions, under-the-table work, and illegal activity don't appear in official statistics. Estimates suggest the informal economy adds 5-10% to measured GDP.

**Household production.** Cooking, cleaning, childcare, and elder care performed without pay aren't counted. If these activities were valued at market rates, they'd add trillions to GDP.

**Quality improvements.** A smartphone today does far more than one from 2010, but GDP statistics struggle to capture quality improvements. This may mean we undercount actual economic progress.

**Distribution.** GDP tells you total output, not who receives it. The same GDP could reflect a society of widespread prosperity or extreme inequality. For distribution, you need separate data on income and wealth.

**Well-being.** GDP measures production, not welfare. More is not always better—if production degrades the environment, undermines health, or requires unsustainably long working hours, GDP rises while well-being may fall.

These limitations don't invalidate economic statistics, but they do counsel humility. The numbers provide a useful map of the economy, not the territory itself.

## Key Takeaways

1. **The American economy is enormous:** \$27 trillion in GDP, 157 million workers, 8 million establishments. Only China approaches its scale.
2. **Services dominate:** Over 80% of GDP comes from services, not goods production. Professional services, real estate, healthcare, and finance are the largest sectors.
3. **Employment and output diverge:** Labor-intensive sectors (healthcare, leisure) employ disproportionately many workers; capital-intensive sectors (manufacturing, tech) produce disproportionately much output.
4. **Large firms employ most workers:** 0.3% of firms account for 54% of employment. The American economy is structurally concentrated despite millions of small businesses.
5. **Statistics require interpretation:** Understanding what GDP measures (and doesn't), the difference between nominal and real, and the sources of data is essential for informed analysis.

## Data Sources and Further Reading

### Key Data Sources

- **Bureau of Economic Analysis (bea.gov):** GDP, industry accounts, regional data
- **Bureau of Labor Statistics (bls.gov):** Employment, wages, prices
- **Census Bureau (census.gov):** Business statistics, economic census
- **FRED (fred.stlouisfed.org):** Federal Reserve database aggregating thousands of series

## Further Reading

- Diane Coyle, *GDP: A Brief but Affectionate History* (2014)—The best accessible history of national income accounting
- Bureau of Economic Analysis, *Concepts and Methods of the U.S. National Income and Product Accounts*—The technical reference for GDP measurement
- J. Steven Landefeld, “*GDP: One of the Great Inventions of the 20th Century*,” *Survey of Current Business* (2000)

## Exercises

### Review Questions

1. The United States produces roughly \$27 trillion in GDP. Name the three largest sectors by GDP contribution and explain why their rankings might surprise someone unfamiliar with the economy.
2. Manufacturing contributes about 11% of GDP but only 8% of employment. Healthcare contributes about 9% of GDP but 17% of employment. What concept explains this divergence, and what are its implications for wages in each sector?
3. The text states that 0.3% of firms employ 54% of American workers. How does this challenge the common narrative that small businesses are the “backbone” of the economy? In what sense is the narrative still partially correct?
4. GDP measures the market value of final goods and services. List three economically important activities that GDP fails to capture, and explain why each omission matters for understanding true economic well-being.
5. Explain the difference between nominal and real GDP. Why would using nominal GDP to compare the economy in 2000 and 2023 be misleading?
6. What is the difference between a “firm” and an “establishment”? Why does this distinction matter when interpreting economic data? Give an example.

### Data Exercises

7. **Exploring NAICS codes:** Go to the Bureau of Labor Statistics Occupational Employment Statistics page ([bls.gov/oes](http://bls.gov/oes)). Look up a 3-digit NAICS industry of your choice. What occupations does it include? What is the median annual wage for the industry’s largest occupation? How does this compare to the economy-wide median?
8. **GDP by state:** Using the BEA’s regional data ([bea.gov/data/gdp/gdp-state](http://bea.gov/data/gdp/gdp-state)), find the GDP of your home state. What share of national GDP does it represent? How does your state’s per capita GDP compare to the national average? What industries drive the difference?
9. **Tracking revisions:** Go to FRED ([fred.stlouisfed.org](http://fred.stlouisfed.org)) and look up the series “GDPC1” (Real GDP). Compare the “advance” estimate for any recent quarter

with the most recent revised figure. How large was the revision? What does this tell you about the reliability of first-release economic data?

### **Deeper Investigation**

10. The text notes that GDP “conflates activity with welfare.” Research one alternative measure of economic well-being (such as the Genuine Progress Indicator, the Human Development Index, or the OECD Better Life Index). How does the United States rank on this measure compared to its GDP ranking? What does the gap reveal about the American economy?

# 2. How It All Fits Together

The previous chapter presented the economy as a collection of sectors—manufacturing here, healthcare there, finance somewhere else. But the economy isn’t a collection of independent silos. It’s a vast network of buyers and sellers, inputs and outputs, where every industry depends on others and supplies others in turn.

A car doesn’t emerge from an automobile factory alone. It requires steel from mills, which require iron ore from mines and coal for energy. It requires semiconductors from fabs, which require specialized chemicals and precision equipment. It requires rubber for tires, glass for windows, plastic for dashboards, aluminum for engine blocks. The factory itself needs electricity, insurance, legal services, advertising, trucking, and thousands of other inputs. And once the car is built, dealers need financing, consumers need auto loans, cities need roads.

This chapter maps these connections: how industries link together, how money flows through the economy, and how disruption in one sector ripples through others.

## The Input-Output Framework

### What Input-Output Tables Show

In 1936, economist Wassily Leontief published the first input-output tables for the U.S. economy, work that would later earn him a Nobel Prize. The idea was straightforward: track what each industry buys from every other industry.

#### □ Info:

**Input-Output Table:** A matrix showing inter-industry purchases and sales. Rows display what each industry sells; columns display what each industry buys. First developed by Wassily Leontief (Nobel Prize, 1973), these tables form the backbone of supply chain analysis.

An input-output table is a matrix. Each row shows what an industry sells—to other industries and to final consumers. Each column shows what an industry buys—from other industries and from primary factors (labor, capital). The whole economy becomes a web of transactions.

Consider a simplified example:

	Agriculture	Manufacturing	Services	Final Demand	Total Output
<b>Agriculture</b>	10	30	5	55	100
<b>Manufacturing</b>	20	50	40	190	300
<b>Services</b>	15	40	30	215	300
<b>Value Added</b>	55	180	225	-	460
<b>Total Input</b>	100	300	300	460	-

### Simplified Circular Flow of the Economy

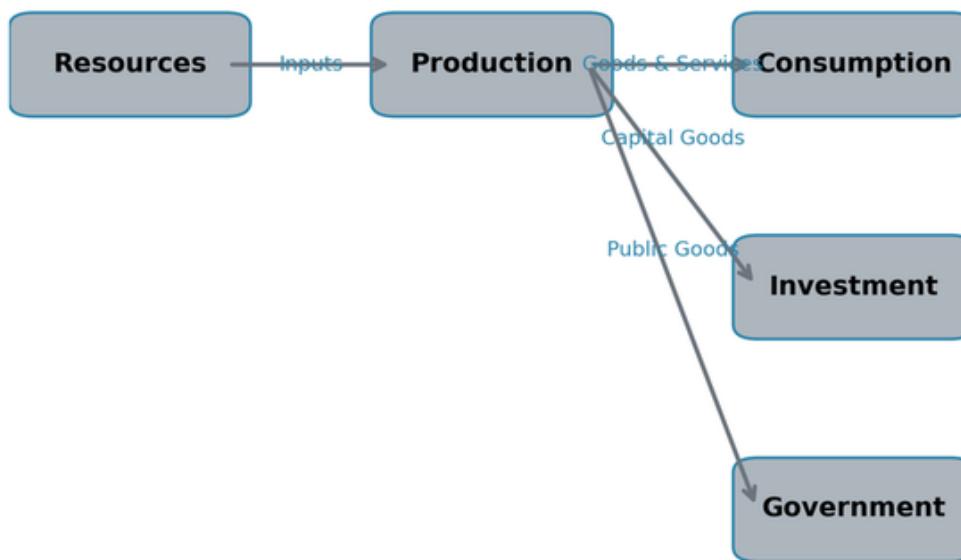


Figure 4: Figure 2.1: A simplified representation of inter-industry flows. Every sector buys from and sells to other sectors; the economy is a network, not isolated silos.  
Source: BEA I-O Accounts

Reading this table: - Agriculture sells \$30 to manufacturing (grain for food processing, cotton for textiles), \$5 to services, \$55 to final consumers (food), and \$10 to itself (seeds, feed). - Manufacturing buys \$30 from agriculture, \$50 from itself (components, intermediate goods), \$40 from services (business services, finance), plus \$180 in value added (wages, profits).

### Why Input-Output Matters

Standard GDP statistics miss three structural features this framework makes visible:

**Interdependence.** Every industry depends on others. Even “primary” sectors like agriculture require manufactured inputs (tractors, fertilizer) and services (financing,

insurance). The economy is not divisible into independent pieces.

**Multiplier effects.** When final demand for cars increases by \$1 million, the automobile industry needs to produce \$1 million more—but that requires more steel, more semiconductors, more electricity, more trucking. Those industries need more of their inputs. The total economic impact ripples through the system, multiplying the initial shock.

**Vulnerability.** Supply chain disruptions cascade. When a pandemic shuts chip factories in Asia, American automakers can't build cars—not because of any problem in Detroit, but because a critical input vanished. Input-output analysis helps identify these chokepoints.

**Structural change.** The mix of inputs changes over time. In 1950, making a car required lots of steel and labor; in 2020, it requires more electronics, software, and robots. Input-output tables track this evolution.

## Upstream and Downstream

Economists use spatial metaphors to describe industry linkages:

**Upstream** industries provide inputs: mining extracts raw materials, agriculture grows crops, utilities generate power. They're "upstream" in the flow from raw materials to finished goods.

**Downstream** industries use those inputs: manufacturing transforms materials, retail sells finished products, services deliver them to consumers.

**Backward linkages** connect an industry to its suppliers. When auto production expands, it pulls resources from upstream: more steel, more glass, more semiconductors.

**Forward linkages** connect an industry to its customers. When steel production expands, it enables more cars, more buildings, more appliances downstream.

Some industries are hubs with dense connections in both directions. Energy is the classic example: nearly every industry requires electricity or fuel, making energy disruptions particularly damaging.

### □ Info:

#### Linkage Terminology Quick Reference

- **Backward linkages:** An industry's purchases from suppliers (e.g., auto plants buying steel)
- **Forward linkages:** An industry's sales to customers (e.g., steel mills selling to auto plants)
- **Direct effects:** Jobs and output in the industry itself
- **Indirect effects:** Jobs and output in supplier industries
- **Induced effects:** Spending by workers in all affected industries

## Following the Money: Circular Flow

### The Basic Circuit

Money circulates through the economy in predictable patterns. The simplest model shows two sectors:

1. **Households** own factors of production (labor, capital) and consume goods and services.
2. **Businesses** hire factors, produce goods, and sell to households.

Money flows in a circle: businesses pay wages and profits to households; households spend on goods and services from businesses. GDP equals total spending equals total income—different ways of measuring the same circular flow.

### The Circular Flow of the American Economy

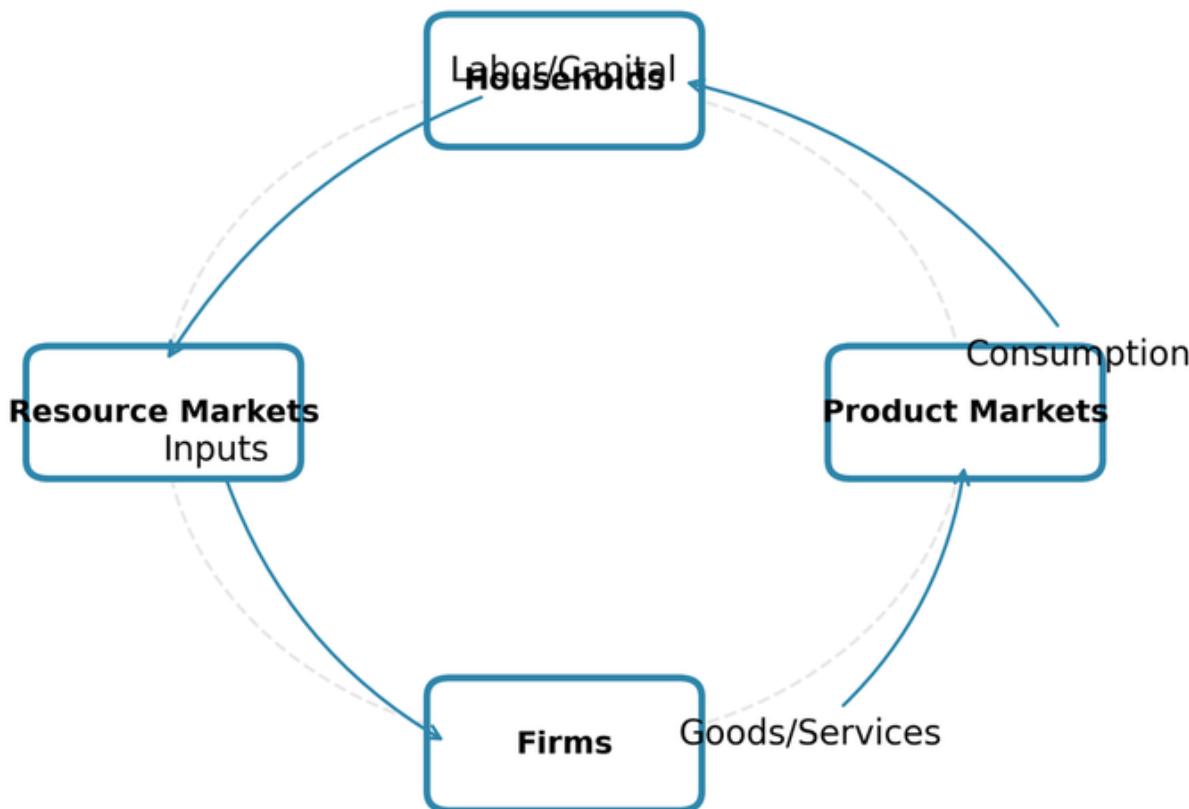


Figure 5: Figure 2.2: The circular flow of income and spending. Money flows from businesses to households as wages and profits, and from households to businesses as consumer spending. Government, finance, and foreign trade add complexity. View interactive version. Source: Author illustration

## Adding Complexity

The real economy has more moving parts:

**Government** collects taxes and purchases goods and services. Federal, state, and local governments together spend about \$10 trillion annually—nearly 40% of GDP when you include transfer payments like Social Security.

**Financial institutions** intermediate between savers and borrowers. Households deposit savings in banks; banks lend to businesses and homebuyers. The financial sector doesn't produce goods, but it lubricates every transaction.

**The rest of the world** buys American exports and sells us imports. The U.S. runs a trade deficit—we import more than we export—meaning foreign money flows in to finance American consumption and investment.

## The Sectoral Balance Identity

### The Iron Law

One of the most powerful tools for understanding how the economy fits together is the **sectoral balance identity**. It derives from the national income identity but reveals something profound: the surpluses and deficits of different sectors must sum to zero.

Start with the familiar GDP equation:

$$Y = C + I + G + (X - M)$$

Rearranging to group by sector:

$$(S - I) + (T - G) + (M - X) = 0$$

Where: - **(S - I)**: Private sector balance (household and business saving minus investment) - **(T - G)**: Government balance (taxes minus spending) - **(M - X)**: Foreign sector balance (imports minus exports, or the trade deficit)

**These three balances must sum to zero.** This isn't a theory or assumption—it's an accounting identity that holds by definition. One sector cannot run a surplus unless another runs a deficit.

### What the Balances Tell Us

This identity explains much of American economic history:

**The private sector** (households plus businesses) almost always runs a surplus—Americans save more than they invest domestically, on net.

**The government** almost always runs a deficit—spending exceeds tax revenue, requiring borrowing.

**The foreign sector** has been in surplus since the 1980s—foreigners accumulate claims on the U.S. because we import more than we export.

The policy implication is stark: if the government tries to reduce its deficit (raising T-G), either the private sector must save less (S-I falls) or the trade deficit must shrink (M-X falls). You cannot have government surplus and high private saving and a trade deficit simultaneously. The arithmetic forbids it.

This constraint explains why fiscal austerity often disappoints. When governments cut spending without a corresponding shift in private behavior or trade, GDP simply fails to make the identity hold.

## The Flow of Funds

### Tracking Who Owes What to Whom

While Kuznets was building GDP accounts to track production, economist Morris Copeland was asking a different question: where is the money going? In 1952, he published *A Study of Moneyflows in the United States*, arguing that to understand a capitalist economy, you must track the flow of funds—who is lending to whom.

The Federal Reserve adopted Copeland's framework, creating what are now called the **Financial Accounts of the United States** (the Z.1 release). These accounts track assets and liabilities for four main sectors:

1. **Households and Nonprofits:** The ultimate owners of wealth. They hold real assets (houses) and financial assets (deposits, stocks, bonds) and owe debt (mortgages, credit cards).
2. **Nonfinancial Business:** Firms that produce goods and services. They borrow to invest in capital.
3. **Government:** Federal, state, and local. The federal government is unique because it issues the currency that others use as safe assets.
4. **Rest of the World:** Foreign entities engaging with the U.S. A trade deficit means foreigners acquire U.S. assets.

### The Balance Sheet Picture

At any moment, the Z.1 accounts show the accumulated stocks:

Sector	Assets	Liabilities	Net Worth
Households	roughly \$175 trillion	roughly \$20 trillion	roughly \$155 trillion
Nonfinancial Business	roughly \$55 trillion	roughly \$35 trillion	roughly \$20 trillion
Federal Government	roughly \$5 trillion	roughly \$35 trillion	-\$30 trillion

Sector	Assets	Liabilities	Net Worth
Financial Sector	roughly \$130 trillion	roughly \$125 trillion	roughly \$5 trillion

Household net worth—about \$155 trillion—is the most important number for financial stability. When asset prices rise, households feel wealthier and spend more (the “wealth effect”). When prices crash, as in 2008, consumption collapses.

## Flows vs. Valuations

A crucial distinction: changes in balance sheets come from both transactions (flows) and price changes (valuations).

$$\Delta \text{Level} = \text{Flow} + \text{Valuation Change}$$

In 2008, household net worth collapsed not primarily because people stopped saving, but because house and stock prices crashed. The flow of saving was actually positive; the valuation losses overwhelmed it. This is why crises often appear suddenly—balance sheets can deteriorate through price movements even when behavior hasn’t changed.

## Why This Matters: The 2008 Lesson

For decades, the Flow of Funds accounts were a backwater, ignored by models that treated finance as a “veil” over the real economy. The main action was in GDP.

The 2008 financial crisis changed everything. Models based only on GDP failed to see the crisis coming because the leverage was hidden in balance sheets, not production flows. Household debt had risen from 60% of GDP in 1990 to 100% by 2007. Corporate leverage was elevated. The financial sector had built an elaborate shadow banking system. All of this was visible in the Z.1 accounts—but few were watching.

Economist Wynne Godley, using stock-flow analysis, warned repeatedly in the mid-2000s that the configuration was unsustainable. His 2006 paper at the Levy Economics Institute was remarkably prescient:

“The growth in lending... has been so rapid in recent years that a host of pathologies have emerged... we remain skeptical that household borrowing can continue to be the main factor driving the U.S. economy.”

When the crisis hit, the scenario Godley outlined played out almost exactly: household spending collapsed, government deficits exploded to absorb the private sector’s shift to surplus, and the recession was deeper than any since the 1930s.

Today, “macro-finance” is the dominant paradigm, trying to reunite production accounts with financial accounts. The lesson: you cannot understand the economy by looking only at GDP. You must also track who owes what to whom.

## Value Chains: Three Examples

Abstract input-output tables become concrete when you trace specific value chains—the sequence of activities that transform raw materials into products consumers buy.

### From Farm to Fork: The Food System

Consider a loaf of bread on a grocery shelf. Its journey:

**Agriculture** (1% of GDP, roughly 2.6 million farm workers): Wheat farmers in Kansas plant, fertilize, irrigate, and harvest. They buy seeds, tractors, fuel, fertilizer—inputs from manufacturing and chemicals. They sell to grain elevators and commodity traders.

**Food processing** (part of manufacturing): Mills grind wheat into flour. Commercial bakeries mix flour with other ingredients, bake, and package. These operations require equipment, energy, packaging materials, and food science expertise.

**Wholesale distribution** (6% of GDP): Sysco, US Foods, and other distributors buy from manufacturers and deliver to retailers. They operate vast warehouse networks and truck fleets.

**Retail** (6% of GDP): Kroger, Walmart, or your local grocery stocks shelves, employs cashiers, and sells to consumers. The store itself requires real estate, electricity, cleaning, security, and checkout systems.

**Support services** permeate every stage: banking provides financing, insurance covers risk, trucking moves goods, advertising builds brands, legal services handle contracts.

The consumer pays \$3 for the bread. That \$3 is divided among all these participants, with retail taking the largest share (margins), then processing, then agriculture. The farmer receives perhaps 15 cents.

### From Silicon to Smartphone: Electronics

A smartphone's value chain is global:

**Mining** (0.1% of U.S. GDP, but critical): Rare earth elements from China, cobalt from Congo, lithium from Australia, copper from Chile. American mining contributes some materials, but the supply chain is overwhelmingly international.

**Component manufacturing** spans dozens of countries: - Semiconductors: designed in California, fabricated in Taiwan or South Korea - Displays: produced in South Korea, Japan, or China - Batteries: cells from China, Japan, or South Korea - Memory chips: South Korea, Japan - Cameras, sensors, connectors: Japan, China, Southeast Asia

**Assembly** happens mostly in China (Foxconn) or increasingly India and Vietnam. Assembly is labor-intensive but low-margin.

**Software and services** are increasingly where value concentrates. Apple captures about 30% of smartphone industry profits despite manufacturing nothing itself. The App Store, iCloud, and services generate high-margin revenue streams.

**Retail and distribution:** Apple Stores, carrier stores, Best Buy, Amazon.

This value chain shows how “American” products are really global assemblages. An iPhone is “designed in California, assembled in China”—but that understates the geographic complexity. Hundreds of suppliers in dozens of countries contribute.

## From Wellhead to Gas Tank: Energy

Gasoline’s journey from underground to your car:

**Exploration and production** (upstream): Geologists identify reserves; drilling companies extract oil and gas. This happens in the Permian Basin of Texas and New Mexico, the Gulf of Mexico, North Dakota’s Bakken, and elsewhere. It’s capital-intensive—a single offshore platform costs billions.

**Transportation** (midstream): Pipelines, rail cars, and trucks move crude oil to refineries. The U.S. has 2.6 million miles of pipelines, a vast but mostly invisible infrastructure.

**Refining** (downstream): About 130 refineries transform crude oil into gasoline, diesel, jet fuel, and petrochemicals. Refining is concentrated on the Gulf Coast (Texas, Louisiana), with smaller clusters in California and the Midwest. It’s one of the most capital-intensive industries.

**Distribution:** Refined products move by pipeline to storage terminals, then by truck to gas stations. The “rack price” at the terminal is the wholesale price; stations add their margin.

**Retail:** About 145,000 gas stations in the U.S., most owned by independent operators rather than oil companies. Average margin: about 10-15 cents per gallon.

This chain is strategically important because energy feeds into everything. Disruption at any point—a pipeline attack, a refinery fire, a hurricane in the Gulf—ripples through the entire economy.

## Where Households Spend

Input-output tables track industry-to-industry transactions. But ultimately, the economy serves households. Where does the money go?

### Consumer Expenditure

American households spend about \$18 trillion annually. The breakdown reveals priorities:

Category	Share	Annual Amount
Housing	33%	\$5.9 trillion
Transportation	17%	\$3.1 trillion
Food	13%	\$2.3 trillion
Insurance & Pensions	12%	\$2.2 trillion

Category	Share	Annual Amount
Healthcare	8%	\$1.4 trillion
Entertainment	5%	\$0.9 trillion
Other	12%	\$2.2 trillion

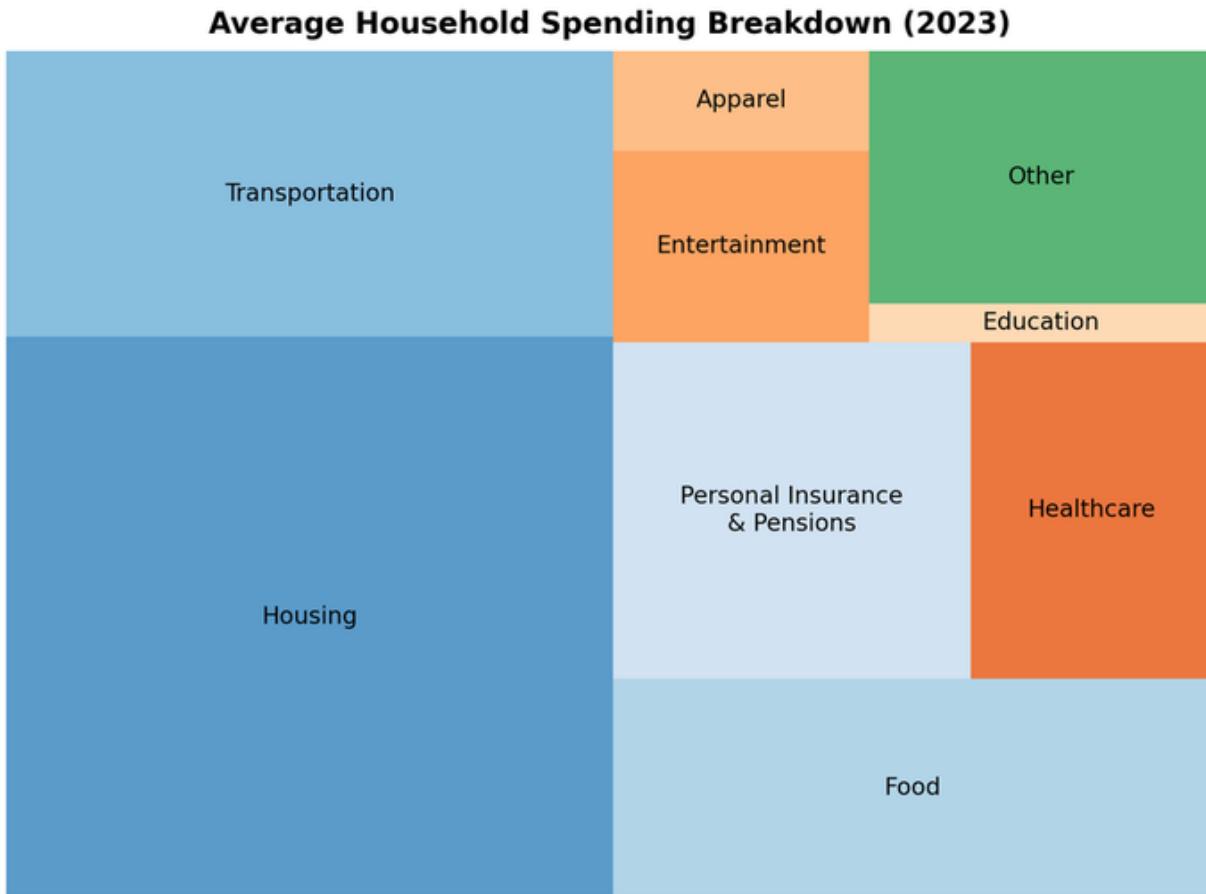


Figure 6: Figure 2.3: Where household spending goes. Housing dominates, followed by transportation and food. Source: BLS Consumer Expenditure Survey (2023)

**Housing** dominates. Rent or mortgage payments, utilities, furniture, maintenance—together they consume a third of household budgets. This explains real estate's outsized role in the economy and in household wealth.

**Transportation** is the second-largest category, reflecting America's car dependence. Vehicle purchases, fuel, insurance, maintenance, and repairs—plus public transit for urbanites.

**Food** splits between groceries (about 55%) and restaurants (45%). The restaurant share has grown steadily for decades as eating out has become more common.

**Healthcare** appears smaller here (8%) than in GDP accounts (18%) because much healthcare spending flows through employers and government, not directly from

households. Out-of-pocket costs are just the visible tip.

## The Services Shift

Household spending has shifted dramatically toward services over the past century:

- In 1950, goods (durable + nondurable) were about 60% of consumption.
- In 2023, goods are about 35%; services are 65%.

This shift reflects both changing preferences (more healthcare, education, entertainment) and relative prices (goods have gotten cheaper through productivity gains and imports; services, especially labor-intensive ones, have gotten more expensive).

## Interdependence and Vulnerability

### Critical Infrastructure

Some sectors are critical nodes—their failure cascades through everything:

**Energy:** Every industry requires power. A grid failure doesn't just shut off lights; it stops manufacturing, spoils food, crashes computers, and grounds planes.

**Finance:** Modern commerce runs on credit and payments. When banks stopped lending in 2008, the entire economy seized up, even sectors with no direct connection to housing.

**Transportation:** Just-in-time supply chains require continuous movement. A port shutdown, trucker strike, or rail blockage creates shortages within days.

**Telecommunications:** Digital infrastructure is now as essential as physical infrastructure. An internet outage disrupts commerce, healthcare, and government services.

### Supply Chain Shocks

The COVID-19 pandemic and its aftermath revealed supply chain fragility:

**Semiconductors:** When pandemic demand shifted to electronics while fabs faced shutdowns, chip shortages halted auto production worldwide. Ford, GM, and others parked half-finished vehicles waiting for chips worth a few hundred dollars each.

**Shipping:** Container shipping costs spiked 10x as demand surged while port capacity didn't. Ships anchored for weeks outside Los Angeles waiting to unload.

**Labor:** Sudden shifts in labor demand created shortages in some sectors (trucking, nursing) while others (hospitality, travel) laid off millions.

These disruptions illustrated how concentrated, optimized supply chains are efficient in normal times but brittle under stress. The response—“reshoring,” “friend-shoring,” inventory building—trades efficiency for resilience.

# Shock Propagation Through I-O Linkages

## How Shocks Move Through the Economy

The input-output framework does more than describe static relationships—it explains how economic shocks propagate. When demand or supply changes in one sector, the effects ripple through backward and forward linkages, multiplying as they go.

Consider the sequence of effects from an initial shock:

**Direct effects** hit the sector experiencing the shock. An oil price collapse reduces drilling; a tariff reduces imports of targeted goods; a pandemic closes restaurants.

**Indirect effects** propagate through supply chains. Fewer drilling rigs means less demand for steel pipe, oilfield services, and trucking. Restaurant closures reduce demand for food service distributors, commercial landlords, and linen services.

**Induced effects** come from changes in household income. Laid-off oil workers spend less on cars, housing, and retail. That spending reduction affects those industries, which then reduce employment and spending further.

The total impact—direct plus indirect plus induced—is the **multiplier**. For most industries, the multiplier ranges from 1.5 to 2.5, meaning a \$1 million shock ultimately affects \$1.5 to \$2.5 million in economic activity.

## Case Study: The 2014-2016 Oil Price Collapse

The oil price collapse of 2014-2016 provides a textbook example of shock propagation through I-O linkages.



Figure 7: Figure 2.4: Brent crude oil fell from \$115/barrel in June 2014 to \$28/barrel in January 2016—a 75% collapse. Source: FRED

**The initial shock:** Brent crude oil fell from \$115/barrel in June 2014 to \$28/barrel in January 2016. The causes were complex—Saudi Arabia’s decision not to cut production, U.S. shale output growth, weakening global demand—but the effect was immediate.

**First-round effects (energy sector):** - The U.S. rig count dropped from 1,900 to 400—an 80% decline - Energy sector employment fell by 200,000 jobs - Capital expenditure by oil and gas companies collapsed

**Second-round effects (backward linkages):** - Steel pipe manufacturers lost orders as drilling stopped - Oilfield service companies (Halliburton, Schlumberger) laid off tens of thousands - Trucking firms serving drilling regions saw volumes plummet - Hotels near oil fields emptied; Williston, North Dakota went from full to vacant

### Third-round effects (regional economies):

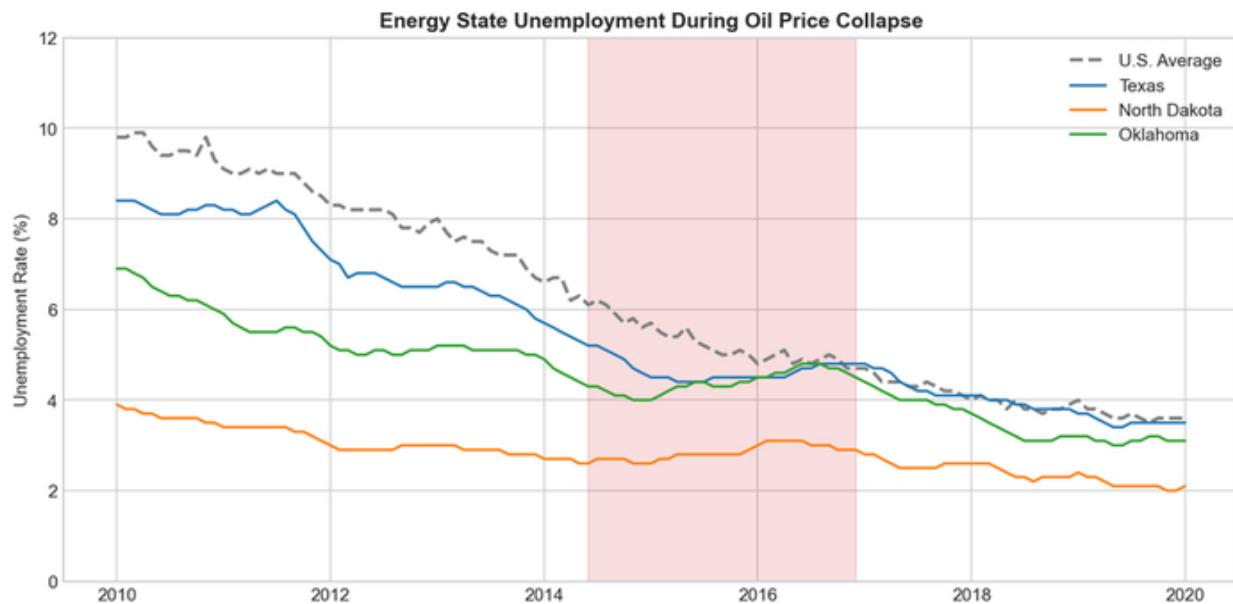


Figure 8: Figure 2.5: Texas, North Dakota, and Oklahoma unemployment rose sharply during the oil collapse while the national rate continued falling. Source: BLS via FRED

Texas unemployment rose from 4.2% to 5.4%; North Dakota’s unemployment tripled from 2.7% to 4.0%. Houston office vacancy spiked as energy companies consolidated or closed. State government revenues, heavily dependent on severance taxes, collapsed—forcing budget cuts that further reduced economic activity.

**Offsetting effects (forward linkages):** Lower oil prices helped consumers and oil-importing industries. Gasoline savings left households with more to spend elsewhere. Airlines’ fuel costs dropped. Chemical manufacturers using oil as feedstock saw input costs fall. These positive effects partially offset the damage to oil-producing regions—but the geography was different. Oil states lost while consuming states gained.

**The lesson:** I-O analysis reveals that a shock to one sector doesn’t stay contained. The 2014-2016 oil collapse was an “oil sector” event, but its effects propagated

through steel, trucking, hospitality, real estate, state governments, and ultimately into household spending patterns across energy-dependent regions. (For a fuller treatment of how this shock moved through financial markets, labor markets, and geographic channels beyond I-O linkages, see Chapter 32.)

## **Case Study: The CHIPS Act Investment Boom (A Positive Shock)**

The I-O framework doesn't just explain how downturns propagate—it also explains booms. The CHIPS and Science Act (2022) and the Inflation Reduction Act (2022) together authorized roughly \$400 billion in incentives for semiconductor fabrication, clean energy, and advanced manufacturing. The resulting investment surge illustrates the multiplier in a growth context.

**The initial shock:** TSMC announced a \$65 billion investment in semiconductor fabs near Phoenix, Arizona. Intel committed \$20 billion to a new campus in Chandler, Arizona (later expanded). Samsung began a \$17 billion facility in Taylor, Texas. These were among the largest industrial investments in American history.

### **Direct effects (backward linkages):**

Constructing a semiconductor fab requires enormous quantities of specialized inputs. A single advanced fab employs 3,000-6,000 construction workers during peak construction, typically lasting 3-4 years. This creates direct demand for:

- Structural steel, concrete, and ultra-pure piping systems
- Clean room construction specialists (a niche labor market)
- Electrical infrastructure upgrades (a modern fab consumes as much electricity as a small city)
- Water treatment systems (fabs use millions of gallons daily)

### **Indirect effects (the supply chain ripple):**

The construction boom rippled through local economies. In Phoenix, the TSMC investment triggered:

- Housing development: apartment construction surged as thousands of workers relocated
- Equipment suppliers: companies manufacturing semiconductor tools opened regional offices
- Support services: food service, cleaning, and transportation companies expanded to serve the new workforce
- Education: Arizona State University and community colleges launched training programs for semiconductor technicians

### **Induced effects (the spending multiplier):**

Construction workers earning \$60,000-\$100,000 annually spent their wages locally. Once operational, the fabs will employ roughly 10,000-15,000 permanent workers at salaries averaging \$100,000+. Their consumer spending—on housing, restaurants, retail, healthcare—sustains additional jobs in the local economy. Regional economists estimated a multiplier of roughly 2.5: each direct fab job supports an additional 1.5 jobs in the surrounding economy.

## □ Info:

### Comparing Shocks: Oil Collapse vs. CHIPS Boom

The oil shock (2014-2016) and the CHIPS boom (2022-2025) illustrate the same I-O mechanisms working in opposite directions. Both concentrated their direct effects geographically (Texas/North Dakota for oil; Arizona/Ohio/Texas for chips). Both propagated through backward linkages to suppliers and forward through induced consumer spending. The key difference: the oil shock was market-driven and caught communities by surprise, while the CHIPS investment was policy-driven and gave communities time to prepare. Both demonstrate why understanding the production network matters—the same multiplier that amplifies contraction also amplifies expansion.

## Key Takeaways

1. **The economy is a network.** Industries buy from each other and sell to each other. Disruption anywhere ripples everywhere.
2. **Input-output tables map the production structure.** Leontief's framework shows who supplies whom, enabling analysis of multiplier effects and supply chain vulnerabilities.
3. **Sectoral balances must sum to zero.** The private sector, government, and foreign sector surpluses/deficits are arithmetically linked. You cannot change one without affecting the others.
4. **Balance sheets reveal financial fragility.** The Flow of Funds accounts track who owes what to whom. The 2008 crisis was visible in rising household debt years before it hit—but few were watching.
5. **Value chains are global.** Most products involve inputs from many countries. “American” products often contain more foreign value than domestic.
6. **Households spend mostly on services.** Housing, transportation, food, and healthcare dominate budgets. The shift toward services has transformed the economy.
7. **Critical infrastructure creates systemic risk.** Energy, finance, transportation, and telecommunications are nodes whose failure cascades through everything.

## Data Sources and Further Reading

### Key Data Sources

- **BEA Input-Output Tables** ([bea.gov](http://bea.gov)): Annual and benchmark I-O accounts showing inter-industry flows
- **Federal Reserve Financial Accounts (Z.1)** ([federalreserve.gov/releases/z1](http://federalreserve.gov/releases/z1)): Balance sheets and flows for all sectors

- **BLS Consumer Expenditure Survey** ([bls.gov/cex](http://bls.gov/cex)): How households spend

## **Further Reading**

- Wassily Leontief, *Input-Output Economics* (1986)—The classic introduction by the field’s founder
- Marc Levinson, *The Box* (2006)—How containerization transformed global supply chains
- Wynne Godley & Marc Lavoie, *Monetary Economics: An Integrated Approach to Credit, Money, Income, Production and Wealth* (2007)—The stock-flow consistent framework
- Claudio Borio, “The Financial Cycle and Macroeconomics: What Have We Learnt?” *Journal of Banking and Finance* (2014)—How balance sheet dynamics drive business cycles
- Christopher Mims, *Arriving Today* (2021)—A journalist traces a product’s journey through modern logistics

## **Exercises**

### **Review Questions**

1. Explain the concept of an input-output table. What does a row represent? What does a column represent? Why did Leontief’s development of this framework earn a Nobel Prize?
2. The sectoral balance identity states that  $(S - I) + (T - G) + (M - X) = 0$ . In plain language, what does this mean? Why is it called an “identity” rather than a “theory”?
3. If the U.S. government reduces its deficit (raises  $T - G$  toward zero), what must happen to either the private sector balance or the trade balance? Why does this constraint make fiscal austerity politically difficult?
4. Explain the difference between “backward linkages” and “forward linkages.” Give an example of each using the automobile industry.
5. The text describes household net worth of roughly \$155 trillion as “the most important number for financial stability.” Why? What happened to household net worth in 2008, and how did this affect the broader economy?
6. Why did the 2014-2016 oil price collapse hurt Texas while benefiting consumers in oil-importing states? Use the concepts of backward and forward linkages to explain.
7. Consumer spending on services has grown from about 40% of the total in 1950 to 65% today. Name two factors driving this shift and explain their economic logic.

## Data Exercises

8. **Exploring input-output tables:** Go to the BEA's Input-Output Accounts page ([bea.gov/industry/input-output-accounts-data](http://bea.gov/industry/input-output-accounts-data)). Find the "Use Table" for the most recent year. Identify the three largest intermediate inputs purchased by the construction industry. What does this tell you about which industries would be most affected by a construction boom or bust?
9. **Tracking the sectoral balances:** Using FRED, find the federal government surplus/deficit as a share of GDP (series: FYFSGDA188S) and the current account balance as a share of GDP (series: NETFI). For the most recent year, what is the approximate private sector balance implied by the identity? Does the private sector appear to be a net saver or net borrower?
10. **Consumer expenditure trends:** Using the BLS Consumer Expenditure Survey ([bls.gov/cex](http://bls.gov/cex)), compare household spending on food at home vs. food away from home for the most recent year. How has this ratio changed over the past decade? What economic and social factors might explain the trend?

## Deeper Investigation

11. Choose a product you use daily (a coffee, a piece of clothing, a smartphone app). Trace its value chain as far as you can, identifying at least five distinct industries that contribute to its production and delivery. Which stages occur domestically, and which involve international inputs? Where in the chain is the most value added?

# 3. The Geography of Production

Economic activity clusters intensely. Five states—California, Texas, New York, Florida, and Illinois—produce half of U.S. GDP. The New York metro area alone outproduces all but a handful of nations. Meanwhile, vast rural stretches have bled population and jobs for decades.

This concentration determines policy, politics, and opportunity. Where you live dictates available jobs, wages, and life prospects. To understand America, start with geography.

## The State-Level Picture

### Economic Giants

State	GDP (2023)	Share of U.S.	Population
California	\$3.25 trillion	12%	39 million
Texas	\$2.10 trillion	8%	30 million
New York	\$1.79 trillion	7%	19 million
Florida	\$1.29 trillion	5%	22 million
Illinois	\$886 billion	3%	12 million

Source: Bureau of Economic Analysis, Regional Economic Accounts, 2023

California's economy exceeds that of India or the United Kingdom. It would rank among the world's five largest countries. Texas has grown rapidly, riding oil production and business-friendly policies to become America's second-largest economy. New York punches above its population weight, reflecting the concentration of finance, media, and professional services in Manhattan.

### The Productivity Divide

GDP per capita varies enormously across states:

**Highest:** - Washington, D.C.: roughly \$260,000 (distorted by small population and federal concentration) - New York: \$111,000 - Massachusetts: \$105,000 - Washington State: \$95,000 - California: \$83,000

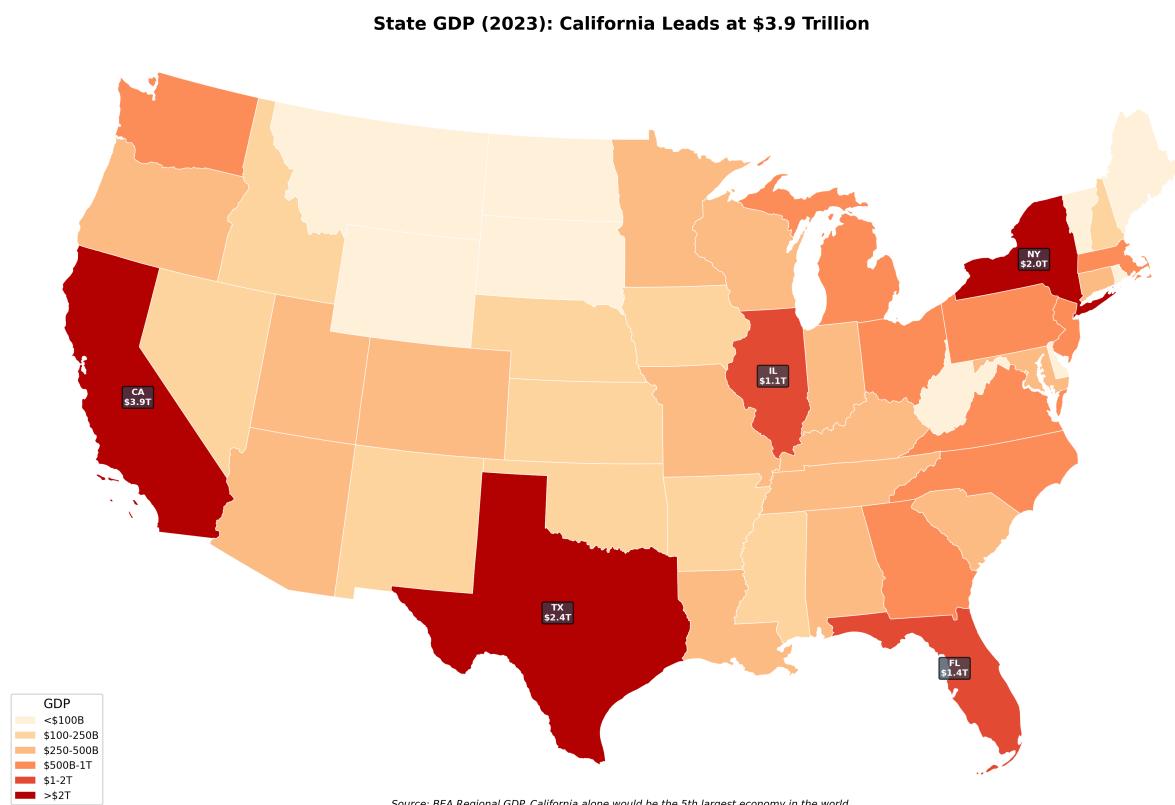


Figure 9: Figure 3.0: State GDP (2023). California dominates at nearly \$4 trillion, followed by Texas and New York. The top five states produce half of national output. Source: BEA Regional GDP

**Lowest:** - Mississippi: roughly \$30,000 - West Virginia: roughly \$32,000 - Arkansas: roughly \$35,000 - Alabama: roughly \$37,000 - New Mexico: roughly \$38,000

Source: Bureau of Economic Analysis, Regional Economic Accounts, 2023

The gap is striking: a worker in Massachusetts produces (on average) three times as much value as a worker in Mississippi. This reflects differences in industry mix, educational attainment, capital investment, and agglomeration effects.

## Regional Patterns

Broad regions show distinct economic characters:

**The Northeast** (New England plus Mid-Atlantic): High productivity, high costs, concentrated in finance, healthcare, education, and professional services. Population growth has stagnated but economic output remains strong.

**The Southeast:** Rapid growth, driven by migration from the Northeast and Midwest. Mix of legacy industries (auto transplants, textiles remnants) and new growth (logistics, tech outposts). Lower wages but lower costs.

**The Midwest:** The old manufacturing heartland, now more diversified. Agriculture remains important. Major metros (Chicago, Minneapolis, Columbus) thrive while small cities struggle.

**The Southwest:** Texas and Arizona drive growth, fueled by energy, migration, and business relocation. Water constraints loom as a long-term challenge.

**The West Coast:** Technology dominance in California and Washington. High productivity, high costs, severe housing constraints. Oregon combines tech (Portland) with resource industries.

**The Mountain West:** Low population density, resource extraction (mining, energy), tourism, and increasingly remote workers fleeing coastal costs. Colorado and Utah have diversified; Wyoming and Montana remain resource-dependent.

## Metropolitan Dominance

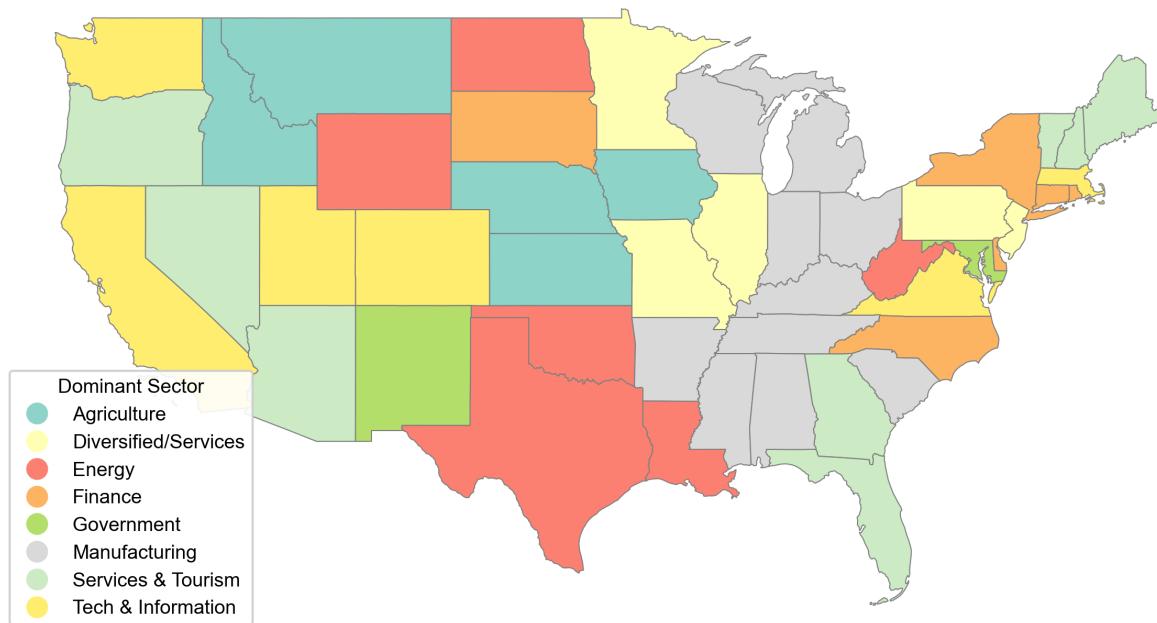
### The Metro Economy

Economic activity concentrates in metropolitan areas—urban cores plus surrounding suburbs. About 85% of U.S. GDP comes from the 384 metropolitan statistical areas (MSAs), even though they cover only about 3% of land area.

#### Info:

**Metropolitan Statistical Area (MSA):** A Census Bureau designation for a core urban area of 50,000+ population plus adjacent counties with strong commuting ties. The 384 MSAs range from New York-Newark (20 million) to Carson City, NV (57,000). MSAs enable consistent economic comparison across metro regions.

### Primary Economic Drivers by State (Generalized)



Source: BEA Regional GDP, BLS QCEW. Author classification.

Figure 10: Figure 3.1: The dominant economic sector varies across states. Coastal states rely heavily on professional services and finance, while interior states depend more on manufacturing, energy, or government. Source: BEA (2023)

At the top, concentration is extreme:

Metro Area	GDP (2023)	Notable Industries
New York-Newark	\$2.3 trillion	Finance, media, professional services
Los Angeles	\$1.3 trillion	Entertainment, trade, aerospace
Chicago	\$895 billion	Finance, manufacturing, logistics
San Francisco	\$779 billion	Technology, biotech, finance
Dallas-Fort Worth	\$745 billion	Corporate HQs, telecom, defense
Washington, D.C.	\$715 billion	Government, defense, professional services
Houston	\$697 billion	Energy, healthcare, petrochemicals
Boston	\$610 billion	Healthcare, biotech, education, finance

Source: Bureau of Economic Analysis, Gross Domestic Product by Metropolitan Area, 2023

The top eight metros produce nearly \$8 trillion—about 30% of GDP. Add the next dozen, and you've accounted for half the economy.

## Why Cities?

Why the intense clustering? Four mechanisms—collectively called **agglomeration economies**—reward proximity:

### Info:

**Agglomeration Economies:** The productivity benefits arising from geographic concentration: (1) Knowledge spillovers—ideas diffuse through informal contact; (2) Labor market pooling—deep specialist talent pools; (3) Input sharing—specialized suppliers nearby; (4) Matching efficiency—lower search costs for jobs, partners, capital.

**Knowledge spillovers:** Ideas spread faster when people interact. Silicon Valley engineers learn from each other across company lines. Wall Street traders share market intelligence. Academic researchers collaborate across institutions. These informal knowledge flows are hard to replicate at a distance.

**Labor market pooling:** Dense metros offer deep labor pools for specialized skills. A software company in San Francisco can find machine learning engineers; in rural Nebraska, it cannot. Workers benefit too—if one employer fails, others are nearby.

**Input sharing:** Specialized suppliers locate near customers. A biotech company in Boston can access contract manufacturers, specialty chemicals, regulatory consultants, and patent lawyers all nearby. In isolation, it would need to do everything in-house or ship inputs from far away.

**Matching:** Cities facilitate better matches between workers and jobs, between firms and suppliers, between ideas and capital. The friction of search declines when options are concentrated.

## Top 20 U.S. Metropolitan Economies by GDP

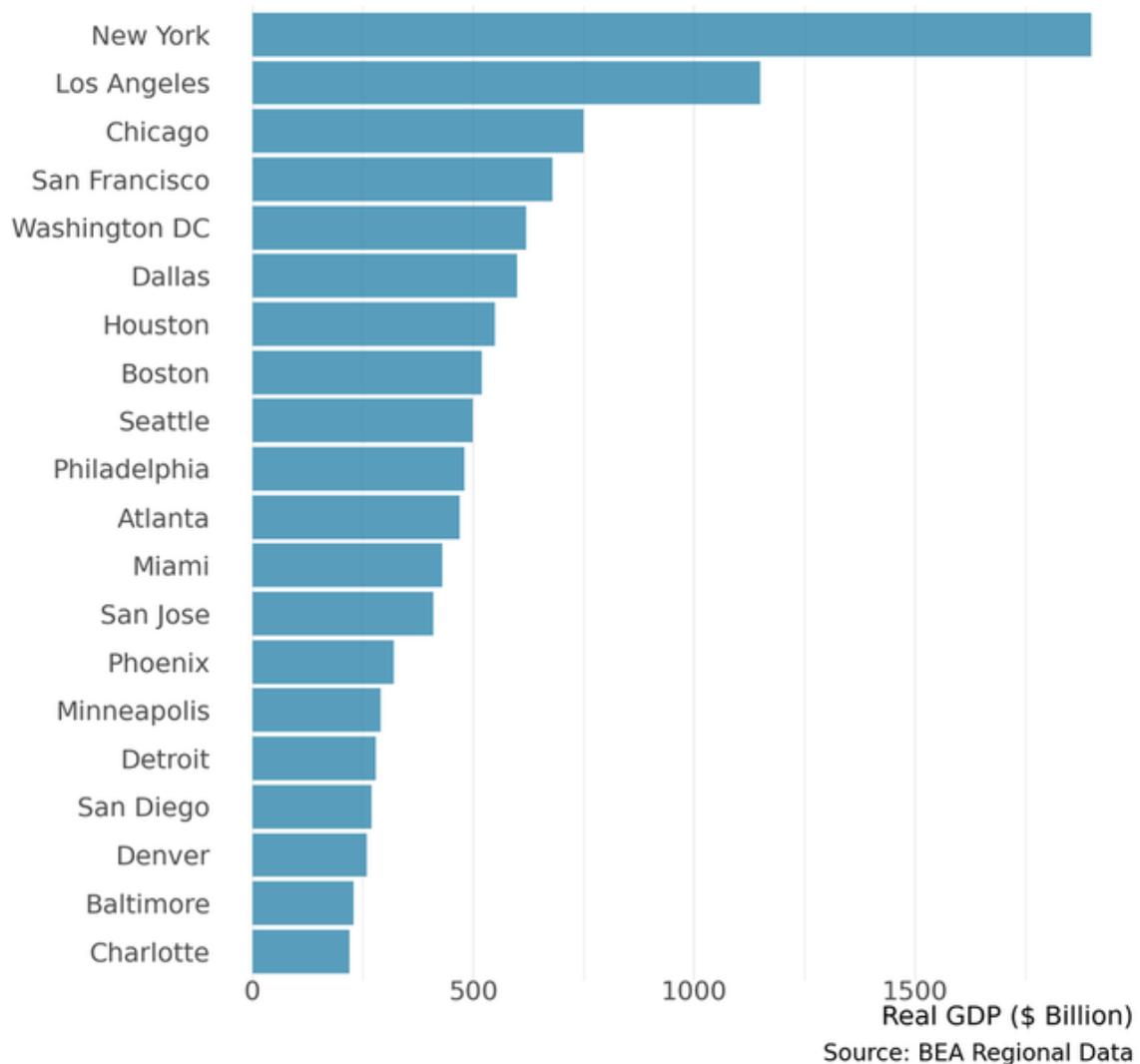


Figure 11: Figure 3.2: The top 20 metropolitan areas by GDP. New York alone produces more than most countries. Source: BEA Metropolitan GDP (2023)

### Employment Concentration in Major Metros (Millions of Jobs)

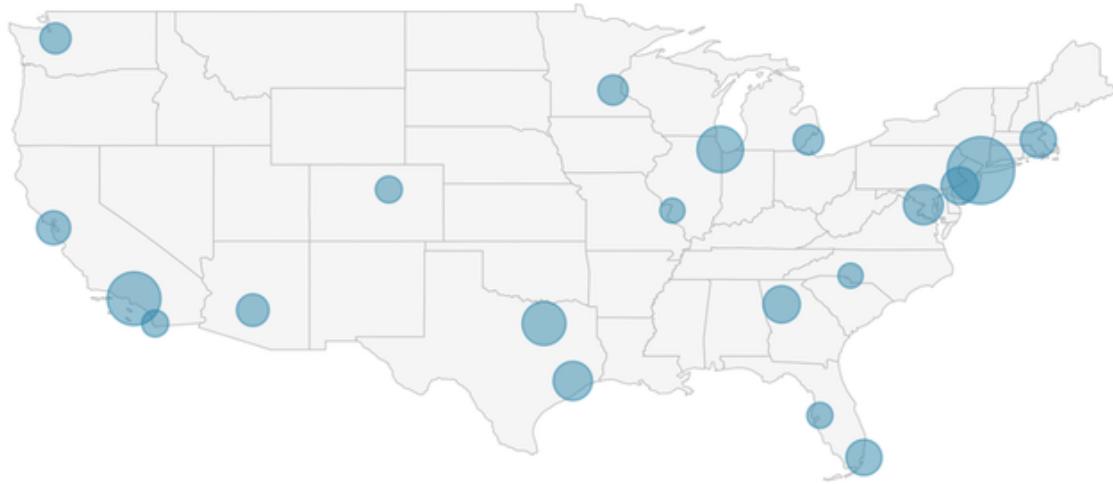


Figure 12: Figure 3.3: Job concentration in major metros. Bubble size represents total employment. Economic activity clusters intensely in a handful of urban centers. Source: BLS QCEW (2023)

## The Superstar City Phenomenon

Some metros have pulled away from the pack. Economists Enrico Moretti, Chang-Tai Hsieh, and others have documented growing divergence among cities:

- In 1980, wages in San Francisco were about 20% above the national average. By 2020, the gap exceeded 50%.
- Productivity growth has concentrated in a handful of metros; most others have stagnated.
- The pattern is particularly stark in innovation: a few metros (San Francisco, San Jose, Seattle, Boston) account for most patents and venture capital investment.

### □ Note:

## The Superstar City Divergence

In 1980, wages in San Francisco were about 20% above the national average. By 2020, the gap exceeded 50%. This divergence reflects the concentration of high-productivity industries in a handful of metros—and the housing constraints that limit who can access these opportunities.

This concentration creates both opportunity and tension. Workers in superstar cities earn high wages but face crushing housing costs. Workers elsewhere enjoy affordability but limited job options. The divergence fuels political polarization between thriving metros and struggling hinterlands.

# Industry Location Patterns

## Measuring Specialization: Location Quotients

Economists measure geographic specialization using **location quotients (LQ)**. If an industry's share of employment in a region exceeds its national share, the region is specialized in that industry.

$$LQ = \frac{\text{Industry share in region}}{\text{Industry share in nation}}$$

An LQ of 1.0 means the region matches the national average. An LQ of 2.0 means the industry is twice as concentrated locally as nationally.

Examples: - **Finance in New York:** LQ ≈ 2.5 (Wall Street concentration) - **Entertainment in Los Angeles:** LQ ≈ 3.0 (Hollywood dominance) - **Auto manufacturing in Michigan:** LQ ≈ 4.0 (Detroit's legacy) - **Oil and gas in Houston:** LQ ≈ 8.0 (extreme concentration)

## Where Industries Cluster

Different industries have different geographic logic:

**Resource-bound industries** locate near natural endowments: - Oil and gas: Permian Basin (TX/NM), Gulf Coast, Bakken (ND), Appalachia - Mining: Nevada (gold), Arizona (copper), Wyoming (coal), Minnesota (iron ore) - Agriculture: Great Plains (wheat), Midwest (corn/soybeans), California (fruits/vegetables)

**Market-oriented industries** locate near customers: - Retail: distributed roughly proportional to population - Hospitals: located in population centers - Construction: follows population and investment

**Transport-oriented industries** locate at logistics nodes: - Ports: Los Angeles/Long Beach, New York/New Jersey, Houston, Savannah - Distribution centers: Inland Empire (CA), Memphis, Dallas, Chicago - Refineries: Gulf Coast (near both oil supply and shipping)

**Knowledge-intensive industries** cluster for agglomeration benefits: - Tech: Silicon Valley, Seattle, Austin, Boston - Finance: New York, Chicago, Charlotte - Biotech: Boston/Cambridge, San Francisco Bay Area, San Diego - Entertainment: Los Angeles, New York

## Industry Clusters

Clusters are geographic concentrations of interconnected industries, suppliers, and institutions. Famous examples:

**Silicon Valley** (tech): The original and still dominant tech cluster. Stanford and Berkeley provide research and talent. Venture capital is concentrated nearby. A dense network of suppliers, service providers, and former colleagues enables rapid company formation and scaling.

**Wall Street** (finance): Lower Manhattan houses the New York Stock Exchange, major banks, hedge funds, and the infrastructure of American finance. Proximity to capital and to each other creates information advantages that resist dispersal despite modern communications.

**Detroit** (auto): Despite decades of decline, the Detroit area retains the densest concentration of automotive engineering talent, suppliers, and expertise. The Big Three maintain headquarters there; even foreign automakers locate design and engineering centers nearby.

**Houston** (energy): The headquarters of most major oil companies, plus the service companies, engineering firms, and legal practices that support them. When oil prices move, Houston's economy responds immediately.

**Research Triangle** (NC): A deliberate creation of three universities (Duke, UNC, NC State) plus corporate research parks. Biotech, pharma, and tech have built critical mass over decades.

## Urban vs. Rural

### The Rural Economy

Rural America faces persistent economic challenges:

#### Info:

#### Defining Rural America

Rural areas contain 20% of the U.S. population spread across 97% of the land. The economic base varies dramatically: resource extraction in the Mountain West, agriculture in the Plains, manufacturing legacy in Appalachia, and retirement communities in Florida.

**Population decline:** Most rural counties have lost population since 2010. Young people leave for education and opportunity; few return.

**Job losses:** Agriculture employs fewer workers each year as technology substitutes for labor. Manufacturing has declined. Mining booms and busts.

**Lower productivity:** Rural workers earn about 70% of urban wages on average. The gap has widened over time.

**Service deserts:** As population thins, services consolidate. Hospitals close. Schools consolidate. Main streets empty.

Yet rural America is not monolithic:

**Resource-rich rural areas** (Permian Basin oil country, Bakken shale, productive farmland) can be prosperous, at least while resources last.

**Recreational rural areas** (mountain towns, beach communities, national park gateways) attract retirees and tourists, supporting service economies.

### **Employment Growth: Urban vs. Rural (2010-2024)**

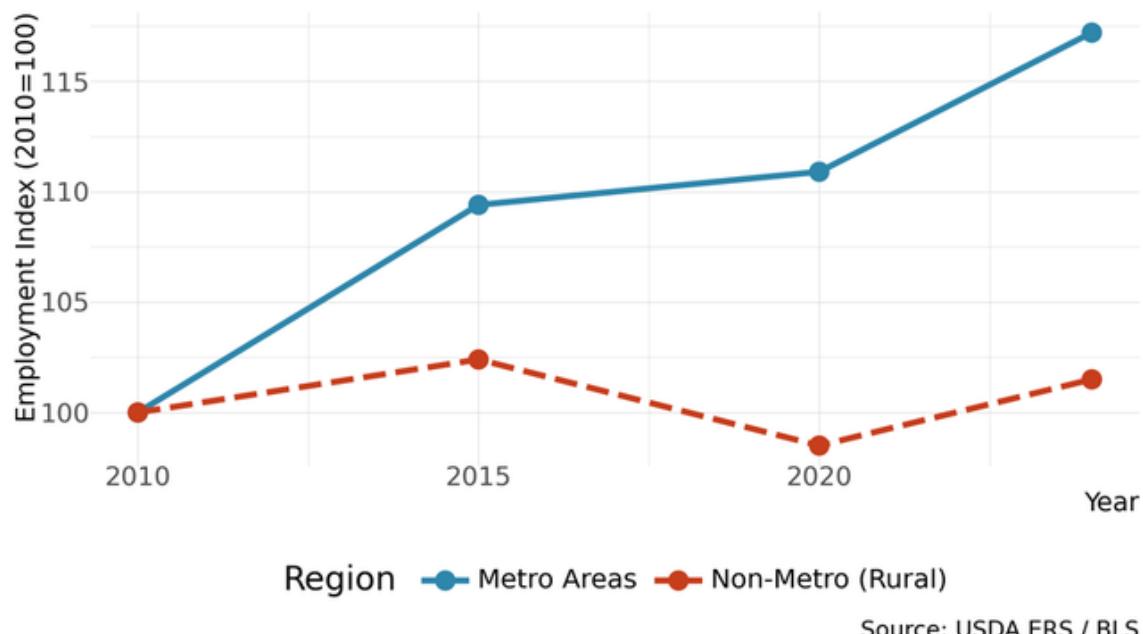


Figure 13: Figure 3.4: The urban-rural divide in employment. Urban areas have diversified economies; rural areas depend more heavily on agriculture, mining, and government. Source: BLS (2023)

**Commuter rural areas** within reach of metros function as exurbs, with residents earning urban wages while enjoying rural amenities.

**Declining rural areas** far from metros and without distinctive resources face the toughest challenges. These are the places losing population, closing stores, and aging rapidly.

## The Remote Work Shift

The COVID-19 pandemic accelerated remote work adoption, potentially reshaping economic geography. If workers can do their jobs from anywhere, will they leave expensive metros for affordable rural areas or smaller cities?

Evidence so far is mixed:

- Some outmigration from expensive metros (San Francisco, New York) occurred, but population flows were modest compared to the hype.
- Mid-size cities and suburbs gained more than truly rural areas.
- Employers have increasingly called workers back to offices, limiting permanent dispersal.
- Industries most suited to remote work (tech, finance, professional services) were already concentrated in metros.

The long-term impact remains uncertain. Remote work has loosened but not severed the link between productive jobs and major metros.

## The Cost of Geography

### Housing Constraints

Housing costs mediate the relationship between productive places and opportunity. Workers would like to move to high-wage metros, but housing costs eat their wage gains.

San Francisco wages are 50%+ above the national average, but median home prices are 5x the national average. A worker who moves there earns more but spends more, potentially ending up worse off in living standards.

Research by Chang-Tai Hsieh and Enrico Moretti estimates that housing constraints in high-productivity metros have reduced U.S. GDP growth significantly. If workers could move freely to the most productive places, national output would be substantially higher. Instead, restrictive zoning, NIMBY opposition, and geographic constraints (San Francisco is surrounded by water on three sides) limit housing supply and force workers to less productive locations.

### Spatial Mismatch

Jobs and workers don't always align geographically:

**Within metros:** Jobs often concentrate in suburbs (corporate campuses, industrial parks) while affordable housing concentrates in urban cores. Workers without cars struggle to reach employment.

**Across regions:** Good jobs concentrate in coastal metros while affordable housing exists in the heartland. But those places have few good jobs.

**Skill mismatch:** Local jobs may not match local skills. A displaced factory worker in Ohio may have the wrong skills for growing healthcare or tech sectors—and those sectors may not exist locally anyway.

These mismatches reduce efficiency and opportunity. Workers who “should” move often don’t, because of housing costs, family ties, home equity, or simple friction.

## The Political Economy of Place

Economic geography shapes political geography. The divergence between thriving metros and struggling rural areas maps onto partisan divisions:

- Urban counties voted Democratic by large margins in 2020; rural counties voted Republican by large margins.
- The counties producing the most GDP voted heavily Democratic; those producing least voted Republican.
- “Red” states often have “blue” metros (Austin in Texas, Atlanta in Georgia) that produce most of the state’s economic output.

These patterns reflect real economic differences: urban voters tend to work in sectors (tech, professional services, education) that benefit from globalization and credentialing, while rural voters disproportionately work in sectors (manufacturing, extraction, agriculture) that have faced trade competition and technological displacement.

Economic policy debates—over trade, immigration, climate, taxation—often pit places against each other as much as classes or ideologies.

## Key Takeaways

1. **Economic activity is geographically concentrated.** Five states produce half of GDP. Eight metros produce 30%. Most rural counties are losing population and employment.
2. **Agglomeration economies explain clustering.** Knowledge spillovers, labor pooling, and input sharing make dense metros more productive—but also more expensive.
3. **Superstar cities have pulled away.** A handful of metros (New York, San Francisco, Boston, Seattle) capture disproportionate shares of innovation, productivity growth, and high-wage jobs.
4. **Rural America faces structural challenges.** Resource extraction and agriculture employ fewer workers; distance from metros limits opportunity. Some rural areas thrive, but many decline.

5. **Housing costs constrain mobility.** Workers can't easily move to productive places when housing is unaffordable. This reduces national productivity and opportunity.
6. **Geography shapes politics.** The divergence between prosperous metros and struggling hinterlands maps onto partisan divisions and policy debates.

## Data Sources and Further Reading

### Key Data Sources

- **BEA Regional Data** ([bea.gov](http://bea.gov)): GDP by state and metro area
- **BLS Quarterly Census of Employment and Wages** ([bls.gov/qcew](http://bls.gov/qcew)): Employment by county and industry
- **Census American Community Survey** ([census.gov](http://census.gov)): Demographics, income, housing costs by geography
- **USDA Economic Research Service** ([ers.usda.gov](http://ers.usda.gov)): Rural economy data and research

### Further Reading

- Enrico Moretti, *The New Geography of Jobs* (2012)—Essential reading on spatial divergence and brain hubs
- Edward Glaeser, *Triumph of the City* (2011)—Why cities make us richer and happier
- James Fallows and Deborah Fallows, *Our Towns* (2018)—A journalistic tour of smaller cities finding their way
- Chang-Tai Hsieh and Enrico Moretti, “Housing Constraints and Spatial Misallocation,” *American Economic Journal: Macroeconomics* (2019)

## Exercises

### Review Questions

1. Five states produce roughly half of U.S. GDP. Name them and identify the dominant industry or economic driver in each. Why does economic activity concentrate so heavily rather than spreading evenly?
2. Define “agglomeration economies” and explain three mechanisms through which they operate. Why might a tech firm choose to locate in an expensive city like San Francisco rather than a low-cost city with available workers?
3. The text describes a “spatial mismatch” between jobs and workers. Explain three forms this mismatch takes (within metros, across regions, and by skill). What prevents the labor market from correcting these mismatches naturally?
4. Housing costs in San Francisco are roughly 5x the national average, while wages are roughly 1.5x the national average. Explain why a worker might be worse off

moving to a “high-wage” city. What does Hsieh and Moretti’s research suggest about the national economic cost of this dynamic?

5. How does the economic geography of the United States map onto its political geography? What economic factors help explain why urban areas tend to vote differently from rural areas?
6. The text distinguishes four types of rural areas: resource-rich, recreational, commuter, and declining. Give an example of each and explain why their economic prospects differ so dramatically.

## Data Exercises

7. **Your metro’s economy:** Using the BEA’s GDP-by-metropolitan-area data ([bea.gov/data/gdp/gdp-metropolitan-area](http://bea.gov/data/gdp/gdp-metropolitan-area)), find the GDP and top industries for the metro area nearest to you. How does its per capita GDP compare to the national average? What are the three largest industries by GDP share, and how do they compare to the national sectoral composition in Chapter 1?
8. **County-level analysis:** Using the BLS Quarterly Census of Employment and Wages ([bls.gov/qcew](http://bls.gov/qcew)), look up employment data for a rural county and an urban county in the same state. Compare: (a) total employment, (b) the share of employment in the three largest industries, and (c) average weekly wages. What structural differences do you observe?
9. **Population migration:** Using Census Bureau data or the IRS Statistics of Income migration data, find which counties or states gained and lost population in the most recent year. Do the patterns align with the economic geography described in this chapter? Are people moving toward or away from high-productivity areas?

## Deeper Investigation

10. Select a “declining rural area” (e.g., a county in Appalachia, the Great Plains, or the Mississippi Delta). Using Census and BLS data, build an economic profile: population trend, unemployment rate, median household income, top industries, and educational attainment. Based on the concepts in this chapter, what structural factors explain its decline? What, if anything, might reverse the trend?

# Interlude: Who Benefits — Distribution and Inequality

The American economy produces \$27 trillion in annual output. The preceding three chapters mapped what gets produced, how sectors interconnect, and where activity concentrates. This interlude asks a different question: who captures the gains?

The answer has changed dramatically over the past half century. In 1970, a male worker at the 50th percentile of the income distribution earned enough to support a family of four at a middle-class standard of living. His inflation-adjusted wages have barely budged since. Meanwhile, incomes at the top have roughly tripled. The American economy has grown enormously; the distribution of that growth has been extraordinarily uneven.

Understanding distribution is not a political aside—it is structural economics. Who earns what shapes consumer spending patterns, housing markets, political coalitions, educational investment, and health outcomes. A \$27 trillion economy where the median household earns \$75,000 functions very differently from one where the median earns \$50,000, even if GDP is the same. The distribution is the economy, experienced from the inside.

## Income Distribution: The Basic Facts

### Household Income

Median household income in the United States was approximately \$80,600 in 2023 (Census Bureau). This is the income level at which half of households earn more and half earn less. But the median conceals enormous dispersion:

Percentile	Household Income (2023)	Context
10th	~\$17,000	Below the poverty line for a family of two
25th	~\$35,000	Near-poverty; eligible for many means-tested programs

Percentile	Household Income (2023)	Context
50th (median)	~\$80,600	The statistical “middle”
75th	~\$135,000	Comfortable; homeownership likely
90th	~\$220,000	Upper-middle class; professional dual-earner households
95th	~\$310,000	Top of the wage distribution for most occupations
99th	~\$660,000	Overwhelmingly capital income, business ownership, or elite professions
99.9th	~\$3.4 million	Finance, corporate leadership, business owners

Source: Census Bureau, Current Population Survey, 2024 Annual Social and Economic Supplement; Congressional Budget Office income distribution data

## □ Info:

### Mean vs. Median

The mean (average) household income is roughly \$115,000—44% higher than the median. This gap is itself a measure of inequality: the distribution is heavily right-skewed, meaning a relatively small number of very high-income households pull the average far above what the typical household earns. Whenever you see “average income” cited, ask whether it’s the mean or the median. The difference matters enormously.

[Figure: Figure I.1: U.S. household income distribution (2023). The distribution is sharply right-skewed: most households cluster between \$30,000 and \$120,000, while a long tail extends into the millions. The mean (average) is pulled far above the median by top earners. Source: Census Bureau CPS ASEC]

## The Top Pulls Away

The most important distributional trend of the past 50 years is the divergence at the top. Using data from tax returns, economists Thomas Piketty and Emmanuel Saez documented that:

- The **top 1%** captured roughly 10% of pre-tax national income in 1970. By 2023, their share had risen to approximately 20%.
- The **top 0.1%** (about 130,000 households) saw their share rise from 3% to roughly 10% of national income.
- The **bottom 50%** saw their share decline from approximately 20% to about 13%.

These shifts are not the result of population growth or demographic change. They reflect a genuine reallocation of economic gains from the broad middle to the top of the distribution.

[Figure: Figure I.2: Share of pre-tax national income going to the top 1% and bottom 50%, 1970-2023. The two lines crossed in the mid-1990s—the top 1% now receives a larger share of income than the entire bottom half of the population. Source: World Inequality Database (WID.world)]

## What Drives Income Inequality?

Income inequality has multiple structural causes, most of which connect to the sectoral analysis in Part II:

**The education premium.** Workers with a bachelor's degree earn roughly 65% more than those with only a high school diploma—up from about 40% in 1980. Graduate and professional degrees command even larger premiums. As the economy has shifted toward knowledge-intensive sectors (Chapter 7, Professional Services; Chapter 11, Technology), demand for educated workers has outpaced supply, driving up their wages relative to less-educated workers.

**The decline of mid-wage jobs.** Automation and offshoring have hollowed out the middle of the wage distribution. Manufacturing jobs (Chapter 9) that once paid \$25-35/hour have been replaced by a combination of higher-paid technical jobs and lower-paid service jobs. The labor market has “polarized” into high-skill, high-wage work and low-skill, low-wage work, with less in between.

**The rise of winner-take-all markets.** In technology (Chapter 11), finance (Chapter 8), professional services (Chapter 7), and entertainment, top performers capture disproportionate rewards. Network effects, global markets, and scalable production mean that the best software engineer, fund manager, or athlete can serve a much larger market than their predecessors could—and capture a much larger share of the revenue.

**Institutional changes.** Union membership has fallen from 35% of private-sector workers in the 1950s to under 6% today (Chapter 30). The federal minimum wage has been \$7.25 since 2009, losing roughly 30% of its purchasing power to inflation. Corporate governance has shifted toward maximizing shareholder value, which has directed more income to capital owners and top executives.

**Tax policy.** Top marginal income tax rates fell from 70% in 1980 to 37% today. Capital gains are taxed at lower rates than wage income. These policy choices amplify pre-tax inequality into even larger after-tax differences.

### □ Key Point:

#### **Deep Dive: The China Shock and Regional Inequality**

Economists David Autor, David Dorn, and Gordon Hanson documented that regions most exposed to Chinese import competition after 2001 experienced sharply higher unemployment, lower wages, higher disability claims, and worse health outcomes. The effects were persistent: twenty years later, affected communities had not recovered. This research demonstrated that trade's costs are not spread evenly across the economy but concentrated in specific places and populations—contributing to both income inequality and the geographic divergence described in Chapter 3.

## **Wealth Distribution: The Deeper Divide**

Income inequality tells only part of the story. Wealth—the accumulated stock of assets minus debts—is far more unequally distributed than income.

### **The Numbers**

The Federal Reserve's Survey of Consumer Finances (SCF) provides the most comprehensive picture:

Group	Share of Total Wealth (2022)	Median Net Worth
Top 1%	30%	~\$13.7 million
Top 10%	67%	~\$3.8 million
50th-90th percentile	29%	~\$250,000
Bottom 50%	2.5%	~\$51,000

Source: Federal Reserve, Survey of Consumer Finances, 2022; Federal Reserve Distributional Financial Accounts

The bottom 50% of American households—roughly 65 million families—own 2.5% of the nation's wealth. The top 1%—about 1.3 million families—own 30%. This concentration is more extreme than at any point since the 1920s.

[Figure: Figure I.3: Distribution of household wealth in the United States (2022). The top 10% own two-thirds of all wealth; the bottom 50% own just 2.5%. Source: Federal Reserve, Distributional Financial Accounts]

### **Why Wealth Is More Concentrated Than Income**

Several mechanisms amplify wealth inequality beyond income inequality:

**Asset appreciation.** The wealthy hold their assets primarily in equities and real estate, which have appreciated dramatically. The S&P 500 returned roughly 10% annually over the past four decades. A family that owned \$1 million in stocks in 1990 holds roughly \$17 million today from appreciation alone—no additional saving required. Meanwhile, a family with \$5,000 in a savings account earned negligible returns.

**Homeownership as the dividing line.** For middle-class families, home equity is the primary form of wealth. Homeownership rates vary dramatically by income, race, and geography. In high-cost metros (Chapter 3), rising home prices created enormous wealth for existing owners while locking out newcomers. For renters—disproportionately low-income, young, and minority—rising housing costs are a pure expense, building no wealth.

**Inheritance and intergenerational transmission.** Wealth is passed between generations. The Federal Reserve estimates that roughly \$70 trillion will be transferred via inheritance over the next 25 years—overwhelmingly within already-wealthy families. This perpetuates inequality across generations independent of individual effort or talent.

**Debt as negative wealth.** Many low-income and young households have negative net worth: their debts (student loans, credit cards, auto loans) exceed their assets. The student debt burden alone stands at \$1.75 trillion, disproportionately borne by younger, less-wealthy Americans.

## The Racial Wealth Gap

The most striking dimension of wealth inequality in America runs along racial lines.

Group	Median Household Net Worth (2022)
White households	\$285,000
Black households	\$44,900
Hispanic households	\$61,600
Asian households	\$536,000

Source: Federal Reserve, Survey of Consumer Finances, 2022

The median white household holds roughly six times the wealth of the median Black household. This gap has persisted—and in some periods widened—despite decades of civil rights legislation, affirmative action, and educational attainment gains among Black Americans.

### Note:

#### **Common Misconception: The Racial Wealth Gap Is About Income Differences**

Income differences explain only part of the racial wealth gap. Even at the same income level, Black households hold significantly less wealth than

white households. The gap is driven by historical asset exclusion (redlining, denial of GI Bill benefits, exclusion from homeownership subsidies), lower rates of inheritance, lower homeownership rates, and differences in the type and return on assets held. Closing the income gap alone would not close the wealth gap.

The roots of the racial wealth gap are structural and historical:

- **Homeownership exclusion:** Redlining, racially restrictive covenants, and discriminatory lending systematically excluded Black Americans from the primary wealth-building vehicle of the 20th century. The effects compound: families denied homeownership in the 1950s missed decades of home price appreciation that white families captured.
- **Lower inheritance:** Because previous generations were excluded from wealth accumulation, today's Black families receive substantially less in intergenerational transfers.
- **Asset composition:** Black households that do have wealth hold it more heavily in housing (which appreciated less than equities) and less in stocks and retirement accounts.

## Geographic Inequality

As Chapter 3 documented, economic activity concentrates geographically. So do income and wealth.

**Metro divergence:** Per capita income in the San Francisco metro area exceeds \$100,000; in the McAllen, Texas metro area, it's roughly \$25,000. This 4:1 ratio within a single country is extraordinary by international standards.

**The cost-of-living adjustment:** High-income metros also have high costs, particularly housing. After adjusting for local prices, some high-income metros (San Francisco, New York) offer less purchasing power than lower-cost alternatives (Houston, Minneapolis). But the adjustment doesn't eliminate the gap—it merely narrows it.

**Rural-urban divergence:** Rural workers earn roughly 70% of urban wages. The gap has widened over time as knowledge-economy jobs concentrate in metros while rural areas depend on lower-productivity sectors (agriculture, extraction, government services).

[Figure: Figure I.4: Per capita income across U.S. metro areas. The highest-income metros (San Jose, San Francisco, New York) earn 3-4x more per capita than the lowest-income metros (McAllen, Brownsville). Source: BEA, Regional Economic Accounts]

## The Gender Pay Gap

Women working full-time earned approximately 84 cents for every dollar earned by men in 2023—a ratio that has improved from 60 cents in 1980 but has plateaued since roughly 2005.

The gap varies dramatically by occupation and sector:

- In healthcare (Chapter 6), women dominate nursing and allied health but are underrepresented among surgeons and specialists—the highest-paid positions.
- In finance (Chapter 8), women hold 50%+ of entry-level positions but less than 25% of C-suite and managing director roles.
- In technology (Chapter 11), women represent roughly 28% of the workforce, and the gap widens at senior levels.

#### □ Info:

#### **Explained vs. Unexplained Gap**

Economists decompose the gender pay gap into “explained” factors (differences in occupation, industry, hours worked, education, experience) and an “unexplained” residual. Roughly 55-60% of the gap is “explained” by these measurable differences; the remaining 40-45% persists after controlling for all observable characteristics. The unexplained portion is consistent with—though does not definitively prove—discrimination, negotiation differences, and unmeasured factors like willingness to relocate or work unpredictable hours.

A key structural factor is the **motherhood penalty**: women’s earnings decline significantly after having children, while men’s do not. Research by Henrik Kleven and colleagues shows that 10 years after a first birth, women earn roughly 40% less than comparable women without children. This reflects some combination of reduced hours, career interruptions, employer discrimination against mothers, and sorting into more flexible but lower-paying positions. The childcare infrastructure—or lack thereof—documented in Chapter 30 is central to this dynamic.

## **Intergenerational Mobility**

If inequality were temporary—if today’s poor were tomorrow’s middle class—distributional concerns would be less pressing. The evidence suggests otherwise.

Economist Raj Chetty and colleagues, using IRS tax records for millions of Americans, found that:

- A child born to parents in the bottom 20% of the income distribution has roughly a **7.5% chance** of reaching the top 20% as an adult.
- A child born to parents in the top 20% has roughly a **33% chance** of remaining there.
- Mobility varies dramatically by geography: Charlotte, NC has mobility rates comparable to developing countries; Salt Lake City’s rates rival Denmark’s.
- Mobility has declined over time: roughly 90% of children born in 1940 earned more than their parents; for children born in 1980, the figure is roughly 50%.

[Figure: Figure I.5: Intergenerational income mobility by commuting zone. Darker areas indicate higher upward mobility (greater chance of a child born to low-income parents reaching high income). Mobility is highest in

the Upper Midwest and Mountain West; lowest in the Southeast and Rust Belt. Source: Opportunity Insights ([opportunityinsights.org](http://opportunityinsights.org))]

The factors most strongly correlated with local mobility are: residential segregation (less segregation, more mobility), income inequality (less inequality, more mobility), school quality, family structure, and social capital. Many of these factors connect to the structural features examined throughout this book.

## How Distribution Connects to Structure

The distributional patterns described above are not separate from the sectoral and geographic analysis in the rest of this book. They are the structural economy experienced at the household level:

- **Sector determines wages:** A worker in information technology (Chapter 11) earns a median of \$100,000+; a worker in leisure and hospitality (Chapter 17) earns a median of \$22,000. Sectoral composition drives local income levels.
- **Geography determines opportunity:** Being born in San Jose versus McAllen correlates more strongly with adult income than most individual characteristics.
- **Financial architecture shapes wealth:** Access to the capital markets (Chapter 19) and homeownership (Chapter 5) determines which households build wealth and which do not.
- **Institutions set the rules:** Federal governance (Chapter 28), labor law (Chapter 30), tax policy, and regulatory choices determine how the gains from production are divided.

The economy described in the chapters ahead is not a neutral machine. It produces extraordinary abundance—and distributes it very unevenly. Keeping both facts in view is essential for understanding how America actually works.

## Key Takeaways

1. **Income inequality has risen sharply since 1970.** The top 1% now receives roughly 20% of national income, up from 10%. The bottom 50%'s share has declined from 20% to 13%.
2. **Wealth inequality is more extreme than income inequality.** The top 10% own 67% of all wealth; the bottom 50% own 2.5%. Wealth compounds through asset appreciation, inheritance, and differential access to financial markets.
3. **The racial wealth gap reflects structural history.** The median white household holds six times the wealth of the median Black household—a gap rooted in historical exclusion from homeownership, education, and capital accumulation.
4. **Geographic inequality is severe and growing.** Per capita income varies 4:1 across metro areas. Rural-urban divergence has widened as knowledge-economy jobs concentrate in major metros.
5. **Intergenerational mobility has declined.** A child born poor in the U.S. has a roughly 7.5% chance of reaching the top quintile—lower than in most peer

nations. Mobility varies enormously by geography.

6. **Distribution is structural, not incidental.** Sector, geography, financial access, and institutional rules determine who benefits from economic growth. Understanding the economy requires understanding its distributional outcomes.

## Data Sources and Further Reading

### Key Data Sources

- **Census Bureau, Current Population Survey** ([census.gov](https://census.gov)): Annual income and poverty data
- **Federal Reserve, Survey of Consumer Finances** ([federalreserve.gov/econres/scfindex.htm](https://federalreserve.gov/econres/scfindex.htm)): Wealth distribution every 3 years
- **Federal Reserve, Distributional Financial Accounts** ([federalreserve.gov/releases/z1/data/](https://federalreserve.gov/releases/z1/data/)): Quarterly wealth distribution estimates
- **World Inequality Database** ([wid.world](https://wid.world)): Pre-tax income shares by percentile, international comparisons
- **Opportunity Insights** ([opportunityinsights.org](https://opportunityinsights.org)): Intergenerational mobility data by geography
- **Congressional Budget Office** ([.cbo.gov](https://.cbo.gov)): Distribution of household income and federal taxes

### Further Reading

- Thomas Piketty, Capital in the Twenty-First Century (2014)—The landmark study of wealth concentration across centuries and countries
- Raj Chetty et al., “Where Is the Land of Opportunity?” Quarterly Journal of Economics (2014)—The foundational study of intergenerational mobility by geography
- William Darity Jr. and A. Kirsten Mullen, From Here to Equality (2020)—A systematic analysis of the racial wealth gap and the case for reparations
- Claudia Goldin, Career and Family (2021)—How the gender pay gap evolved and why it persists
- David Autor, “Work of the Past, Work of the Future,” AEA Papers and Proceedings (2019)—Job polarization and the hollowing of the middle class

## Exercises

### Review Questions

1. The top 1% receives roughly 20% of national income while the bottom 50% receives roughly 13%. Explain three structural factors that drive this divergence. For each, identify which sector chapter(s) in Part II are most relevant.
2. The median white household holds six times the wealth of the median Black household. Why does controlling for income differences not eliminate this gap?

Identify at least three historical and structural factors that contribute independently.

3. Explain the concept of “job polarization.” How does it relate to the sectoral structure described in Part II—specifically, the decline of manufacturing employment (Chapter 9) and the growth of both professional services (Chapter 7) and leisure/hospitality (Chapter 17)?
4. The text states that roughly 50% of children born in 1980 earned more than their parents, compared to 90% of those born in 1940. What economic and structural changes over that period might explain this decline in absolute mobility?
5. Why is wealth more unequally distributed than income? Identify at least three mechanisms that cause wealth concentration to exceed income concentration.
6. The gender pay gap has plateaued at roughly 84 cents per dollar since about 2005. Using the concepts of “explained” and “unexplained” components, describe what structural changes might be needed to close the remaining gap.

## Data Exercises

7. **Exploring wealth data:** Go to the Federal Reserve’s Distributional Financial Accounts page ([federalreserve.gov/releases/z1/dataviz/dfa](https://federalreserve.gov/releases/z1/dataviz/dfa)). Find the wealth share held by the top 1%, 50th-90th percentile, and bottom 50% for the most recent quarter. How do these compare to the figures in this chapter? Plot the top 1% share over the past 10 years—what trend do you observe?
8. **Mobility by geography:** Visit Opportunity Insights ([opportunityinsights.org/data](https://opportunityinsights.org/data)). Look up the mobility statistics for your home county or commuting zone. What is the probability that a child born to parents at the 25th percentile reaches the top quintile? How does your area compare to the national average? What local factors (segregation, school quality, inequality) might explain the difference?
9. **Income by sector:** Using the BLS Occupational Employment and Wage Statistics ([bls.gov/oes](https://bls.gov/oes)), compare the median annual wage in three sectors discussed in Part II: professional and business services, manufacturing, and leisure and hospitality. Calculate the ratio between the highest and lowest. How does this sectoral wage dispersion contribute to overall income inequality?

## Deeper Investigation

10. Choose one dimension of inequality discussed in this chapter (income, wealth, racial, gender, or geographic). Using data from the sources listed above, construct a detailed profile of how that dimension of inequality has evolved over the past 30 years. What structural economic changes (sectoral shifts, policy changes, technological disruption, globalization) best explain the trend? What policy interventions have been proposed, and what does the evidence suggest about their effectiveness?

## **Part II: The Sectors**

# Chapter 4. Government at All Levels

The United States has 89,500 governments. One federal. Fifty state. The rest—over 89,000—are local: counties, cities, townships, school districts, fire districts, water authorities, transit agencies. Each levies taxes. Each employs workers. Each writes rules. Americans talk about “the government” as if it were a single actor. It isn’t.

## Info:

### **89,000+ Governments**

The Census Bureau counts 89,500 government units: 1 federal, 50 state, 3,031 counties, 19,502 municipalities, 16,097 townships, 12,957 school districts, and 37,683 special districts. Each has taxing authority, a budget, and employees. No other developed nation fragments public authority so extensively.

Together these governments spend \$10 trillion annually—40% of GDP. They employ 23 million workers, more than manufacturing and construction combined. The federal government alone commands \$6.5 trillion, exceeding Japan’s entire economic output. State and local governments add another \$3.5 trillion (net of federal transfers).

The division of labor follows a rough pattern. Washington handles defense, Social Security, Medicare, and macroeconomic stabilization. States run universities, prisons, highways, and Medicaid. Local governments educate children, patrol streets, fight fires, and pump water. But the layers overlap constantly. Federal grants fund state programs. State mandates constrain local budgets. Shared programs blur accountability.

The result: a system that is simultaneously massive and fragmented, powerful and incoherent.

## **How Government Works as an Economic Actor**

### **Revenue: Where the Money Comes From**

**Federal Revenue** (roughly \$4.5 trillion, FY 2024):

Source	Amount	Share
Individual income tax	\$2.2T	49%
Payroll taxes (Social Security, Medicare)	\$1.5T	33%
Corporate income tax	\$420B	9%
Excise taxes	\$75B	2%
Other (customs, estate, fees)	\$305B	7%

Source: Office of Management and Budget, FY 2024

The federal government runs persistent deficits—spending exceeding revenue by \$1-2 trillion annually since 2020. The difference is financed by borrowing (Treasury bonds), adding to the \$35+ trillion national debt.

### **State and Local Revenue** (roughly \$4 trillion):

Source	Amount	Share
Federal grants	\$900B	23%
Property taxes	\$600B	15%
Sales taxes	\$500B	13%
Individual income taxes	\$500B	13%
Charges and fees	\$700B	18%
Other (corporate tax, lottery, etc.)	\$800B	18%

Source: Census Bureau, State and Local Government Finances, 2022

State and local governments are generally required to balance their operating budgets (most state constitutions prohibit operating deficits), though they can borrow for capital projects.

## **Spending: What Government Buys**

### **Federal Spending by Function** (roughly \$6.5 trillion):

Category	Amount	Share	Notes
Social Security	\$1.4T	22%	Mandatory
Medicare	\$900B	14%	Mandatory
Medicaid/CHIP	\$600B	9%	Mandatory (grants to states)
Defense	\$850B	13%	Discretionary
Interest on debt	\$700B	11%	Mandatory
Other mandatory	\$700B	11%	SNAP, UI, veterans, etc.
Non-defense discretionary	\$800B	12%	Education, transportation, R&D, etc.

Category	Amount	Share	Notes
Other	\$550B	8%	

Source: Office of Management and Budget, FY 2024

### Federal Outlays by Major Category, 2023

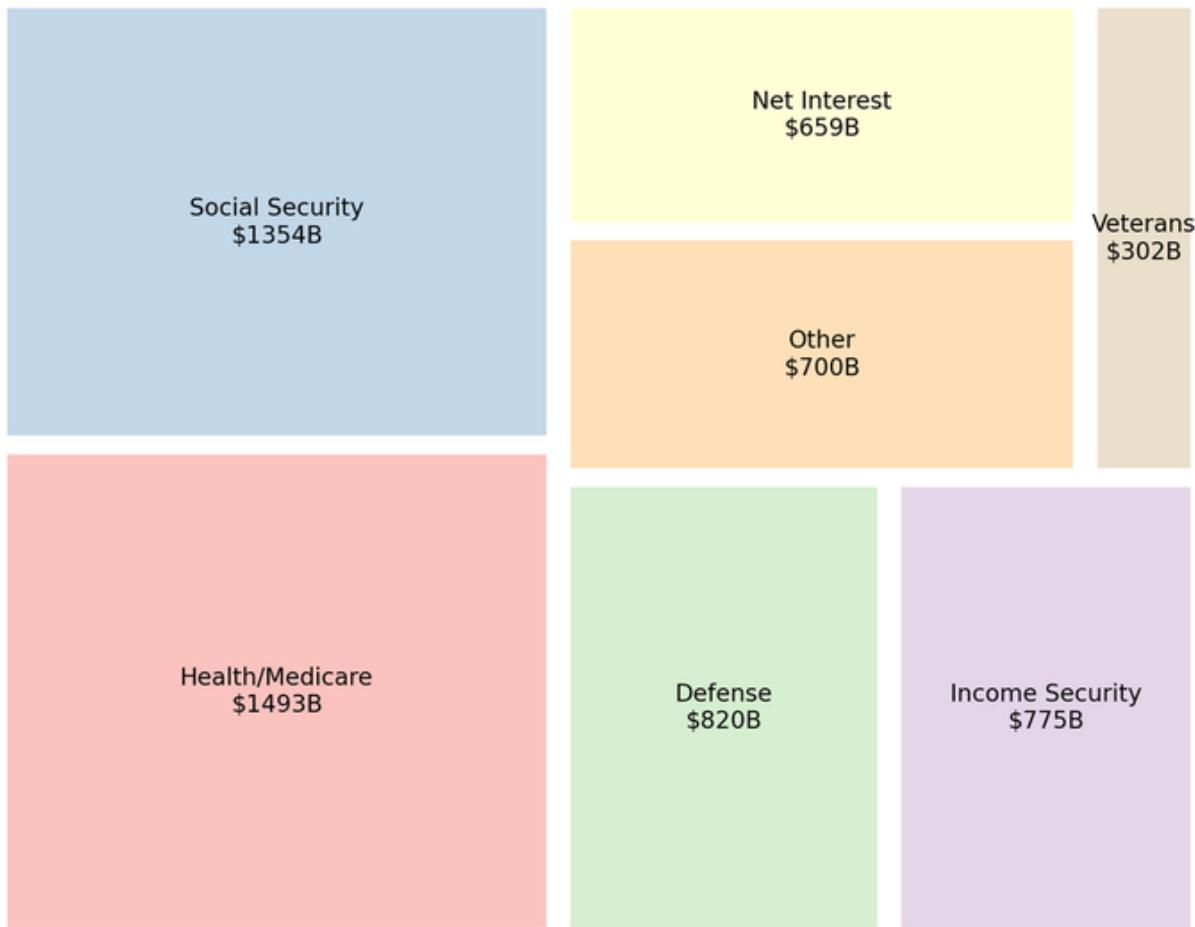


Figure 14: Figure 4.1: Federal spending by function. Mandatory spending (Social Security, Medicare, Medicaid) dominates, while discretionary spending is squeezed. Source: OMB Budget (FY 2024)

The critical distinction: **mandatory spending** (Social Security, Medicare, Medicaid, interest) happens automatically based on eligibility laws. **Discretionary spending** requires annual appropriations. Mandatory spending is roughly 70% of the budget and growing; discretionary is roughly 30% and squeezed.

**State and Local Spending by Function** (roughly \$3.5 trillion net):

Category	Share	Primary Level
Education (K-12 and higher)	35%	Local/State
Public welfare (Medicaid)	20%	State
Health and hospitals	10%	State/Local
Police and corrections	8%	State/Local
Transportation	8%	State
Other	19%	Various

Source: Census Bureau, State and Local Government Finances, 2022

Education is by far the largest state/local function, accounting for over a third of spending and employing the largest share of state/local workers.

## Government as Employer

Government directly employs 23 million Americans—about 14% of total employment. The composition matters:

### Federal Civilian Workforce (2.2 million):

Department/Agency	Employment	Notes
Defense (civilian)	750,000	Largest civilian employer
Veterans Affairs	410,000	Healthcare system
Homeland Security	240,000	Includes TSA, CBP, ICE, Coast Guard
Justice	115,000	FBI, prisons, prosecutors
Treasury	95,000	IRS is bulk
Agriculture	90,000	USDA programs, Forest Service
Interior	65,000	Parks, land management
HHS	80,000	FDA, CDC, NIH
All other	355,000	

Source: Office of Personnel Management, FedScope, 2023

The federal civilian workforce has been roughly flat for 50 years despite enormous growth in federal spending—a result of contracting out, automation, and grants to states rather than direct federal employment.

### Military Personnel (1.3 million active duty):

Branch	Active Duty	Reserves/Guard
Army	450,000	520,000
Navy	340,000	100,000
Air Force	325,000	180,000
Marine Corps	175,000	95,000
Coast Guard	42,000	10,000
Space Force	10,000	-

Source: Department of Defense, Defense Manpower Data Center, 2023

Plus roughly 800,000 civilian DOD employees and millions of contractor employees.

### **State Government Employment** (5.2 million):

Function	Share
Higher education	40%
Corrections	10%
Highways	8%
Hospitals	12%
Public welfare	5%
Other	25%

Source: Bureau of Labor Statistics, Current Employment Statistics, 2023

State employment is dominated by higher education—public university faculty, staff, and administrators.

### **Local Government Employment** (14.5 million):

Function	Share
K-12 education	55%
Police	7%
Fire	2%
Hospitals	5%
Other	31%

Source: Bureau of Labor Statistics, Current Employment Statistics, 2023

Local government employment is dominated by schools: teachers, administrators, and support staff account for over half of all local government workers.

## **Government as Purchaser**

Beyond payroll, government purchases vast amounts of goods and services from the private sector:

### **Federal Procurement** (roughly \$700 billion annually):

Category	Amount
Defense contracts	\$450B
Civilian agency contracts	\$250B

Federal procurement is governed by the Federal Acquisition Regulation (FAR), a dense set of rules covering everything from competitive bidding to small business set-asides to labor standards.

## **Government Employment by Level, 2023**

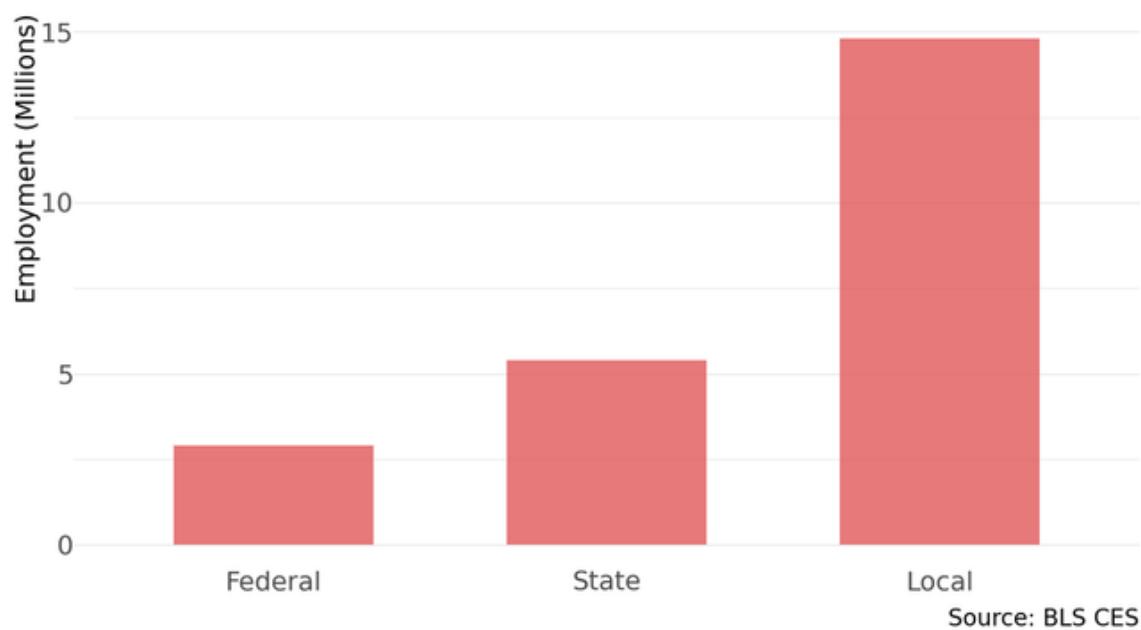


Figure 15: Figure 4.2: Government employment by level. Local governments employ far more workers than federal or state, with education dominating local payrolls. Source: BLS CES (2023)

## **Major Federal Contractors** (by contract value):

Rank	Company	FY2023 Contracts	Primary Business
1	Lockheed Martin	\$75B	Aerospace, defense systems
2	RTX (Raytheon)	\$35B	Missiles, electronics
3	General Dynamics	\$30B	Ships, IT, munitions
4	Boeing	\$25B	Aircraft, satellites
5	Northrop Grumman	\$20B	Aerospace, cyber
6	Leidos	\$12B	IT, engineering
7	Huntington Ingalls	\$10B	Shipbuilding
8	L3Harris	\$8B	Electronics, communications
9	BAE Systems	\$7B	Vehicles, electronics
10	Deloitte	\$5B	Consulting, IT

Source: USASpending.gov, FY 2023

The defense industrial base is concentrated: five companies (Lockheed, RTX, General Dynamics, Boeing, Northrop) receive over half of defense contract dollars. Consolidation since the 1990s reduced the number of prime contractors from dozens to a handful.

## **Geographic Distribution**

### **Federal Employment Geography**

Federal civilian employment is concentrated in several clusters:

**Washington, DC Metropolitan Area:** roughly 400,000 federal civilian employees (excluding military)—the largest concentration. Every cabinet department headquarters, most agencies, and Congress are here. The DC metro has the highest concentration of federal workers of any region.

**Military Installations:** Major bases shape regional economies: - San Diego (Navy): 120,000+ military and civilian DOD - Hampton Roads, VA (Navy): 100,000+ - San Antonio (Air Force, Army): 80,000+ - Fayetteville, NC (Fort Bragg/Army): 50,000+ - Colorado Springs (Air Force, Army): 50,000+

**Other Concentrations:** - Sacramento (due to California's large population and federal land) - Atlanta (CDC headquarters, regional offices) - Denver (land management agencies) - Baltimore (Social Security Administration, other agencies)

### **Federal Presence by State** (federal employment per capita):

Highest	Per 1,000	Lowest	Per 1,000
DC	130	Michigan	4.5
Virginia	25	Wisconsin	4.5
Maryland	22	Ohio	5.0
Hawaii	18	Minnesota	5.0

Highest	Per 1,000	Lowest	Per 1,000
Alaska	17	Oregon	5.5

States with military bases, federal lands, or proximity to DC have high federal employment; Midwest manufacturing states have low federal presence.

## State and Local Employment Geography

State and local employment reflects population and public service needs:

**Highest State/Local Employment** (per capita): - Wyoming, Alaska, New Mexico: High due to large state roles in education, land management - New York, California: Large state workforces despite private sector dominance

**Variation in Local Government Structure:** - Fragmented metros (Chicago, St. Louis): Dozens of overlapping local governments - Consolidated metros (Indianapolis, Louisville): City-county merger reduces fragmentation - Special districts: Water, fire, transit, and other districts add complexity

## Industry Structure

### The Defense Industrial Base

Defense procurement creates a distinct industrial ecosystem:

**Prime Contractors:** Lockheed Martin, RTX, General Dynamics, Boeing, Northrop Grumman dominate major weapons systems. Each specializes: - Lockheed: F-35 fighter, missiles, space systems - RTX (Raytheon + Collins): Missiles, radar, avionics - General Dynamics: Submarines, tanks, IT systems - Boeing: Aircraft, satellites, tankers - Northrop: Bombers, drones, cyber

**Subcontractor Networks:** Primes depend on thousands of suppliers. A single F-35 fighter involves 1,500+ suppliers across 46 states—a distribution deliberately structured to create Congressional support.

**Concentration Concerns:** Post-Cold War consolidation reduced competition. Some weapon categories have only one or two potential suppliers (nuclear submarines: Huntington Ingalls and General Dynamics; stealth bombers: Northrop). This reduces cost pressure and complicates acquisition.

**Foreign Dependence:** Some critical components (rare earth minerals, microchips, certain alloys) come from foreign sources, including potential adversaries. “Supply chain security” has become a major policy focus.

## Healthcare as Government Business

Government is the largest payer for healthcare: - Medicare: \$900 billion - Medicaid (federal share): \$600 billion - Veterans Affairs healthcare: \$100 billion - Military

## Top 10 Federal Contractors, FY 2023

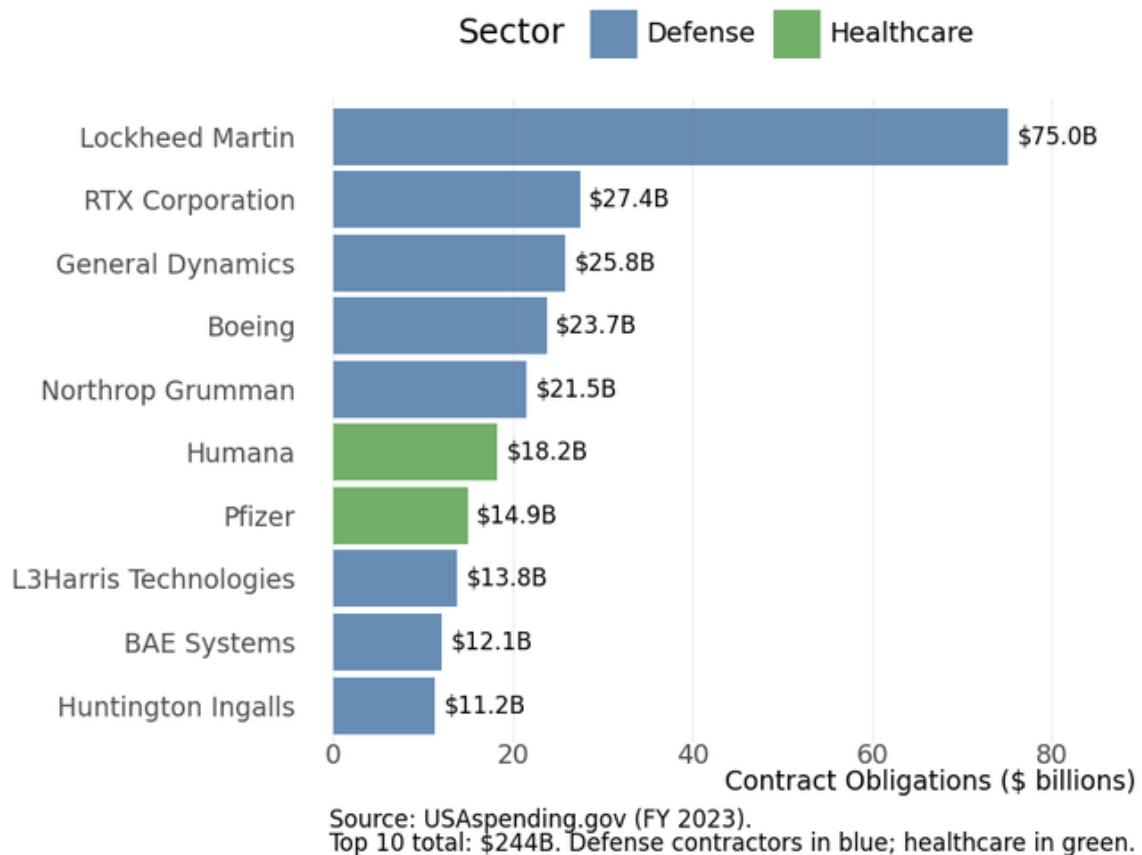


Figure 16: Figure 4.3: Top 10 federal contractors by contract value. Defense dominates federal procurement, with Lockheed Martin alone receiving \$75 billion annually. Source: USASpending.gov (FY 2023)

### Federal Civilian Employment by State (CONUS), 2023

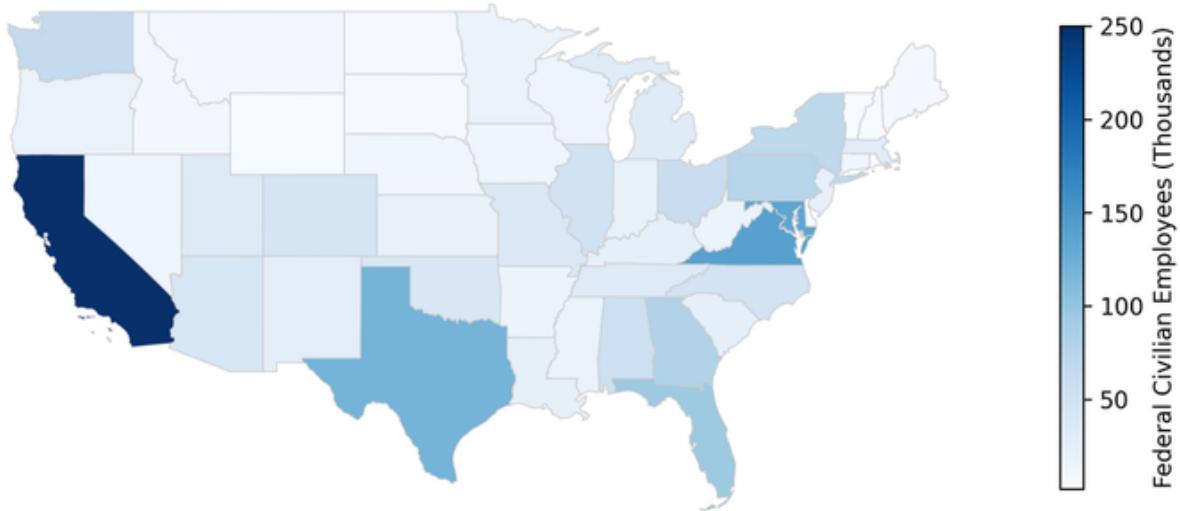


Figure 17: Figure 4.4: Federal civilian employment by state. The Washington, DC metro dominates, with additional concentrations around military bases and federal lands. Source: OPM (2023)

healthcare (TRICARE): \$50 billion - Other (Indian Health Service, CHIP, etc.): \$50 billion

Combined, government pays for roughly 45% of US healthcare spending. This makes HHS, CMS, and VA major economic actors whose payment rates shape provider behavior across the system.

## Education as Government Business

Public education spending (roughly \$900 billion K-12, roughly \$500 billion higher ed) creates enormous demand for: - Construction (school buildings) - Textbooks and curriculum (Pearson, McGraw-Hill) - Technology (laptops, software, internet infrastructure) - Transportation (school buses) - Food service (school lunch programs)

## The Regulatory State

Beyond spending and employment, government shapes the economy through regulation:

### Major Regulatory Agencies

Agency	Domain	Budget	Employees
SEC	Securities markets	\$2.2B	5,000
EPA	Environmental protection	\$10B	14,000

Agency	Domain	Budget	Employees
FDA	Food and drug safety	\$7B	18,000
FTC	Competition, consumer protection	\$400M	1,200
FCC	Communications	\$400M	1,400
OSHA	Workplace safety	\$600M	2,200
CFPB	Consumer finance	\$700M	1,700
FAA	Aviation	\$20B	45,000
FERC	Energy	\$500M	1,500

Source: Agency budget justifications and Office of Management and Budget, 2023

Regulatory agencies are small relative to their economic impact. The SEC's 5,000 employees oversee capital markets with \$50+ trillion in assets. The EPA's 14,000 employees enforce rules affecting virtually every manufacturer.

## Regulatory Cost and Benefit

Regulation imposes compliance costs on businesses—estimated at \$2-3 trillion annually by some counts, though estimates vary wildly. Benefits (cleaner air, safer workplaces, financial stability) are harder to quantify but real.

The regulatory process is governed by the Administrative Procedure Act (1946), requiring notice-and-comment rulemaking, and by executive orders requiring cost-benefit analysis. Major rules face review by the Office of Information and Regulatory Affairs (OIRA) within OMB.

## The Budget Process (Abridged)

### The Annual Cycle

The federal budget follows a nominal cycle: 1. **President's Budget** (February): The administration's proposal 2. **Budget Resolution** (April target): Congress sets spending limits 3. **Appropriations** (before October 1): 12 bills fund agencies 4. **Fiscal Year** begins October 1

In practice, Congress rarely completes appropriations on time. Government operates on **continuing resolutions** (temporary extensions) and **omnibus bills** (giant packages passed at deadline). Government shutdowns occur when funding lapses.

### Mandatory vs. Discretionary

The crucial distinction: - **Mandatory** (Social Security, Medicare, Medicaid, interest): Spending determined by eligibility rules, not annual appropriations. roughly 70% of budget. - **Discretionary** (defense, education, transportation, R&D): Requires annual appropriations. roughly 30% of budget.

Mandatory spending grows automatically as the population ages and healthcare costs rise. Discretionary spending is squeezed—Congress can only appropriate what's left after mandatory obligations.

## **Deficits and Debt**

The federal government has run deficits in most years since 1970. Annual deficits of \$1-2 trillion since 2020 have pushed the national debt above \$35 trillion (roughly 120% of GDP). Interest costs (roughly \$700 billion annually) are now larger than defense spending.

Debt sustainability depends on the relationship between interest rates ( $r$ ) and economic growth ( $g$ ): - If  $r < g$ : Debt-to-GDP ratio can stabilize even with deficits - If  $r > g$ : Primary surpluses required to stabilize debt

Rising interest rates since 2022 have shifted this calculus unfavorably.

## **Recent Trends**

### **1. The Contractor State**

Direct federal employment has been flat for decades, but government's economic footprint has grown through contractors. Federal contract spending has doubled since 2000. Contractors perform functions once done by government employees—IT, logistics, security, even policy analysis.

This creates accountability challenges: contractors are less visible than employees, and the revolving door between government and contractors raises conflict-of-interest concerns.

### **2. State and Local Fiscal Stress**

The 2020-2022 period saw unprecedented federal aid to state and local governments (American Rescue Plan provided \$350 billion). As this aid exhausts, many jurisdictions face structural deficits—revenues that can't sustain pre-pandemic service levels plus inflation-driven cost increases.

Pension obligations are a particular concern: many states and cities have unfunded pension liabilities in the hundreds of billions, representing promises to retired workers that will strain budgets for decades.

### **3. The IRS Transformation**

The Inflation Reduction Act (2022) provided \$80 billion for IRS modernization over 10 years—the largest investment in tax administration in decades. Goals include improving taxpayer service, updating ancient IT systems, and increasing enforcement against high-income tax evaders.

This is the rare example of investment in government capacity, countering decades of erosion in administrative capability.

## **4. Climate and Industrial Policy**

Recent legislation (Infrastructure Investment and Jobs Act, CHIPS Act, Inflation Reduction Act) represents a major expansion of federal industrial policy—government directing investment toward preferred sectors (semiconductors, clean energy, infrastructure).

This marks a shift from the post-Reagan consensus against “picking winners.” Whether it succeeds will shape debates about government’s economic role for decades.

## **5. Defense Spending Trajectory**

After a post-Cold War “peace dividend” and sequestration cuts in the 2010s, defense spending has resumed growth. Great power competition (China, Russia) drives demand for military modernization. The defense budget is projected to reach \$1 trillion within a decade.

## **Profiles**

### **Department of Defense**

**Quick Facts** - Headquarters: The Pentagon, Arlington, VA - Budget: roughly \$850 billion (FY 2024) - Employees: 2.9 million (1.3M active military, 750K civilian, 800K+ reserves/guard) - Secretary: Civilian, Cabinet rank

The Department of Defense is the largest employer in the world. Its budget exceeds the next several countries’ defense spending combined. DOD manages: - Four military departments (Army, Navy, Air Force, Marines) plus Space Force - Nine unified combatant commands covering geographic regions and functions - Defense agencies (DIA, NGA, DARPA, DISA, and many more) - 4,800+ sites worldwide, including 750+ overseas bases

DOD procurement shapes entire industries. The F-35 program (\$1.7 trillion lifetime cost) is the most expensive weapons program in history. Nuclear modernization will cost \$1.5 trillion over 30 years. Shipbuilding sustains specialized yards that would otherwise not exist.

The department’s size creates management challenges. GAO has kept DOD on its “high risk” list for financial management since 1995. DOD has never passed a clean financial audit.

### **California State Government**

**Quick Facts** - Capital: Sacramento - Budget: roughly \$310 billion (including federal funds) - Employees: roughly 240,000 state workers - Governor: Elected, 4-year term

California's state government, the largest of the 50 states, provides a window into state operations:

**Major functions:** - Healthcare (Medi-Cal/Medicaid): roughly \$150 billion, covering 15 million Californians - Education (K-12 state aid + higher ed): roughly \$100 billion - Corrections: roughly \$15 billion (operating the nation's largest state prison system) - Transportation: roughly \$15 billion

**The UC and CSU systems** employ roughly 200,000 people across 33 campuses, making higher education the largest state function by employment.

**Fiscal structure:** California relies heavily on income tax (especially capital gains), creating volatile revenues that surge in booms and crash in recessions. Proposition 13 (1978) capped property taxes, shifting school funding to the state and making revenue more dependent on income tax.

**Policy laboratory:** California often leads on policy—environmental regulation (CARB sets de facto national vehicle standards), minimum wage, climate policy, marijuana legalization. Its size means California policy affects national markets.

## New York City Government

**Quick Facts** - Budget: roughly \$110 billion - Employees: roughly 330,000  
- Mayor: Elected, 4-year term - Population: 8.3 million

New York City operates the largest municipal government in the United States, with a budget larger than most states:

**Major functions:** - Public schools (NYC DOE): 1 million students, 75,000 teachers - Police (NYPD): 35,000 officers—largest police force in the US - Fire (FDNY): 11,000 firefighters - Public hospitals (NYC Health + Hospitals): 11 hospitals, 70+ clinics - Public housing (NYCHA): 175,000 units, 400,000 residents

**Revenue:** NYC has unusual taxing authority for a city—its own income tax, commercial rent tax, and hotel tax supplement property and sales taxes.

**Complexity:** The city government interacts with numerous independent authorities (MTA, Port Authority, CUNY), state mandates, and federal programs. The MTA (which runs subways and buses) is technically a state agency, not city-controlled, creating persistent governance tensions.

## Data Sources and Further Reading

### Key Data Sources

- **USASpending.gov:** Federal spending and contract data
- **BLS Quarterly Census of Employment and Wages:** Government employment by level and function
- **Census Bureau Government Finance Statistics:** State and local revenue and spending
- **Office of Personnel Management:** Federal workforce data

- **Federal Procurement Data System (FPDS)**: Contract awards
- **Congressional Budget Office**: Budget projections, cost estimates

## Further Reading

**Accessible** - Wessel, David (2012). Red Ink. Accessible introduction to federal budget politics. - Light, Paul (1999). The True Size of Government. Classic on contractor workforce.

**Intermediate** - Schick, Allen (2007). The Federal Budget: Politics, Policy, Process. Standard budget process text. - Oates, Wallace (1972). Fiscal Federalism. Foundational theory of federal-state-local structure.

**Government Reports** - Congressional Budget Office. Budget and Economic Outlook (annual). Essential budget reference. - GAO. High Risk List (biennial). Government management challenges. - OMB. Analytical Perspectives (annual). Detailed budget background.

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Chapter 4 | Government at All Levels The American Economy: A Structural Geography  
Draft v1 — January 2026

## Exercises

### Review Questions

1. The United States has 89,500 governments—more than any other developed nation. What are the consequences of this fragmentation for accountability, efficiency, and citizen experience? Give a specific example of how overlapping federal, state, and local authority creates confusion in a policy area discussed in the chapter.
2. Mandatory spending (Social Security, Medicare, Medicaid, interest on debt) constitutes roughly 70% of the federal budget and grows automatically, while discretionary spending requires annual appropriations. Explain why this structure makes it increasingly difficult for Congress to fund priorities like infrastructure, education, and R&D. What would have to change for discretionary spending to grow?
3. The federal civilian workforce has been roughly flat at 2.2 million for 50 years, even as federal spending has grown enormously. The chapter attributes this to the rise of the “contractor state.” What are the advantages of delivering government services through contractors rather than federal employees? What accountability problems does contracting create?
4. The F-35 fighter program involves 1,500+ suppliers across 46 states—a distribution the chapter describes as “deliberately structured to create Congressional support.” Explain how this geographic dispersion functions as a political strategy. What are the consequences for cost control and program management?

5. California's state government relies heavily on income tax (especially capital gains), while local governments nationwide depend on property taxes capped in California by Proposition 13. What are the consequences of these different revenue structures for budget stability? Why does California experience more revenue volatility than states that rely on sales or property taxes?
6. Local government employment is dominated by K-12 education, which accounts for 55% of all local government workers. If the school-age population in a community declines due to demographic shifts, what fiscal pressures does this create? Why might local governments struggle to reduce education spending even as enrollment falls?
7. The chapter presents the debt sustainability framework: if the interest rate on government debt ( $r$ ) exceeds the rate of economic growth ( $g$ ), primary surpluses are required to stabilize debt-to-GDP. With interest costs now exceeding \$700 billion annually—larger than defense spending—and rising interest rates since 2022 shifting the  $r-g$  calculus unfavorably, what policy options exist to restore fiscal sustainability?

## Data Exercises

8. Go to USASpending.gov and select “Spending Explorer.” Choose a state of your choice and examine federal spending by category (contracts, grants, direct payments, loans). What is the largest category of federal spending in that state? Who are the top five federal contractors? How does the composition compare to the national pattern described in the chapter?
9. Using FRED (fred.stlouisfed.org), pull the series “USGOVT” (All Employees: Government) and compare it with “MANEMP” (All Employees: Manufacturing) from 1990 to the present. In what year did government employment surpass manufacturing employment? What does this crossover tell you about the changing structure of the American economy?
10. The Congressional Budget Office publishes annual budget projections at cbo.gov. Find the most recent “Budget and Economic Outlook” report. What does CBO project for mandatory spending, discretionary spending, and interest costs as shares of GDP over the next 10 years? How does the projected growth in mandatory spending compare to projected revenue growth?

## Deeper Investigation

11. Select a state or major city facing significant unfunded pension liabilities (examples include Illinois, New Jersey, California, Chicago, or New York City). Research the size of the unfunded liability, the annual required pension contribution as a share of the budget, and the assumptions underlying the pension fund’s projected returns. What policy options exist—benefit reductions, contribution increases, investment changes, legal constraints? Assess whether the pension obligations are sustainable and what trade-offs any reform would entail.

# Chapter 5. Real Estate, Rental, and Leasing

American housing wealth exceeds \$50 trillion—more than the entire market capitalization of U.S. stocks. Unlike a stock portfolio, you cannot diversify this asset. You live in one place, work in one metro, and your largest holding sits immovable on a single plot of land. Every business requires premises. Every worker needs a home. For most households, housing plays a triple role—shelter, investment vehicle, retirement plan—creating dynamics found nowhere else in the economy. When prices rise, existing homeowners grow wealthier while aspiring buyers face exclusion. When prices fall, household balance sheets implode, as 2008 demonstrated with devastating clarity.

## Overview

### Size and Scope

- **GDP Share:** 13–14% of GDP strictly defined; rising to 16–17% when including housing services and residential investment. Real estate is consistently the single largest sector of the American economy.
- **Asset Value:** The total value of the U.S. housing stock exceeds **\$50 trillion** (2024)—a figure that dwarfs the capitalization of the entire U.S. stock market.
- **Commercial Real Estate:** An additional \$20+ trillion in office, retail, industrial, and multifamily properties.
- **Employment:** Approximately 2.3 million workers in real estate activities proper (agents, property managers, appraisers), plus millions more in construction, mortgage finance, and related services.
- **Establishments:** Over 800,000 firms operate in the sector, ranging from accidental sole-proprietor landlords renting out a spare bedroom to multinational Real Estate Investment Trusts (REITs) with properties on four continents.

Real estate sits at the intersection of shelter, investment, and finance. For most American households, their home is simultaneously their largest expense, their primary asset, and their retirement plan. This triple role creates unique dynamics: when housing prices rise, existing homeowners grow wealthier while aspiring buyers are priced out. When they fall, household balance sheets implode, as 2008 demonstrated.

□ **Note:**

## Housing as Wealth Engine

American households hold over \$50 trillion in housing wealth—more than the combined value of all U.S. stocks. For most families, their home represents 60-70% of total wealth, making housing policy inseparable from wealth inequality.

## How the Industry Works

The real estate industry functions on a fundamental split between **residential** and **commercial** markets, each with distinct financing, operating models, and ownership structures.

### Residential Real Estate: The 30-Year Mortgage

#### Info:

#### An American Anomaly

The 30-year fixed-rate mortgage is a uniquely American product—virtually unknown elsewhere. This government-backed structure transfers all interest rate risk from borrowers to lenders (and ultimately to taxpayers). Private markets would never offer such terms. The entire system depends on Fannie Mae and Freddie Mac, which buy mortgages from lenders and package them for global investors.

The U.S. residential market is structurally unique due to the **30-year fixed-rate mortgage**. In most of the world, mortgages have variable rates or require refinancing every 5-10 years. A German homebuyer faces rate adjustments; a British borrower typically gets a 2-5 year fix. The American 30-year fixed loan is a peculiarly American, government-backed anomaly that transfers interest rate risk entirely from the borrower to the lender—and ultimately to the federal government.

This product exists only because of an elaborate federal infrastructure. Private lenders would never offer 30-year fixed rates on their own: the interest rate risk is too severe. Instead, the system depends on the Government-Sponsored Enterprises (Fannie Mae and Freddie Mac), which buy mortgages from lenders, package them into securities, and sell them to global investors with an implicit (now explicit) government guarantee.

### The Mortgage System: Originate-to-Distribute

The “local bank” rarely holds the mortgage it issues. Instead, the industry operates on an **originate-to-distribute** (OTD) model that evolved from the 1980s onward:

1. **Origination:** A bank or non-bank lender (like Rocket Mortgage, formerly Quicken Loans) underwrites and funds a mortgage to a homebuyer.
2. **Sale:** Within days or weeks, the lender sells the mortgage to a Government-Sponsored Enterprise—primarily **Fannie Mae** or **Freddie Mac**.
3. **Securitization:** The GSEs bundle thousands of these mortgages into **Mortgage-Backed Securities (MBS)**.

4. **Distribution:** These MBS are sold to global investors—pension funds, sovereign wealth funds, insurance companies—who seek safe, steady yields backed by American housing.

This system achieves remarkable liquidity: a borrower in Iowa gets a 30-year fixed loan at rates competitive with Treasury bonds because global capital flows into the U.S. mortgage market. But it also creates critical **agency problems**. When originators don't hold loans, their incentive is volume, not quality. When servicers (who collect payments) have different interests than investors (who own the loans), troubled borrowers may face foreclosure rather than modification. The 2008 crisis exposed these frictions brutally.

### **Ownership vs. Rental**

The homeownership rate in the United States hovers around **65%**, down from its 2004 peak of 69% but still high by international standards. The remaining 35% of households rent, primarily in multifamily buildings but increasingly in single-family homes.

The rental market operates on the **spread**: landlords profit when rents exceed their cost of capital (mortgage payments, property taxes, maintenance, management). Property management has professionalized, with large operators using yield management software to dynamically adjust rents based on occupancy, seasonality, and comparable properties—a practice that has recently drawn antitrust scrutiny.

### **Commercial Real Estate (CRE)**

Commercial real estate—office, retail, industrial, and multifamily buildings—operates on pure financial logic:

- **Net Operating Income (NOI):** Revenue (Rent) minus Operating Expenses.
- **Cap Rate:** The expected rate of return. A building with \$1 million NOI selling at a 5% cap rate is worth \$20 million ( $\$1M / 0.05$ ). Cap rates vary by property type and location: trophy offices in Manhattan command 4% caps; suburban strip malls might trade at 8%.
- **Leases:** Long-term contracts (5–15 years for commercial) with businesses, often with built-in rent escalations tied to inflation or fixed percentages.

The CRE market is dominated by institutional capital: pension funds, insurance companies, sovereign wealth funds, and REITs. Individual investors rarely own office towers directly but can access the asset class through publicly traded REITs or private real estate funds.

### **The REIT Structure**

Congress created **Real Estate Investment Trusts (REITs)** in 1960 to democratize real estate investment—allowing ordinary investors to own shares of income-producing properties the way they own shares of companies.

- **Tax Advantage:** REITs pay **zero corporate income tax** provided they distribute at least **90% of their taxable income** to shareholders as dividends.

- **Requirements:** At least 75% of assets must be real estate; 75% of income must come from rents or mortgage interest.
- **Impact:** This structure turned illiquid buildings into liquid stocks. Today, retail investors can own fractional shares of Manhattan office towers, data centers in Northern Virginia, or warehouses in the Inland Empire. The REIT market capitalization exceeds \$1.3 trillion.

REITs trade like stocks but behave like bonds—their dividends are relatively stable, and their values fluctuate with interest rates. When rates rise, REIT prices typically fall, as their yields become less attractive relative to bonds.

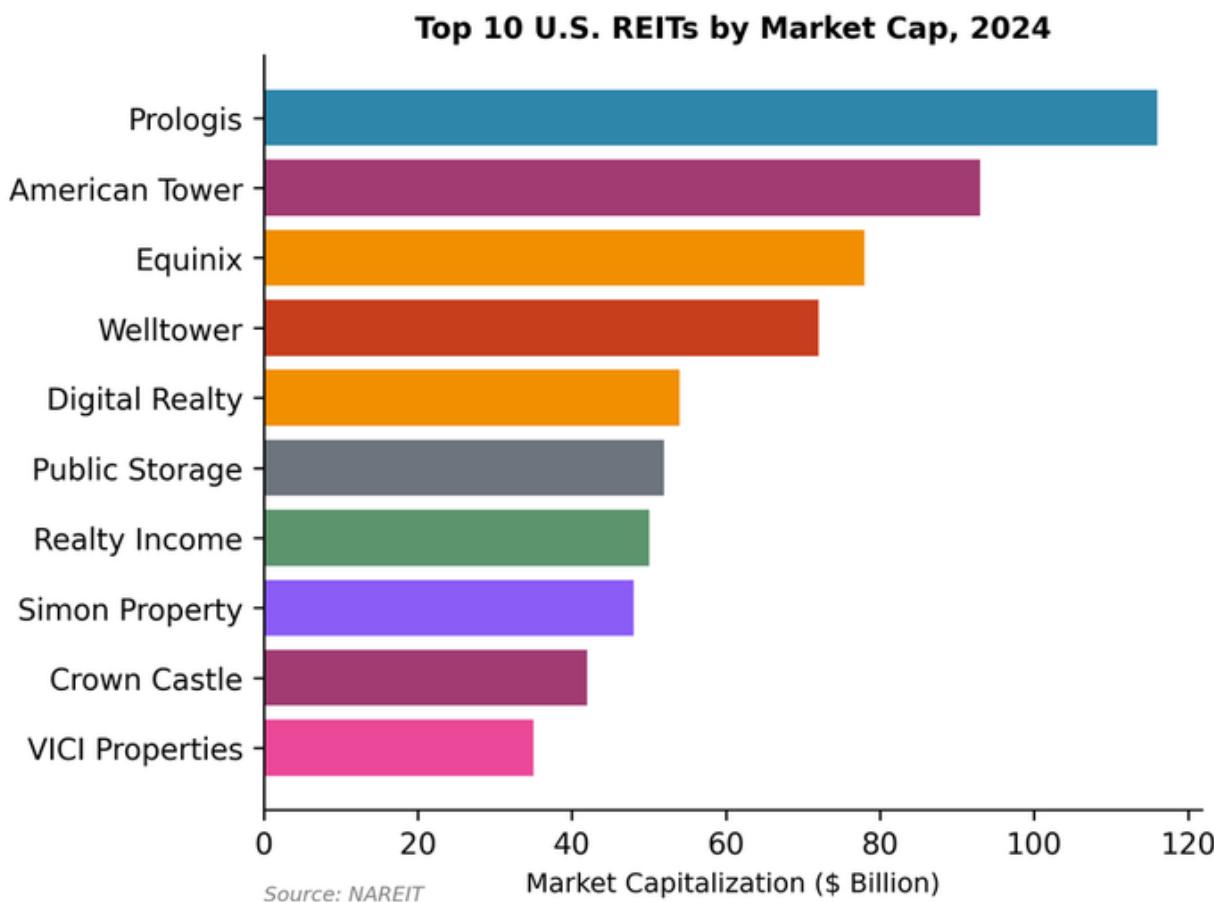


Figure 18: Figure 5.2: Top REITs by market capitalization. Digital infrastructure (data centers, cell towers) now commands higher valuations than traditional property types. Source: NAREIT (2024)

## Industry Structure

The industry divides into those who build, those who own, and those who facilitate transactions. Each segment has distinct economics and market structure.

## Homebuilders: The Manufacturing Wing

Homebuilding has consolidated dramatically. The 2008 crash wiped out smaller builders who lacked access to capital markets, while large public companies like D.R. Horton and Lennar emerged stronger.

- **Market Concentration:** The top 10 homebuilders now control approximately **45% of new home sales**, up from 27% two decades ago.
- **Business Model:** Large builders function like manufacturing operations, not craftsmen. They buy land years in advance, developing “land pipelines” that ensure steady production. They use standardized floor plans, bulk purchasing, and vertical integration (some own mortgage and title companies) to minimize costs.

### Major Homebuilders (2024)

Rank	Company	Revenue	Homes Closed	Headquarters
1	D.R. Horton	\$35B+	roughly 90,000	Arlington, TX
2	Lennar	\$34B	roughly 73,000	Miami, FL
3	NVR	\$10B	roughly 24,000	Reston, VA
4	PulteGroup	\$16B	roughly 28,000	Atlanta, GA
5	Toll Brothers	\$10B	roughly 10,000	Fort Washington, PA

Source: Company annual reports and investor filings, 2023-2024

The industry remains geographically fragmented—homebuilding is fundamentally local, dependent on land entitlements, labor markets, and municipal permitting. A Texas builder may not operate in California, and vice versa. But within regions, consolidation continues.

## Commercial Developers and REITs

Commercial owners are highly specialized. A warehouse operator has nothing in common with a hotel company except that both own buildings.

- **Industrial/Logistics:** **Prologis** dominates, owning nearly 1.2 billion square feet of logistics space globally—roughly 5% of the entire U.S. warehouse market. E-commerce has made Prologis a critical infrastructure provider; Amazon is among its largest tenants.
- **Office:** Fragmented and struggling post-COVID. Major owners include Boston Properties, SL Green (Manhattan-focused), and Brookfield.
- **Retail:** The “retail apocalypse” killed some REITs (CBL, Washington Prime went bankrupt) while leaders like Simon Property Group survived by owning Class A malls.
- **Digital Infrastructure:** **Equinix** (data centers) and **American Tower** (cell towers) now have higher market capitalizations than most traditional real estate companies. They are classified as REITs but function as technology infrastructure.

## Top 10 U.S. Homebuilders by Closings

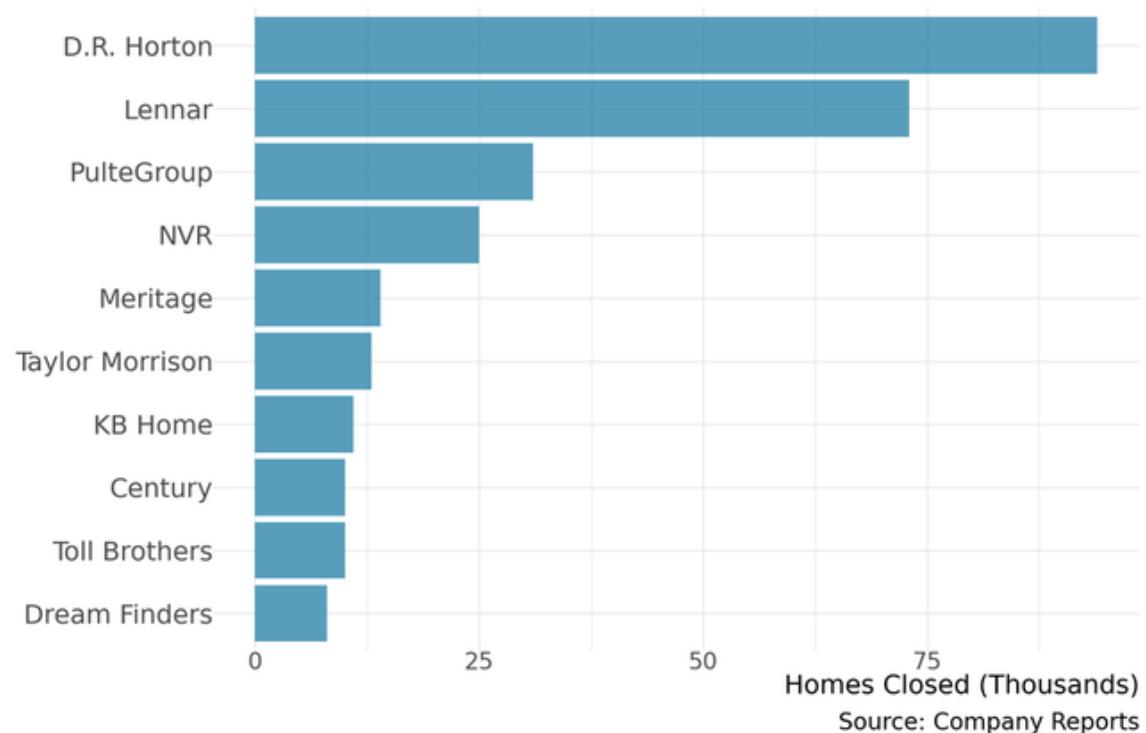


Figure 19: Figure 5.1: Top 10 homebuilders by homes closed. D.R. Horton dominates the market, closing nearly 90,000 homes annually. Source: Company data (2024)

- **Multifamily:** The largest apartment landlords include AvalonBay, Equity Residential, and MAA (Mid-America Apartment Communities, focused on Sunbelt).

## **Brokerages: The Transaction Gatekeepers**

Residential real estate transaction costs in the U.S. are remarkably high—typically 5–6% total commission, split between buyer's and seller's agents. International comparisons suggest 1–2% is achievable. The culprit is the **Multiple Listing Service (MLS)** structure:

- **NAR and MLS:** The National Association of Realtors coordinates local MLSs, which serve as the primary database of homes for sale. Access requires NAR membership and adherence to compensation rules that historically required sellers to offer commissions to buyer's agents.
- **2024 Settlement:** A \$418 million antitrust settlement, effective August 2024, prohibited listing agents from advertising buyer's agent compensation on the MLS and required buyer representation agreements specifying how buyer's agents would be paid. The theory was that “decoupling” would force negotiation and lower commissions. In practice, the impact has been muted: average buyer's agent commissions dropped briefly to 2.36% in Q3 2024 but rebounded to 2.40% by Q1 2025. Sellers' agents continue to communicate commission offers outside the MLS, and most sellers still pay buyer's agent commissions to facilitate sales. The revolution in transaction costs that some predicted has not materialized.

## **Major Residential Brokerages**

- **Anywhere Real Estate:** The conglomerate behind Coldwell Banker, Century 21, Sotheby's International Realty, and Better Homes and Gardens Real Estate.
- **Compass:** Founded in 2012, grew rapidly by recruiting top agents with high commission splits and proprietary technology. Publicly traded but has struggled to achieve profitability.
- **eXp Realty:** A cloud-based brokerage with no physical offices, using a multi-level marketing style agent referral network.
- **Traditional Franchises:** Keller Williams, RE/MAX remain major players.

## **Geographic Distribution**

Real estate value is dictated by the first three rules of the industry: “location, location, location.” But the logic of location varies systematically across markets.

## **The Coastal vs. Interior Divide**

The U.S. housing market is bifurcated by **supply elasticity**—how much new construction responds to rising prices.

**Inelastic Coastal Markets:** In cities like San Francisco, Boston, and New York, a combination of topography (water, mountains) and strict regulation limits supply. When demand rises—tech jobs flood into the Bay Area, finance concentrates in

Manhattan—the housing stock barely grows. The only release valve is price. Median home prices in these markets are **5-10 times** higher than the Midwest median.

Economist Albert Saiz documented that geography sets a ceiling on growth (you can't build on San Francisco Bay), but regulation determines the actual elasticity. The **Wharton Residential Land Use Regulatory Index (WRLURI)** measures restrictiveness; high WRLURI scores correlate strongly with high prices.

**Elastic Interior Markets:** In cities like Houston, Dallas, Phoenix, and Atlanta, land is abundant and regulation looser. When demand rises, developers simply sprawl outward. Prices stay closer to construction costs. Houston has no zoning code at all—an outlier that has kept housing relatively affordable despite strong job growth.

**The Zoning Tax:** Economists Ed Glaeser and Joe Gyourko define this as the gap between the market price of a home and the cost of construction plus land at its unregulated value. In constrained cities, this "tax" represents 50% or more of the home's price—pure regulatory rent captured by existing homeowners.

## The Sunbelt Shift

The dominant geographic trend of the 2020s is migration of population and corporate headquarters to the "Smile States"—the Sunbelt arc from the Carolinas through Texas to Arizona.

- **Winners:** Austin, Phoenix, Raleigh, Nashville, Tampa have transitioned from low-cost destinations to "affordable luxury" markets for knowledge workers fleeing coastal costs.
- **Drivers:** Lower housing costs, lower taxes (no state income tax in Texas and Florida), COVID-era remote work, and business-friendly regulatory environments.
- **Construction Boom:** Texas and Florida now account for a disproportionate share of new home construction, while legacy Northeast metros stagnate.

## The Donut Effect

Post-COVID, the "Donut Effect" describes the hollowing out of dense city centers—particularly Central Business Districts with office towers—and the booming of inner-ring suburbs and exurbs.

- **Office Vacancies:** Downtown San Francisco, Chicago, and Washington have office vacancy rates of 25-35%, crushing property values and municipal tax bases.
- **Suburban Strength:** Single-family home prices in outer suburbs surged as remote workers fled density, then stabilized at elevated levels.

## The Workforce

### Agents and Brokers

There are approximately **1.5 million licensed Realtors** in the United States—more than the combined number of doctors and lawyers.

- **Tournament Market:** The field is extremely stratified. The top 10% of agents earn the vast majority of commissions; the median agent earns under \$50,000 annually and often has a second job.
- **Independent Contractors:** Nearly all agents are classified as independent contractors, meaning they lack employer-provided benefits, job security, and wage protections.
- **Barriers to Entry:** Low—licensing requires a short course and exam. This encourages part-timers and keeps average productivity low.

## Property Management

Behind the passive income of investors is the active labor of property managers.

- **Role:** Management firms handle the “three Ts”: Tenants, Toilets, and Trash. They screen applicants, collect rent, coordinate maintenance, and handle evictions.
- **Fee Structure:** Typically 3–8% of gross rents for residential properties.
- **Technology:** Large multifamily operators now use sophisticated revenue management software (RealPage, Yardi) to set rents dynamically. A 2022 ProPublica investigation alleged these tools facilitate algorithmic collusion, prompting antitrust lawsuits.

## Appraisers, Title Officers, and Escrow

The home purchase transaction requires a small army: - **Appraisers:** Licensed professionals who estimate property value. Required by lenders; their shortage has been a bottleneck during housing booms. - **Title Companies:** Ensure clear ownership and issue title insurance protecting against claims. This is a \$20+ billion industry dominated by Fidelity National Financial and First American. - **Escrow and Closing:** In most states, transactions close through escrow companies or attorneys who hold funds and execute transfers.

## Regulation and Policy

### The Federal Backstop: Fannie Mae and Freddie Mac

**Fannie Mae** (Federal National Mortgage Association) and **Freddie Mac** (Federal Home Loan Mortgage Corporation) effectively nationalize the risk of the U.S. housing market.

- **Scale:** Together they guarantee roughly \$7.5 trillion in mortgages—about half of all outstanding mortgage debt.
- **Conservatorship:** Since September 2008, both GSEs have operated under federal conservatorship. They are technically private corporations but effectively government agencies.
- **Standard Setting:** They establish “conforming loan” standards: maximum loan sizes (currently around \$750,000 in most markets, higher in expensive areas), credit score minimums, debt-to-income ratios. If a bank wants to sell a loan to

Fannie, it must meet Fannie's rules. This makes the GSEs the de facto regulators of mortgage underwriting.

Other federal agencies provide additional support: - **FHA (Federal Housing Administration)**: Insures loans with low down payments (as low as 3.5%), targeting first-time and lower-income buyers. - **VA (Veterans Administration)**: Provides zero-down mortgages to veterans. - **FHFA (Federal Housing Finance Agency)**: The regulator overseeing Fannie, Freddie, and the Federal Home Loan Banks.

## Local Control: Zoning and Land Use

While mortgage finance is federal, construction is intensely local.

- **Euclidean Zoning**: The dominant framework, named after Euclid v. Ambler (1926), separates land uses (residential, commercial, industrial) and limits density.
- **Single-Family Zoning**: In many cities, 70–90% of residential land permits only detached single-family homes—no duplexes, no apartments. This creates artificial scarcity.
- **Height Limits, Setbacks, Parking Minimums**: Additional regulations that limit density and raise construction costs.

The cumulative effect is to make housing supply inelastic in precisely the places where demand is highest. Hsieh and Moretti estimate that housing constraints in San Francisco, San Jose, and New York alone lowered aggregate U.S. GDP growth by up to **36%** between 1964 and 2009 by preventing workers from moving to high-productivity cities.

## Fair Housing

The Fair Housing Act of 1968 prohibits discrimination in housing based on race, color, national origin, religion, sex, familial status, and disability.

- **Legacy of Redlining**: Federal mortgage programs from the 1930s–1960s explicitly refused to insure mortgages in Black neighborhoods ("redlined" areas). Although illegal since 1968, the wealth gap persists: median white household wealth is roughly 8–10 times median Black household wealth, largely due to differential homeownership and home appreciation.
- **Ongoing Discrimination**: Audit studies continue to find discrimination against Black and Hispanic renters and buyers—shown fewer properties, quoted higher prices, steered to certain neighborhoods.

## Trade Associations and Lobbying

Real estate is among the most politically active sectors in America. Property rights and development rules are decided at every level of government, making lobbying essential.

## Major Trade Associations

Association	Members	Focus
<b>National Association of Realtors (NAR)</b>	1.5 million agents	Homeownership promotion, MLS control, licensing standards
<b>Mortgage Bankers Association (MBA)</b>	Lenders and servicers	Mortgage finance policy, GSE reform
<b>National Association of Home Builders (NAHB)</b>	Builders and developers	Building codes, land use, labor
<b>Urban Land Institute (ULI)</b>	Developers, investors	Research, best practices in development
<b>NAREIT</b>	REITs	Tax policy, REIT structure preservation

Source: Trade association websites and public filings, 2024

## Lobbying Activity

- **NAR:** Consistently among the top five lobbying spenders in Washington. Key priorities include preserving the mortgage interest deduction, protecting the MLS system, and opposing regulations that might reduce transaction volume.
- **NAHB:** Fights building code expansions, environmental regulations, and labor rules that increase construction costs.
- **Financial Industry:** Banks, mortgage servicers, and GSEs lobby intensely on mortgage regulation, particularly post-2008 rules under Dodd-Frank.

At the local level, homeowner associations, neighborhood groups, and NIMBY (“Not In My Backyard”) organizations wield enormous influence over zoning and development decisions—often more than formal industry lobbies.

## When Housing Prices Collapse: The 2006-2012 Crisis

Real estate's role in household wealth makes housing price collapses uniquely destructive. Unlike stock market crashes, which affect the minority of Americans with substantial equity holdings, housing busts hit the middle class directly. The 2006-2012 housing crisis demonstrated how a shock originating in real estate could propagate through household balance sheets, the financial system, and the broader economy.

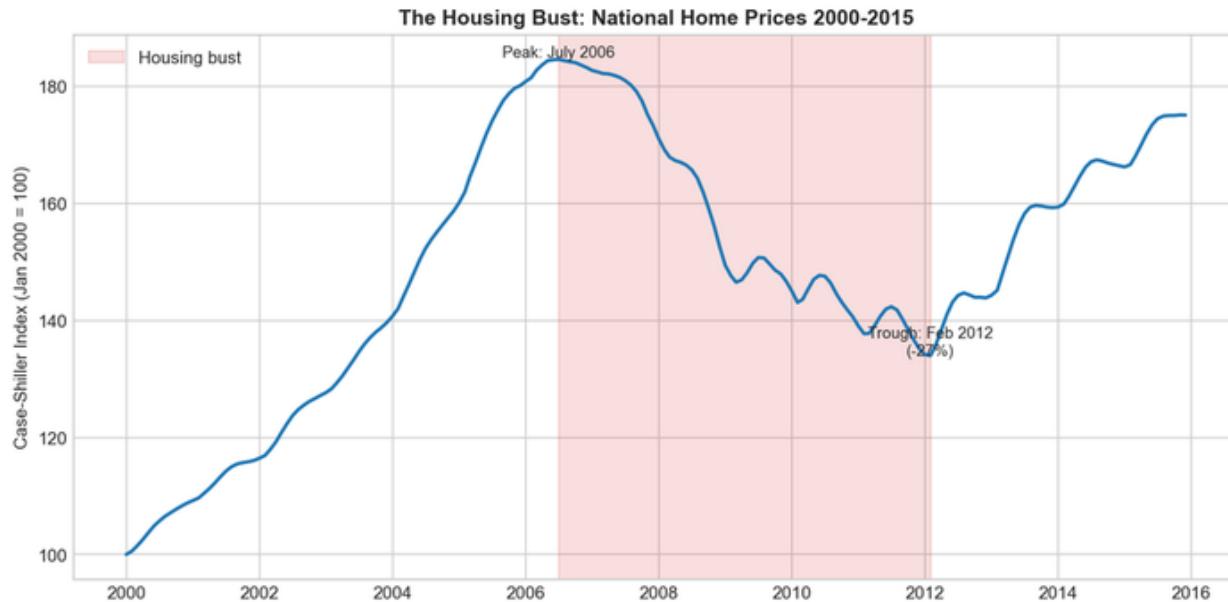


Figure 20: Figure 5.4: The Case-Shiller Home Price Index fell 27% nationally from its 2006 peak, with some markets (Phoenix, Las Vegas, Miami) experiencing declines of 50-60%. Source: S&P/Case-Shiller

## The Boom and Bust

The early 2000s saw the largest housing boom in American history. The Case-Shiller National Home Price Index roughly doubled between 2000 and 2006, fueled by low interest rates, loosened lending standards, and speculative fervor. Subprime mortgages—loans to borrowers with weak credit—grew from a marginal product to 20% of originations. “No-doc” loans required no income verification. Option ARMs let borrowers pay less than the interest due, with unpaid interest added to principal.

The boom masked fundamental mispricing. When prices stopped rising in 2006, the entire structure unraveled. Borrowers who had counted on refinancing or selling at higher prices found themselves underwater—owing more than their homes were worth. Default rates surged. By 2009, roughly one in four mortgages was underwater.

## Geographic Concentration

The crash devastated some regions far more than others:

**Sand States (Arizona, California, Florida, Nevada):** Markets that had boomed the most crashed the hardest. Las Vegas prices fell 62% peak-to-trough. Phoenix fell 56%. Miami fell 51%. Entire subdivisions stood half-built and abandoned. “Ghost neighborhoods” dotted the Sunbelt.

**Industrial Midwest:** Ohio, Michigan, and Indiana, already reeling from manufacturing decline, faced foreclosure waves that accelerated population loss from struggling cities.

**Texas Exception:** Texas experienced only a 6% price decline—its elastic housing

supply had prevented a boom, and the absence of a boom meant no bust. Strict home equity lending laws also limited the use of homes as ATMs.

**Northeast Resilience:** Supply-constrained markets like Boston and New York fell less (15-20%) and recovered faster, as fundamental demand remained strong.

## The Wealth Effect Transmission

The housing crash transmitted to the broader economy primarily through the **wealth effect** on household balance sheets:

- **\$8 trillion in housing wealth destroyed:** American homeowners collectively lost roughly \$8 trillion in home equity between 2006 and 2009—equivalent to half of annual GDP.
- **Consumption collapse:** Households that felt poorer spent less. Economists Atif Mian and Amir Sufi found that zip codes with larger house price declines experienced larger drops in consumer spending, particularly on durables like automobiles and appliances.
- **Construction employment:** Residential construction employment fell from 3.5 million (2006) to 2 million (2011). Construction workers, concentrated in the hardest-hit markets, faced mass unemployment.

## Financial Contagion

The housing shock became a financial crisis through the securitization chain examined in Chapter 18:

1. **Mortgage defaults** caused losses on mortgage-backed securities
2. **MBS holders** (banks, investment funds, insurance companies) faced write-downs
3. **Uncertainty** about who held toxic assets froze interbank lending
4. **Credit contraction** spread from housing to the entire economy

The result was the deepest recession since the 1930s. Unemployment peaked at 10%. The Federal Reserve cut interest rates to zero and launched unprecedented programs to support credit markets. The federal government bailed out Fannie Mae, Freddie Mac, AIG, and the banking system.

### □ Warning:

## The 2008 Collapse by the Numbers

- Home prices fell 33% nationally (62% in Las Vegas, 56% in Phoenix)
- \$8 trillion in housing wealth destroyed
- 10 million foreclosures
- Construction employment: 3.5M (2006) → 2M (2011)
- Unemployment peaked at 10%

## The Long Recovery

Housing prices did not return to 2006 levels until 2016-2018 in most markets—a decade of lost appreciation. For homeowners who bought at the peak, it meant a decade underwater. For those who lost homes to foreclosure, it meant destroyed credit and lasting financial trauma.

The crisis demonstrated several principles of shock transmission:

- **Leverage amplifies:** Households with 80-95% loan-to-value ratios faced devastating wealth destruction from modest price declines
- **Geographic concentration matters:** The Sun States bore disproportionate pain, creating localized depressions within a national recession
- **Financial linkages spread the impact:** Securitization meant that mortgage losses in Phoenix affected pension funds in Norway
- **Recovery is slow:** Unlike stock market crashes that often reverse within years, housing busts take a decade or more to heal

The scars remain visible in policy—the conservatorship of Fannie and Freddie, the post-crisis mortgage regulations, and the caution that kept housing construction depressed for years, contributing to today's affordability crisis.

## Recent Trends

### 1. The Affordability Crisis and “Lock-In” Effect

The post-COVID era created a unique affordability crisis:

- **Price Surge:** Home prices rose roughly 40% from 2020 to 2022, driven by low rates, work-from-home demand, and constrained supply.
- **Rate Shock:** Mortgage rates jumped from 3% to 7%+ in 2022-2023, doubling monthly payments for new buyers.
- **Lock-In Effect:** Homeowners who secured 3% mortgages in 2020-2021 are unwilling to sell, as moving means taking on a 7% mortgage. This has strangled existing home supply, forcing buyers into the new construction market.
- **Cost Burden:** Over half of U.S. renters are now “cost-burdened” (spending more than 30% of income on rent).

### 2. Institutionalization of Single-Family Rental

Historically, rental homes were owned by “mom and pop” landlords. Post-2008, Wall Street entered:

- **The Players:** Firms like **Invitation Homes** (spun off from Blackstone) and **American Homes 4 Rent** bought tens of thousands of distressed homes after the crisis.
- **Current Scale:** Institutional investors own roughly 2-3% of the national single-family stock but are market-makers in specific Sunbelt submarkets (Phoenix, Atlanta, Tampa), where they may own 5-10% of homes.

## **U.S. Real House Prices, 2000-2024**

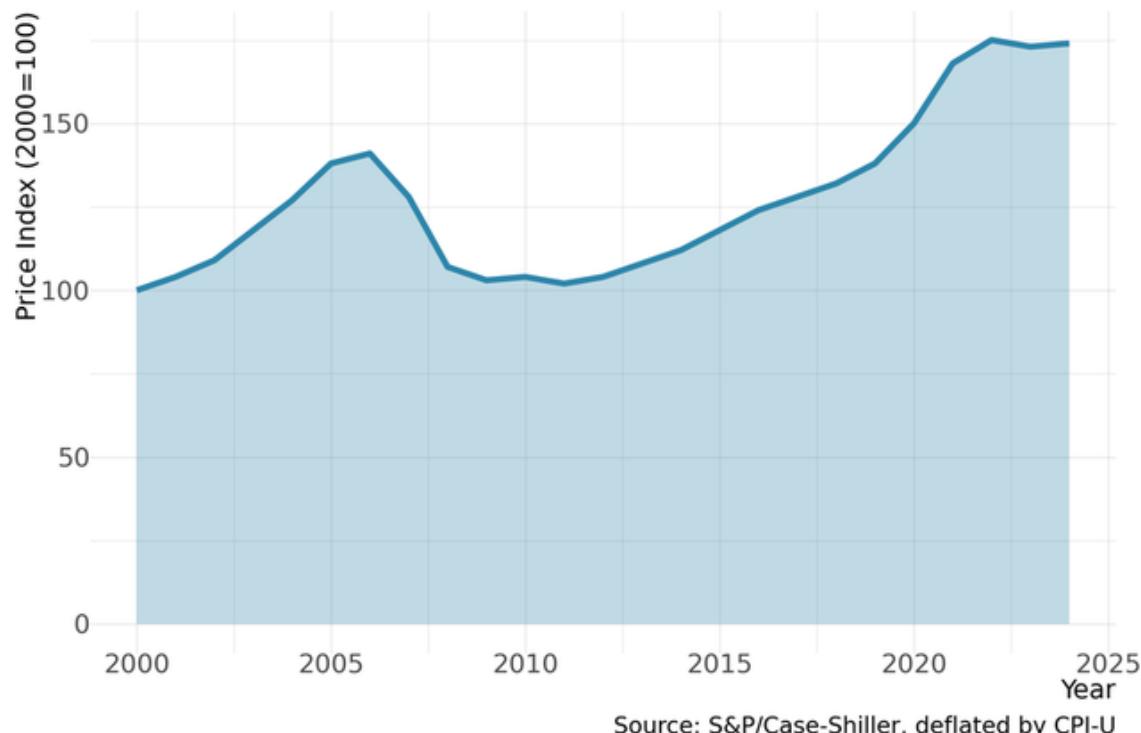


Figure 21: Figure 5.3: Case-Shiller Home Price Index, 2000-2024. Prices surged 40% during the post-COVID boom, then stabilized at elevated levels as mortgage rates rose. Source: S&P/Case-Shiller (2024)

- **Business Model:** Professional management, dynamic pricing, standardized renovation, and economies of scale in maintenance and leasing.

### 3. PropTech and the “Super App” Dream

Companies like **Zillow** are attempting to build a “housing super app” integrating search, touring, financing, and closing.

- **Zillow’s Pivot:** After its \$500+ million iBuying failure (Zillow Offers, shut down in 2021), Zillow pivoted back to its core advertising model while building Zillow Home Loans.
- **iBuying’s Limits:** The failure demonstrated that algorithmically pricing homes is harder than tech companies assumed—real estate lacks the standardization of stocks or even used cars.
- **Opendoor:** The pure-play iBuyer continues operating but has struggled to achieve profitability, narrowing its geographic footprint.

### 4. The Office Apocalypse

Remote work has cratered demand for office space in many markets:

- **Vacancy Rates:** Major CBDs have vacancy rates of 20-35%, with older “Class B” buildings hit hardest.
- **Valuation Collapse:** Some office buildings have sold for 50-70% below their pre-COVID values.
- **Conversion Challenge:** Converting offices to apartments is technically difficult (floor plates, windows, plumbing) and financially marginal without subsidies.
- **Bifurcation:** Trophy buildings with amenities retain tenants; commodity space faces obsolescence.

### 5. The Property Insurance Crisis

A less-discussed threat to housing markets is the emerging insurance crisis. Property insurance is the invisible prerequisite for mortgage finance: no insurance, no mortgage; no mortgage, no sale at conventional prices.

- **Climate Losses:** Insured losses from natural disasters have risen from roughly \$10 billion annually in the 1990s to \$50-100 billion annually in the 2020s. Hurricanes, wildfires, and severe storms are straining the insurance model.
- **Insurer Retreat:** Major insurers are withdrawing from high-risk markets. State Farm and Allstate have stopped writing new homeowner policies in California. In Florida, several regional insurers have gone insolvent, and the state-backed Citizens Property Insurance has become the largest insurer by default.
- **The Mortgage-Insurance Link:** Fannie Mae and Freddie Mac require borrowers to maintain property insurance. If private insurance becomes unavailable or unaffordable, homeowners face a choice between sky-high premiums, inadequate state-backed plans, or losing access to conventional mortgages entirely.
- **Value Implications:** In areas where insurance costs have doubled or tripled, home values are effectively capped by what buyers can afford in total housing

costs (mortgage + insurance + taxes). Some coastal Florida properties have seen 20-30% value declines attributable primarily to insurance cost increases.

The insurance crisis intersects with the housing crisis: if climate risk makes coastal and wildfire-prone areas uninsurable, the housing stock in those areas loses significant value, potentially triggering localized housing busts. This represents a slow-motion version of the 2008 geographic concentration—except instead of speculative excess, the underlying cause is physical climate risk. See Chapter 8 for more on the insurance industry's challenges.

## 6. The Rent Control Debate Returns

As affordability has worsened, rent control has resurfaced as a policy option.

- **Evidence:** Research by Diamond, McQuade, and Qian on San Francisco found that rent control helped incumbent tenants stay in place but reduced rental supply by 15% and increased market rents by 65%—harming future renters.
- **Political Appeal:** Despite economist skepticism, rent control remains popular because it delivers visible benefits to current renters while dispersing costs across future renters and property owners.

## Firm Profiles

### Blackstone Real Estate

**Quick Facts - Headquarters:** New York, NY - **Type:** Private Equity / Alternative Asset Manager - **Real Estate Equity AUM:** \$330+ billion - **Total AUM:** \$1+ trillion

Blackstone is the world's largest real estate owner and the "smart money" bellwether for the sector. They treat real estate strictly as a tradable financial asset class, applying private equity's "buy it, fix it, sell it" playbook. Their portfolio shifts aggressively to follow macro themes: they exited shopping malls early (anticipating e-commerce disruption), piled into logistics warehouses (betting on Amazon and same-day delivery), and bought student housing and single-family rentals (betting on housing shortages and Millennial renting).

Blackstone's non-traded REIT, **BREIT**, accumulated over \$70 billion in assets before facing significant redemption requests in 2022-2023—a reminder that "open-ended" real estate funds face liquidity mismatches when investors want out. The firm remains bullish on real estate's role in institutional portfolios but has evolved from pure opportunistic investing toward longer-duration "core plus" holds.

### Fannie Mae (Federal National Mortgage Association)

**Quick Facts - Headquarters:** Washington, D.C. - **Status:** Government-Sponsored Enterprise in Conservatorship - **Book of Business:** roughly \$4.2 trillion - **Net Income:** roughly \$17 billion annually

Fannie Mae does not issue mortgages; it buys them. It is the invisible engine that allows a community bank in Iowa to lend \$400,000 for 30 years at a fixed rate—the bank sells the loan to Fannie within weeks, freeing up capital for the next mortgage. By guaranteeing principal and interest on trillions of dollars of Mortgage-Backed Securities, Fannie Mae attracts global capital to U.S. housing at rates competitive with Treasury bonds.

Although highly profitable, Fannie Mae remains under government conservatorship since September 2008, sweeping nearly all profits to the Treasury. Shareholders (including hedge funds who bought stock hoping for release from conservatorship) have seen no dividends for 15+ years. The arrangement effectively socializes the catastrophic tail risk of the American housing market while privatizing nothing. Whether to release the GSEs from conservatorship remains a perennial policy debate with no resolution in sight.

## D.R. Horton

**Quick Facts - Headquarters:** Arlington, TX - **Founded:** 1978 - **Revenue:** roughly \$35+ billion - **Homes Closed (2024):** roughly 90,000 - **Employees:** roughly 13,000

D.R. Horton calls itself “America’s Builder,” and the title is earned through sheer volume. Founded by Donald R. Horton with a single lot in Fort Worth, the company grew by acquiring smaller builders and perfecting a high-volume, low-cost production model. They build in 33 states with a focus on the entry-level buyer—first-time homebuyers and move-up families seeking value over customization.

The company operates less like a traditional construction firm and more like a manufacturing operation. Standardized floor plans minimize design costs. Bulk purchasing of lumber, appliances, and finishes provides leverage with suppliers. Vertical integration into mortgage (DHI Mortgage) and title services captures additional margin. The model works in boom times (volume multiplies) and busts (they can cut land purchases and survive on lower volumes)—D.R. Horton emerged from 2008 stronger than almost any competitor. They are, in effect, the Walmart of homebuilding: winning on cost, scale, and logistics rather than luxury or craft.

## Data Sources and Further Reading

### Key Data Sources

- **S&P/Case-Shiller Home Price Indices:** The gold standard for tracking repeated-sales housing prices; available nationally and for 20 metro areas.
- **FHFA House Price Index:** Based on GSE-backed mortgages; broader geographic coverage than Case-Shiller.
- **U.S. Census Bureau Housing Vacancy Survey (HVS):** Homeownership rates and vacancy statistics.
- **American Community Survey (ACS):** Housing costs, tenure, and characteristics.

- **Zillow Research:** High-frequency, granular data on rents and list prices at ZIP code level.
- **CoStar:** The Bloomberg of commercial real estate; primary source for office, retail, and industrial vacancy and rent data (subscription required).
- **NAREIT:** Data on publicly traded REIT performance and market capitalization.
- **Mortgage Bankers Association (MBA):** Origination volume, delinquency rates, refinancing activity.

## Further Reading

- **Glaeser, Edward L. and Joseph Gyourko.** “The Economic Implications of Housing Supply.” *Journal of Economic Perspectives* 32, no. 1 (2018): 3-30. [The definitive overview of supply constraints and the “zoning tax.”]
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- **Saiz, Albert.** “The Geographic Determinants of Housing Supply.” *Quarterly Journal of Economics* 125, no. 3 (2010): 1253-1296. [Seminal paper on topography vs. regulation.]
- **Diamond, Rebecca, Timothy McQuade, and Franklin Qian.** “The Effects of Rent Control Expansion on Tenants, Landlords, and Inequality.” *American Economic Review* 109, no. 9 (2019): 3365-94. [The definitive study on rent control’s tradeoffs.]
- **Desmond, Matthew.** *Evicted: Poverty and Profit in the American City*. Crown, 2016. [Pulitzer Prize-winning account of the rental affordability crisis.]
- **Green, Richard K. and Susan M. Wachter.** “The American Mortgage in Historical and International Context.” *Journal of Economic Perspectives* 19, no. 4 (2005): 93-114. [Explains why the 30-year fixed mortgage is uniquely American.]

## Exercises

### Review Questions

1. The 30-year fixed-rate mortgage is described as “a uniquely American, government-backed anomaly.” Explain why private lenders would never offer this product on their own. What roles do Fannie Mae, Freddie Mac, and the originate-to-distribute model play in making it possible? What risks does this system transfer to taxpayers?
2. The chapter contrasts “inelastic coastal markets” (San Francisco, New York, Boston) with “elastic interior markets” (Houston, Dallas, Phoenix). Using the concepts of supply elasticity and the Wharton Residential Land Use Regulatory Index, explain why a tech hiring boom in San Francisco raises housing prices while a similar boom in Houston primarily increases housing construction.
3. Hsieh and Moretti estimate that housing constraints in San Francisco, San Jose, and New York lowered aggregate U.S. GDP growth by up to 36% between 1964

and 2009. Through what mechanism does restricting housing construction in high-productivity cities reduce national economic output? Why don't workers simply move to where they can afford housing?

4. The 2024 NAR antitrust settlement prohibited listing agents from advertising buyer's agent compensation on the MLS. Yet average buyer's agent commissions dropped only briefly (from roughly 2.5% to 2.36%) before rebounding to 2.40%. Why has the expected "revolution in transaction costs" not materialized? What structural features of the brokerage industry resist commission reduction?
5. During the 2006–2012 housing crisis, Las Vegas prices fell 62%, Phoenix fell 56%, and Miami fell 51%, while Texas experienced only a 6% decline. The chapter attributes Texas's resilience to its elastic housing supply and strict home equity lending laws. Explain how the absence of a boom prevented a bust, and how lending regulations limited household leverage.
6. The chapter describes a post-COVID "lock-in effect": homeowners who secured 3% mortgages in 2020–2021 are unwilling to sell because moving means taking on a 7% mortgage. What are the consequences of this lock-in for existing home supply, housing market liquidity, labor mobility, and new construction?
7. Diamond, McQuade, and Qian found that San Francisco rent control reduced rental supply by 15% and increased market rents for non-controlled units by 65%. Explain the mechanism by which protecting incumbent tenants can raise rents for everyone else. Why does rent control remain politically popular despite this evidence?

## Data Exercises

8. Go to FRED ([fred.stlouisfed.org](http://fred.stlouisfed.org)) and pull the Case-Shiller National Home Price Index (series "CSUSHPIA") and a metro-level index for a city of your choice (e.g., "SFXRSA" for San Francisco, "PHXRSA" for Phoenix, "DAXRSA" for Dallas). Plot both from 2000 to the present. Did your metro experience a larger or smaller boom-bust cycle than the nation? How does this relate to the supply elasticity framework in the chapter?
9. Using the Census Bureau's American Community Survey via [data.census.gov](http://data.census.gov), find the homeownership rate, median gross rent, and median home value for two metropolitan areas—one coastal and one interior. Calculate the price-to-income ratio (median home value divided by median household income) for each. How large is the gap? What does this reveal about the "zoning tax" described by Glaeser and Gyourko?
10. Visit Zillow Research ([zillow.com/research/data/](http://zillow.com/research/data/)) and download the Zillow Observed Rent Index (ZORI) for three Sunbelt metros (e.g., Austin, Phoenix, Tampa) and three legacy metros (e.g., New York, Chicago, San Francisco). Compare rent growth since January 2020. Do the trajectories support the chapter's description of the Sunbelt migration shift and the "donut effect"?

## **Deeper Investigation**

11. Research the emerging property insurance crisis in either Florida or California. How have rising climate-related losses affected insurance availability and premiums? What happens to housing markets when private insurers withdraw—as State Farm and Allstate have done in California? Analyze the connection between insurance availability, mortgage finance (Fannie and Freddie require insurance), and home values. Assess whether insurance-driven value declines could trigger a localized housing bust, and compare the transmission mechanism to the 2008 crisis described in the chapter.

# 6. Healthcare

An MRI of your knee costs \$3,000 in the United States. The same scan, on the same machine, costs \$300 in Japan. That tenfold price gap for an identical service captures everything strange about American healthcare.

Americans spend more on healthcare than on anything else except housing: nearly \$4.5 trillion in 2022, or 17% of GDP. More than 20 million people work in healthcare and social assistance, making it the largest private-sector employer in the country. By any measure, this is the largest healthcare system in the world.

Yet the money does not buy better outcomes. Americans die younger than citizens of peer countries. Infant mortality runs higher. Chronic disease runs rampant. The dollars flow through a byzantine maze of hospitals, insurers, pharmaceutical companies, and physician practices—each extracting value, each adding complexity.

The core problem is structural. When you visit a doctor, three parties sit at the table: you receive the care, an insurer pays the bill, and the physician decides what happens. None of the three faces the full consequences of their choices. This three-way split—patient, payer, provider—drives the economics of American healthcare.

## Overview

### Info:

#### **Healthcare's Unique Structure**

In healthcare, the person receiving care (patient) differs from the person paying (insurer/employer) and the person deciding treatment (physician). This three-way split creates incentive problems that shape much of healthcare economics—and helps explain why the US spends nearly twice as much as peer countries without better outcomes.

## Size and Scope

- **National health expenditure (2022):** \$4.5 trillion
- **Share of GDP:** 17.3%
- **Employment:** 20.5 million (healthcare and social assistance)
- **Share of total employment:** 13%
- **Establishments:** Over 900,000 healthcare establishments

Healthcare spending has outpaced economic growth for decades. In 1960, healthcare claimed just 5% of GDP; by 1980, 9%; by 2000, 13%; today, nearly 18%. An aging population, technological advances, rising incomes, and perverse payment incentives all fuel this growth.

## Key Subsectors

The healthcare sector divides into several distinct segments, each with its own business logic:

Subsector	Spending (2022)	Share
Hospital care	\$1.35 trillion	30%
Physician and clinical services	\$885 billion	20%
Prescription drugs	\$405 billion	9%
Nursing care and continuing care	\$215 billion	5%
Dental services	\$165 billion	4%
Home health care	\$130 billion	3%
Other professional services	\$130 billion	3%
Medical devices and equipment	\$100 billion	2%
Government administration	\$65 billion	1%
Other	\$1 trillion+	23%

Source: CMS National Health Expenditure Accounts

## How the Industry Works

### □ Info:

#### **The Three-Party Problem**

Unlike most markets, healthcare separates the consumer (patient), the payer (insurer or government), and the provider (hospital or physician). This three-party structure breaks normal price signals: patients rarely know costs upfront, providers bill insurers rather than patients, and insurers negotiate rates invisible to consumers.

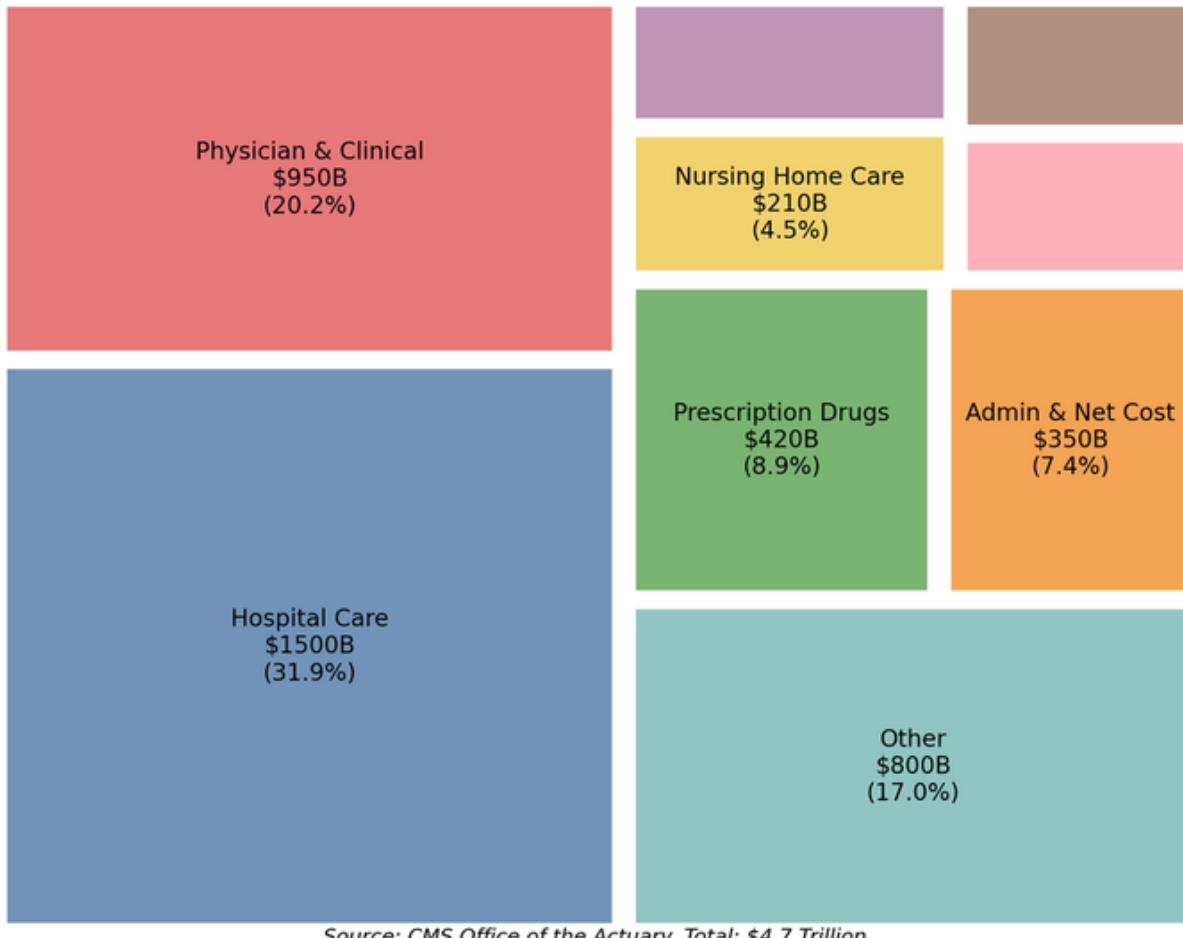
## Revenue Streams: Where Does the Money Come From?

Healthcare spending flows through four main channels:

### **1. Private health insurance (30%)**

Most working-age Americans get health insurance through their employers. Employers contract with insurers (UnitedHealth, Anthem, Cigna, Aetna, Humana, and others) who negotiate rates with healthcare providers. The employer typically pays most of the premium, with employees contributing through payroll deductions.

## National Health Expenditures by Category (2023 Est.)



Source: CMS Office of the Actuary. Total: \$4.7 Trillion.

Figure 22: Figure 6.1: Healthcare spending by category. Hospital care dominates, followed by physician services and prescription drugs. Source: CMS NHE (2022)

### **Healthcare Spending as Share of U.S. GDP**

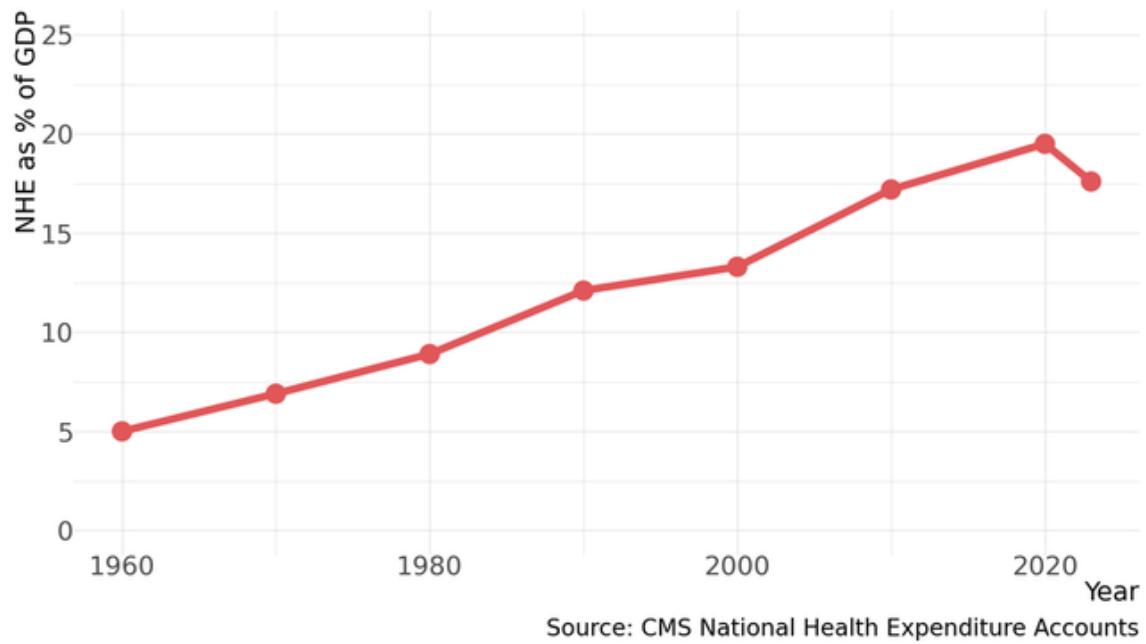


Figure 23: Figure 6.2: Healthcare spending as share of GDP, 1960-2023. Healthcare has grown from 5% to nearly 18% of the economy over six decades. Source: CMS NHE

Employer-sponsored insurance covers about 155 million Americans. The average annual premium for family coverage is over \$23,000, with employers paying roughly 73% and employees 27%.

## **2. Medicare (21%)**

The federal Medicare program covers Americans over 65 and certain disabled individuals—about 65 million people. Medicare is funded through payroll taxes (the 2.9% Medicare tax split between employers and employees), general federal revenues, and beneficiary premiums.

Medicare operates through several parts: - Part A (hospital insurance): covers in-patient hospital stays - Part B (medical insurance): covers outpatient services and physician visits - Part C (Medicare Advantage): private insurance plans that cover Parts A and B - Part D (prescription drugs): covers outpatient medications

## **3. Medicaid (18%)**

Medicaid is a joint federal-state program covering low-income Americans—about 85 million people. The federal government sets minimum requirements and provides matching funds; states administer their own programs with considerable variation in eligibility and benefits.

## **4. Out-of-pocket (10%)**

Patients pay directly for some services—deductibles, copays, services not covered by insurance, and care for the uninsured. Out-of-pocket spending has declined as a share of total spending over time as insurance coverage has expanded.

## **5. Other (21%)**

Other payers include the Veterans Administration, workers' compensation, charitable care, and other government programs.

## **Cost Structure: Where Does the Money Go?**

Healthcare providers face several major cost categories:

### **Labor (50-60% of hospital costs)**

Healthcare is labor-intensive. Hospitals employ nurses, physicians, technicians, administrators, and support staff. Nursing in particular is a major cost center—the United States has about 4.5 million registered nurses.

### **Supplies and drugs (15-20%)**

Medical supplies, pharmaceuticals, and equipment represent significant costs, particularly for hospitals performing complex procedures.

### **Facilities and capital (10-15%)**

Healthcare facilities require significant capital investment in buildings and equipment. Medical imaging equipment (MRI, CT scanners), surgical suites, and hospital beds all require substantial upfront investment.

### **Administration (15-25%)**

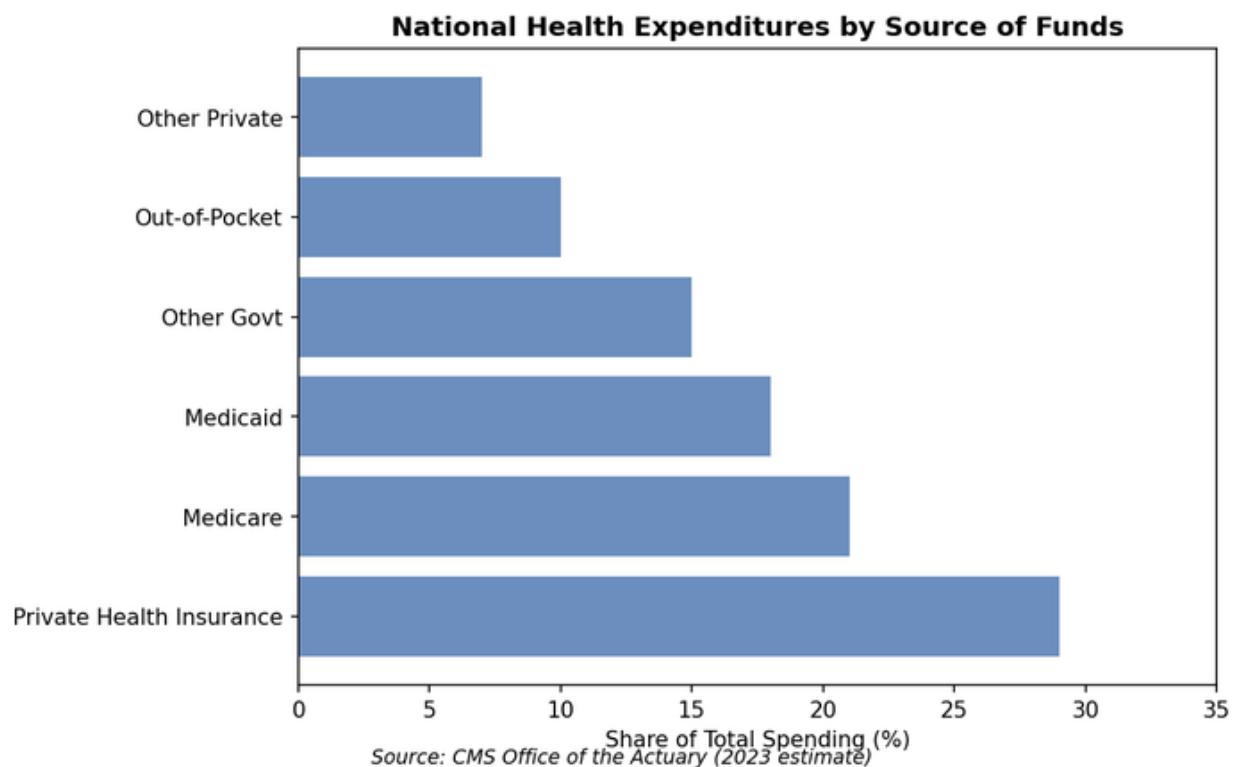


Figure 24: Figure 6.3: Who pays for healthcare. Private insurance, Medicare, and Medicaid each cover roughly 20-30% of spending, with out-of-pocket and other sources making up the rest. Source: CMS NHE (2022)

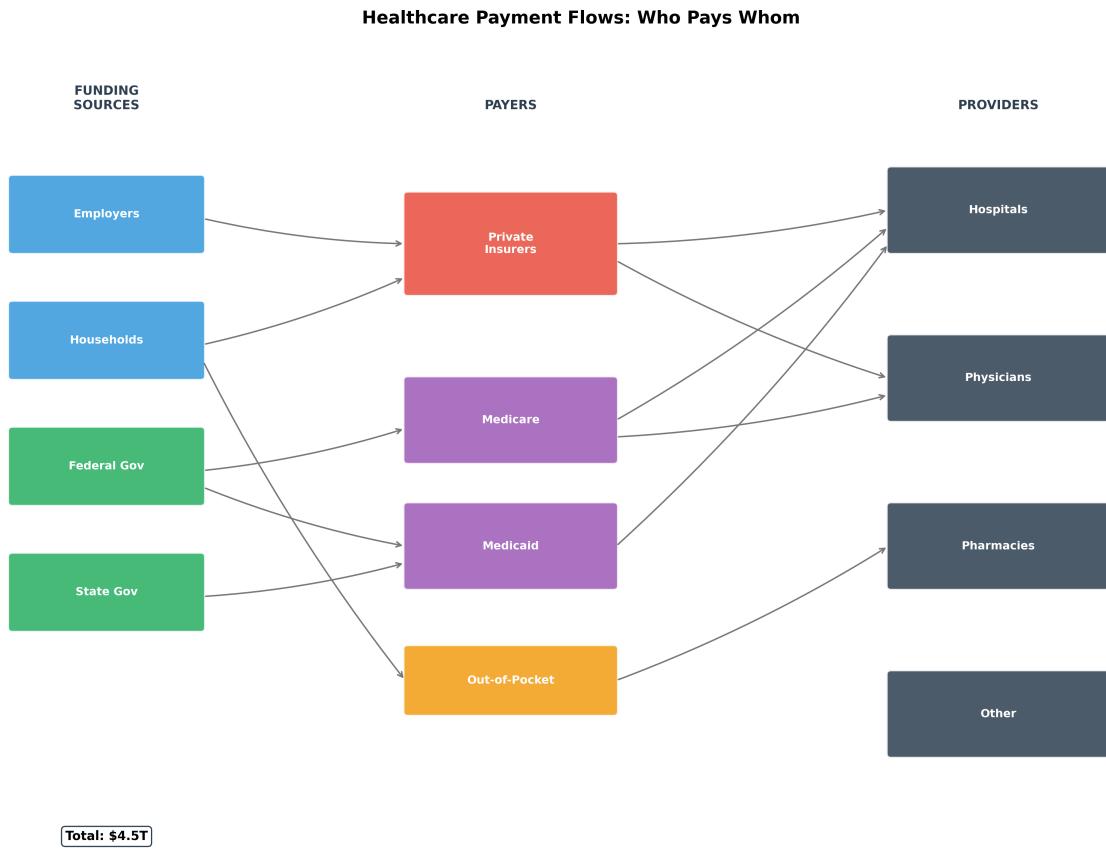


Figure 25: Figure 6.4: Healthcare payment flows: who pays whom. Money flows from employers and households through insurers (private, Medicare, Medicaid) to providers (hospitals, physicians, pharmacies). The complexity of these flows drives significant administrative costs. Source: CMS NHE

The complexity of the American payment system creates substantial administrative costs. Providers must bill multiple insurers with different rules; insurers must process claims and manage networks. Estimates suggest administrative costs consume 15-30% of total healthcare spending.

## **Business Models**

### **Fee-for-service (traditional)**

Historically, most American healthcare operated on fee-for-service: providers bill for each service rendered. This model creates incentives to provide more services, potentially leading to overutilization.

### **Capitation and managed care**

Under capitation, providers receive a fixed payment per patient per month, regardless of services used. This shifts financial risk to providers and creates incentives to limit unnecessary care. Health maintenance organizations (HMOs) popularized this model in the 1990s.

### **Value-based care (emerging)**

Newer payment models tie reimbursement to quality metrics and outcomes rather than volume. Accountable Care Organizations (ACOs) under Medicare exemplify this approach.

## **Industry Structure**

### **Hospitals**

The hospital sector includes roughly 6,100 hospitals in the United States:

- **Community hospitals:** roughly 5,100 (non-federal, short-term general hospitals)
- **Federal hospitals:** roughly 200 (VA, military, Indian Health Service)
- **Psychiatric hospitals:** roughly 400
- **Long-term care hospitals:** roughly 350

### **Ownership**

- **Non-profit:** 58% of community hospitals
- **For-profit:** 24% of community hospitals
- **Government (state/local):** 18% of community hospitals

### **Concentration**

Hospital markets have consolidated significantly over the past two decades. The largest health systems now operate dozens or hundreds of hospitals across multiple states.

System	Hospitals	Beds	Revenue	Headquarters
HCA Healthcare	182	47,000	\$60B	Nashville, TN
CommonSpirit Health	140	25,000	\$35B	Chicago, IL
Ascension	139	22,000	\$28B	St. Louis, MO
Trinity Health	88	14,000	\$21B	Livonia, MI
Providence	52	12,000	\$28B	Renton, WA

Source: American Hospital Association and company filings, 2023

Most hospital markets are highly concentrated. A typical metropolitan area has 2-4 major hospital systems competing for patients and contracts with insurers.

## **Health Insurance**

The health insurance market divides into several segments:

### **Employer-sponsored insurance**

The largest segment by enrollment. Major national carriers include: - UnitedHealth Group (largest by revenue, roughly \$370B) - Elevance Health (formerly Anthem) - Cigna - Aetna (owned by CVS Health) - Humana

### **Medicare Advantage**

Private insurers contract with Medicare to provide Part C coverage. This market has grown rapidly; about 50% of Medicare beneficiaries now choose Medicare Advantage plans. UnitedHealth and Humana dominate this segment.

### **Individual market**

The Affordable Care Act created exchanges for individual coverage. About 16 million people purchase coverage through these exchanges, often with subsidies.

### **Medicaid managed care**

States increasingly contract with private insurers to manage Medicaid benefits. Centene and Molina Healthcare specialize in this market.

## **Pharmaceuticals**

The pharmaceutical industry involves several distinct segments:

### **Drug manufacturers**

Large pharmaceutical companies (Pfizer, Johnson & Johnson, Merck, AbbVie, Bristol-Myers Squibb) develop, manufacture, and market brand-name drugs. The U.S. is the largest pharmaceutical market in the world.

### **Generic manufacturers**

Generic drugs account for about 90% of prescriptions dispensed but only about 20% of drug spending. Major generic manufacturers include Teva, Viatris, and Sandoz.

## **Pharmacy Benefit Managers (PBMs)**

PBMs are intermediaries that negotiate drug prices with manufacturers on behalf of insurers and employers. The three largest PBMs (CVS Caremark, Express Scripts, OptumRx) control about 80% of the market.

## **Pharmacies**

Drug dispensing occurs through retail pharmacies (CVS, Walgreens, Walmart), mail-order pharmacies, and specialty pharmacies for high-cost drugs.

## **Physicians**

The United States has approximately 1 million active physicians. Physician practices have consolidated significantly:

- **Hospital-employed physicians:** Now the majority (>50%) of physicians work for hospitals or health systems, up from roughly 25% in 2000
- **Large physician groups:** Multi-specialty groups and private equity-backed practices have grown
- **Solo/small practices:** Declining but still significant, particularly in primary care in some regions

## **Geographic Distribution**

Healthcare employment is distributed across the country roughly in proportion to population, but with notable variations.

### **Regional Patterns**

**High healthcare employment share:** - **Northeast corridor:** Boston, New York, Philadelphia have major academic medical centers - **Upper Midwest:** Cleveland, Rochester (MN), Indianapolis are regional healthcare hubs - **Texas Medical Center:** Houston hosts the world's largest medical center complex

**Major health system headquarters:** - Nashville, TN: HCA, Community Health Systems - St. Louis, MO: Ascension, Centene - Minneapolis, MN: UnitedHealth Group - Indianapolis, IN: Anthem (Elevance), Eli Lilly

## **State Variation in Healthcare Spending**

Healthcare spending varies substantially by state, reflecting differences in prices, utilization, and population health:

- **Highest spending per capita:** Alaska, Massachusetts, Connecticut
- **Lowest spending per capita:** Utah, Arizona, Georgia

These differences partly reflect regional price variation—healthcare is much more expensive in high-cost-of-living areas—and partly reflect population demographics and health status.

# The Workforce

## Employment

Healthcare and social assistance employs about 20.5 million workers, divided roughly as:

- **Hospitals:** 5.3 million
- **Ambulatory care (physician offices, outpatient centers):** 8.5 million
- **Nursing and residential care:** 3.0 million
- **Social assistance:** 3.5 million

## Key Occupations

Occupation	Employment	Median Wage
Registered nurses	3.1 million	\$81,000
Nursing assistants	1.4 million	\$35,000
Home health aides	3.6 million	\$31,000
Medical assistants	740,000	\$38,000
Physicians	1.0 million	\$220,000+
Pharmacists	320,000	\$128,000

Source: Bureau of Labor Statistics, Occupational Employment and Wage Statistics, 2023

Healthcare employs workers across the wage spectrum, from low-wage home health aides to high-earning specialist physicians.

## Workforce Challenges

- **Nursing shortages:** An aging nursing workforce and pandemic-related burnout have created shortages in many regions
- **Physician distribution:** Rural areas face chronic physician shortages; specialists concentrate in urban areas
- **Wage pressure:** Low-wage healthcare workers (aides, assistants) face difficult working conditions

# Regulation and Policy

## Key Regulatory Agencies

**Federal:** - **CMS** (Centers for Medicare & Medicaid Services): Sets Medicare reimbursement rates, Medicaid policies - **FDA** (Food and Drug Administration): Approves drugs and medical devices - **FTC**: Reviews healthcare mergers, polices anti-competitive behavior - **HHS** (Department of Health and Human Services): Umbrella agency for health policy

**State:** - State insurance commissioners regulate health insurers - State medical boards license physicians - Certificate-of-need laws (in some states) regulate hospital expansion

## Major Regulatory Frameworks

- **Medicare payment systems:** Prospective payment for hospitals, fee schedules for physicians
- **HIPAA:** Health insurance portability and patient privacy
- **Affordable Care Act:** Insurance market reforms, coverage expansions
- **340B Drug Pricing Program:** Discounted drugs for safety-net hospitals
- **Anti-kickback statutes:** Prevent improper referral arrangements

## Trade Associations and Lobbying

Healthcare is one of the most heavily lobbied industries in America. Major trade associations include:

Association	Represents	Focus
AMA (American Medical Association)	Physicians	Scope of practice, reimbursement
AHA (American Hospital Association)	Hospitals	Medicare payments, regulations
PhRMA	Brand pharmaceutical companies	Drug pricing, IP protection
AHIP	Health insurers	Insurance regulations, ACA
ANA (American Nurses Association)	Nurses	Staffing ratios, scope of practice

Source: Trade association websites and public filings, 2023

The healthcare sector consistently ranks as the largest lobbying spender in Washington, spending over \$700 million annually on federal lobbying.

## Recent Trends

### 1. Vertical integration

Insurers, providers, and pharmacy companies are merging. CVS acquired Aetna; UnitedHealth owns both Optum (a large provider network) and OptumRx (a PBM). This integration promises efficiency but raises concerns about market power.

### 2. Hospital consolidation

Hospital mergers continue, creating larger regional systems. Research suggests consolidation raises prices without consistent quality improvements.

### **3. Private equity in healthcare**

Private equity firms have invested heavily in physician practices, nursing homes, and other healthcare businesses, raising concerns about cost-cutting and quality.

### **4. Shift to outpatient care**

Technological advances allow more procedures to be performed in outpatient settings, shifting volume away from hospitals.

### **5. Value-based payment**

Medicare and private insurers are gradually shifting from fee-for-service toward payment models that reward quality and efficiency.

## **Firm Profiles**

### **Kaiser Permanente**

**Quick Facts** - Headquarters: Oakland, California - Founded: 1945 - Revenue: \$95 billion (2022) - Members: 12.5 million - Employees: 300,000+

Kaiser Permanente is America's largest integrated health system—meaning it combines insurance and care delivery. Kaiser members receive care primarily from Kaiser facilities and physicians. This integration allows Kaiser to coordinate care and manage costs more effectively than fragmented fee-for-service systems.

Kaiser originated during World War II, when industrialist Henry Kaiser established health plans for workers at his shipyards. The model—prepaid group practice—was controversial at the time (the AMA opposed it) but proved efficient and popular.

Today Kaiser operates in eight states plus the District of Columbia, with particular strength in California (where it covers about 40% of the commercially insured market). Its integrated model is often cited as a potential model for healthcare reform, though its geographic concentration limits broader applicability.

### **HCA Healthcare**

**Quick Facts** - Headquarters: Nashville, Tennessee - Founded: 1968 - Revenue: \$60 billion (2022) - Hospitals: 182 - Employees: 275,000

HCA is the largest for-profit hospital operator in the United States. Founded by the Frist family (including future Senate Majority Leader Bill Frist's father), HCA pioneered the modern hospital corporation model—acquiring community hospitals, implementing standardized management practices, and achieving economies of scale.

HCA went through a leveraged buyout in 2006 (at the time, the largest LBO in history) and returned to public markets in 2011. The company operates primarily in high-growth Sunbelt markets—Texas, Florida, and Tennessee account for over half of its hospitals.

HCA's for-profit model remains controversial. Critics argue that profit motive conflicts with healthcare's mission; supporters contend that HCA demonstrates that well-run hospitals can be both profitable and provide quality care.

## CVS Health

**Quick Facts** - Headquarters: Woonsocket, Rhode Island - Founded: 1963 (as Consumer Value Stores) - Revenue: \$322 billion (2022) - Employees: 300,000 - Retail locations: 9,000+

CVS exemplifies healthcare's vertical integration trend. What began as a retail pharmacy chain has become a diversified healthcare company combining: - **CVS Pharmacy**: roughly 9,000 retail pharmacies - **CVS Caremark**: One of the three largest PBMs - **Aetna**: Major health insurer (acquired 2018) - **MinuteClinic**: Retail health clinics

CVS's strategy bets that integrating pharmacy, insurance, and primary care can improve outcomes and reduce costs. The company is positioning its retail locations as healthcare destinations, not just pharmacies.

## Data Sources and Further Reading

### Key Data Sources

- **CMS National Health Expenditure Accounts**: Comprehensive data on healthcare spending by category and payer
- **BLS Quarterly Census of Employment and Wages**: Healthcare employment by subsector and geography
- **AHA Hospital Statistics**: Detailed data on hospitals
- **KFF (Kaiser Family Foundation)**: Accessible analysis of health policy data

### Further Reading

- Paul Starr, *The Social Transformation of American Medicine* (1982) — Classic history of American medicine's development
- Uwe Reinhardt, *Priced Out: The Economic and Ethical Costs of American Health Care* (2019) — Health economist's analysis of the U.S. system
- Elisabeth Rosenthal, *An American Sickness* (2017) — Journalist's investigation of healthcare pricing
- Atul Gawande, "The Cost Conundrum," *The New Yorker* (2009) — Influential article on geographic variation in healthcare spending

## Exercises

### Review Questions

1. The chapter opens with a tenfold price gap for an MRI between the United States (\$3,000) and Japan (\$300) on identical machines. What structural features of the

American healthcare system—the three-party payment structure, lack of price transparency, provider market power, or administrative complexity—best explain this price differential? Why don't competitive forces push the American price toward international levels?

2. Explain the “three-party problem” in healthcare: the patient receives care, the insurer pays, and the physician decides treatment. How does this separation break normal price signals? Compare this to a market where the consumer both chooses and pays for a service (e.g., a restaurant meal). What specific distortions does the three-party structure create?
3. Healthcare spending has grown from 5% of GDP in 1960 to nearly 18% today. The chapter identifies four drivers: an aging population, technological advances, rising incomes, and perverse payment incentives. Which of these drivers is most amenable to policy intervention? Which is least? Explain your reasoning.
4. The three largest Pharmacy Benefit Managers—CVS Caremark, Express Scripts (Cigna), and OptumRx (UnitedHealth)—control about 80% of the market. What role do PBMs play between drug manufacturers, insurers, and pharmacies? Why has this level of concentration drawn antitrust and regulatory scrutiny?
5. Over 50% of physicians now work for hospitals or health systems, up from roughly 25% in 2000. What economic forces drive this consolidation? What are the implications for healthcare costs (hospital “facility fees” on previously independent practices), physician autonomy, and the availability of care in rural areas?
6. The chapter describes three payment models: fee-for-service, capitation, and value-based care. Fee-for-service incentivizes volume; capitation incentivizes limiting care; value-based care ties payment to outcomes. Why has the transition away from fee-for-service been so slow, despite decades of policy support for alternatives?
7. Kaiser Permanente integrates insurance and care delivery, covering 12.5 million members primarily through its own facilities and physicians. The chapter notes this model is “often cited as a potential model for healthcare reform.” Why hasn’t the Kaiser model spread more widely across the country? What limits its geographic applicability?

## Data Exercises

8. Go to the CMS National Health Expenditure data ([cms.gov/data-research/statistics-trends-and-reports/national-health-expenditure-data](http://cms.gov/data-research/statistics-trends-and-reports/national-health-expenditure-data)) and download the “NHE by Type of Service” tables. Compare the share of spending going to hospital care versus physician/clinical services in 2000 and the most recent year available. Has the “shift to outpatient care” the chapter describes shown up in the aggregate spending data? What might explain any discrepancy between the trend and the data?
9. Using the Kaiser Family Foundation’s State Health Facts ([kff.org/statedata](http://kff.org/statedata)), compare healthcare spending per capita, Medicaid enrollment, and the uninsured

rate for two states—one that expanded Medicaid under the ACA and one that did not. How do the states differ on these measures? What does this suggest about the effects of Medicaid expansion?

10. Go to the BLS Occupational Employment and Wage Statistics ([bls.gov/oes](http://bls.gov/oes)) and look up wages for registered nurses (SOC 29-1141) and home health aides (SOC 31-1011) in three different metropolitan areas. How much does pay vary geographically for each occupation? How does the ratio of nurse wages to home health aide wages compare across metros? What does this reveal about the healthcare workforce's wage structure?

### **Deeper Investigation**

11. Research the role of private equity investment in one specific healthcare subsector: emergency medicine staffing (Envision, TeamHealth), nursing homes, dental practices (Heartland Dental, Aspen Dental), or dermatology clinics. What is the private equity business model in that subsector—how do firms generate returns? What evidence exists on the effects of PE ownership on prices, service quality, staffing levels, and patient outcomes? Assess whether the growth of private equity in healthcare represents efficiency improvement or value extraction.

# 7. Professional and Business Services

Walk into any office tower in Manhattan, Chicago, or San Francisco and you will find floors of lawyers, consultants, accountants, and software engineers. Most Americans never hire an M&A attorney or a management consultant, yet professional services generates \$2.3 trillion annually and employs 22 million workers. These firms sell expertise—legal judgment, strategic advice, audited financials—and their concentration in a handful of elite metros shapes the economic geography of American cities.

Professional and business services (NAICS 54-56) spans industries united by a single feature: they sell expertise, not physical goods. A law firm sells legal judgment. McKinsey sells strategic advice. Deloitte sells audit opinions and tax planning. Advertising agencies sell creative campaigns and media placement. MBAs, JDs, and CPAs staff these firms, clustered in towers along Park Avenue and Lake Shore Drive, where proximity to clients and competitors drives billion-dollar deals. Since 1980, this sector has added over 12 million jobs while manufacturing shed 6 million.

## Overview

### Size and Scope

- **GDP contribution (2023):** \$2.3 trillion (approximately 9% of GDP)
- **Employment:** 22.4 million workers (Professional, Scientific, Technical Services: 10.2M; Administrative Services: 9.5M; Management of Companies: 2.7M)
- **Establishments:** Over 1.1 million firms
- **Growth:** One of the fastest-growing sectors over the past three decades

Professional services has been a major engine of employment growth since the 1980s. While manufacturing employment fell from 19 million to 13 million between 1980 and 2023, professional and business services employment more than doubled. This shift reflects the broader transformation from a goods-producing to a knowledge-based economy.

### Key Subsectors

Subsector	Revenue (2023 est.)	Employment	Key Players
Legal services	\$370 billion	1.1 million	Kirkland & Ellis, Latham & Watkins, DLA Piper
Accounting and auditing	\$190 billion	1.4 million	Deloitte, PwC, EY, KPMG
Management consulting	\$330 billion	1.0 million	McKinsey, BCG, Bain, Accenture
Architectural/engineering	\$380 billion	1.5 million	AECOM, Jacobs, WSP
Computer systems design	\$550 billion	2.2 million	Accenture, IBM, Infosys, Cognizant
Advertising and marketing	\$280 billion	500,000	WPP, Omnicom, Publicis, IPG
Scientific R&D services	\$190 billion	750,000	IQVIA, Charles River, PPD

Sources: Census Service Annual Survey, BLS QCEW, IBISWorld estimates

## How the Industry Works

Professional services firms share a distinctive business model that differs fundamentally from manufacturing or retail. They sell hours of expert time, face severe information asymmetries with clients, and depend critically on reputation and relationships.

### The Leverage Model

Most professional services firms operate on a **leverage model**: a small number of senior partners supervise a larger number of junior professionals who do the bulk of the work. The economics are straightforward:

- Partners bill at \$1,000-2,000/hour (or more for elite specialists)
- Associates bill at \$300-600/hour
- Partners capture the spread between what they bill for associates' time and what associates are paid

The **leverage ratio** (associates per partner) determines profitability. A law firm with 4 associates per partner earns more per partner than one with 2 associates per partner, all else equal. But higher leverage requires more work to keep associates busy—creating pressure to grow revenue.

This model creates a distinctive career structure: the **tournament**. Junior professionals compete for a limited number of partner slots. Those who make partner earn substantial equity stakes; those who don't typically leave ("up or out"). Marc Galanter and Thomas Palay's Tournament of Lawyers (1991) formalized this model

## **Professional Services GDP by Subsector, 2023**

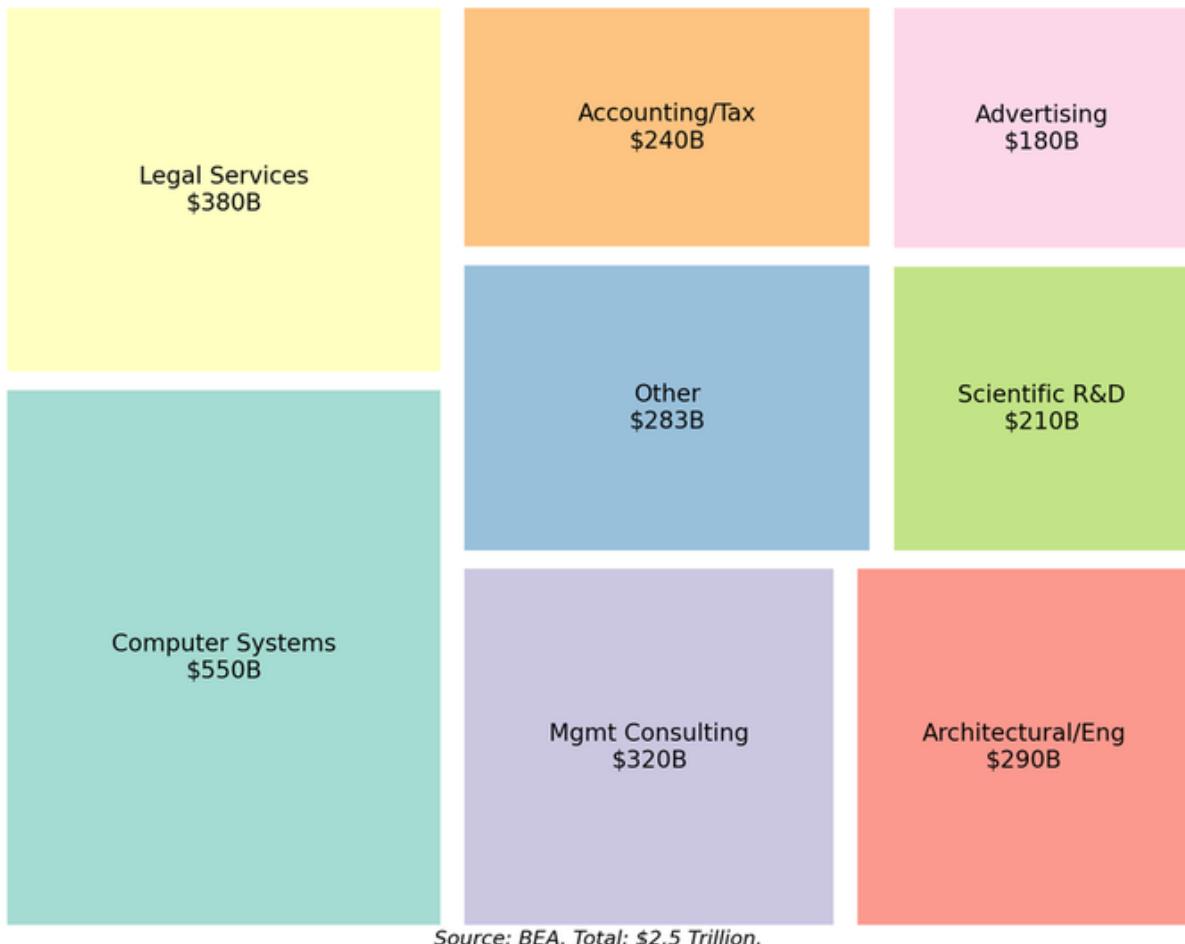


Figure 26: Figure 7.1: Professional services GDP by subsector. Computer systems design leads, followed by legal services and management consulting. Source: BEA (2023)

for law firms, but it applies broadly across consulting, accounting, and investment banking.

**Note:**

### The Tournament's Hidden Costs

The “up or out” model generates intense effort but also burnout, attrition, and perverse incentives. Associates work 80-hour weeks for years pursuing partnership odds of 10-20%. Those who fail leave with transferable skills but often with strained relationships and health consequences. The model persists because it extracts maximum effort from the young while firms are built on their labor.

## Revenue Streams

**Hourly billing** remains dominant in legal services and much of accounting. Clients pay for time spent, creating incentives for efficiency (clients want less time) and inefficiency (firms want more billable hours) that are never fully resolved.

**Project-based fees** are common in consulting and advertising. McKinsey might charge \$5-10 million for a three-month strategy project, regardless of hours worked. This aligns incentives with outcomes but requires accurate scoping.

**Contingency fees** (plaintiff’s litigation) and **success fees** (M&A advisory) tie compensation to results. A plaintiff’s attorney might take 33% of any settlement; an investment bank might earn 1% of deal value. These arrangements shift risk to the service provider.

**Retainer relationships** provide steady revenue: a corporation pays a law firm \$500,000/year for on-call legal advice. Retainers smooth revenue but may create conflicts (the retained firm may be reluctant to recommend costly litigation).

**Audit fees** are unique: public companies are legally required to hire independent auditors, creating a quasi-regulated market. The Big 4 accounting firms audit virtually all large public companies, with fees set through negotiation but constrained by competition for the engagement.

## The Role of Reputation

Professional services markets are plagued by **information asymmetry**: clients cannot easily evaluate service quality. How does a CEO know if the law firm’s M&A advice is sound? How does an audit committee know if the audit was thorough?

**Reputation** partially solves this problem. Elite firms—Cravath in law, McKinsey in consulting, Goldman Sachs in banking—command premium fees because their reputations assure clients of quality. This creates powerful incumbency advantages and explains why the same firms have dominated their industries for decades.

Reputation also explains the **credentialing function** of professional services. When a company hires McKinsey, it’s partly buying analysis but also buying legitimacy: “McKinsey recommended this strategy” provides cover for executives. Similarly, a

Big 4 audit opinion signals to investors that financial statements are reliable (or at least, that a reputable firm reviewed them).

## Industry Structure

### Legal Services

The US legal services market (\$370 billion) is the world's largest, reflecting both the litigiousness of American society and the complexity of American business law.

**Market structure:** Highly fragmented overall (130,000+ law firms), but concentrated at the top. The AmLaw 100 (largest 100 firms by revenue) generate about 40% of total legal revenue. The AmLaw 10 alone account for nearly \$30 billion.

#### Largest firms by revenue (2023):

Rank	Firm	Revenue	Lawyers	PPP*
1	Kirkland & Ellis	\$7.2B	3,600	\$7.5M
2	Latham & Watkins	\$5.8B	3,200	\$5.6M
3	DLA Piper	\$3.7B	4,500	\$2.1M
4	Baker McKenzie	\$3.4B	4,700	\$1.6M
5	Skadden	\$3.3B	1,700	\$5.2M

PPP = Profits Per Partner. Source: American Lawyer

#### □ Info:

##### Key Metric: Profits Per Partner (PPP)

PPP measures a law firm's profitability by dividing total partner profits by number of equity partners. A firm with \$500M in profits and 100 equity partners has PPP of \$5M. This metric drives firm strategy: partners resist promoting new partners (dilutes PPP) and push for higher leverage (increases PPP). The AmLaw rankings by PPP create intense competitive pressure.

**Specialization:** Large firms increasingly specialize. Kirkland & Ellis dominates private equity work; Wachtell Lipton is the premier M&A defense firm; Quinn Emanuel leads commercial litigation. Specialization allows expertise development but creates "rainmaker" dependency—partners who control client relationships hold enormous power.

**Geographic concentration:** Legal services concentrate in major business centers. New York (especially Midtown Manhattan) hosts the largest cluster, followed by Washington DC (regulatory/government work), Chicago, Los Angeles, and San Francisco/Silicon Valley.

**Key trends:** - Rising associate salaries (first-year associates at top firms now earn \$215,000+) - Growing in-house legal departments (corporations bringing work inside) - Alternative Legal Service Providers (ALSPs) handling routine work - Slow adoption of technology despite "LegalTech" hype

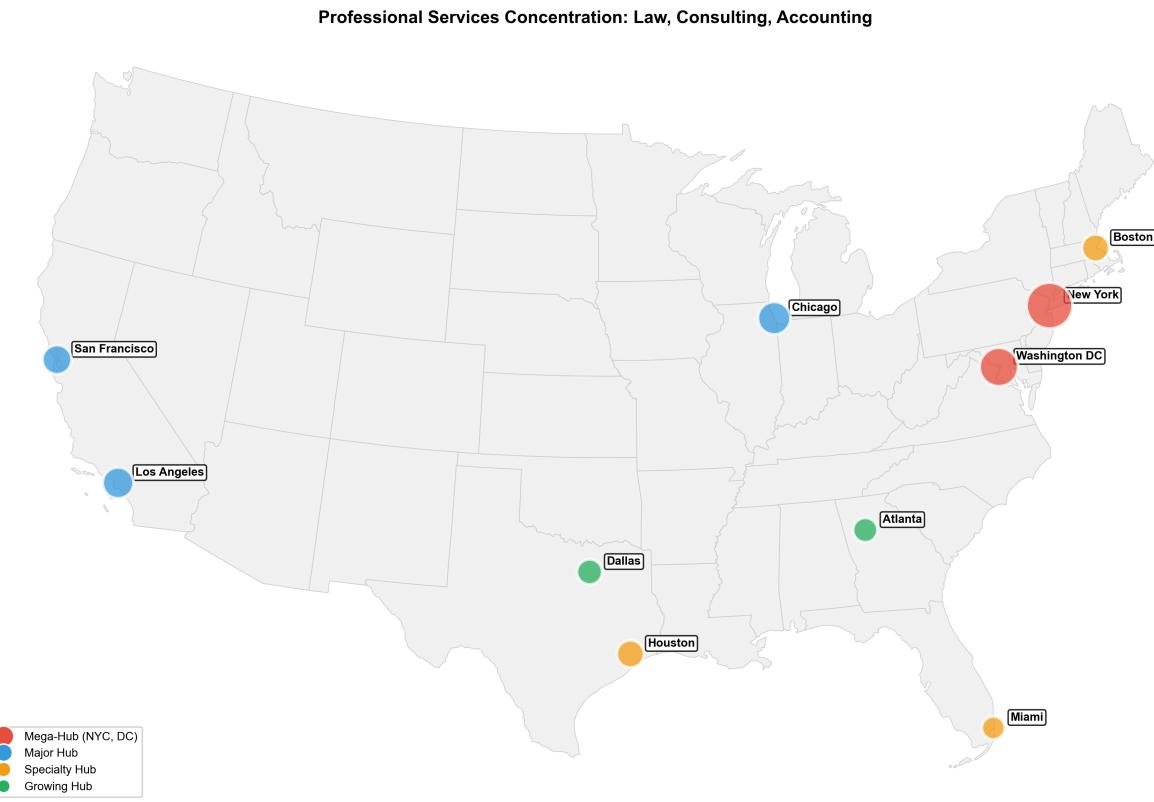


Figure 27: Figure 7.2: Professional services concentration by metro. NYC and DC dominate as “mega-hubs,” hosting the majority of AmLaw 100 firms and Big Four offices. Source: American Lawyer, Vault rankings

## **Accounting and Auditing**

The accounting industry is dominated by the **Big 4**: Deloitte, PwC, EY, and KPMG. These firms audit virtually all large public companies and provide tax and consulting services to corporations worldwide.

### **Big 4 statistics (2023):**

Firm	Global Revenue	US Revenue	US Employees
Deloitte	\$65B	\$28B	175,000
PwC	\$53B	\$21B	75,000
EY	\$50B	\$20B	78,000
KPMG	\$36B	\$14B	40,000

#### **□ Note:**

#### **Too Big to Fail? The Big 4 Problem**

The Big 4 audit 99% of S&P 500 companies. If one firm collapsed (as Arthur Andersen did after Enron), the remaining three could not absorb its clients—creating systemic risk for capital markets. Regulators have considered structural reforms (mandatory firm rotation, audit-only firms) but none have been implemented. The Big 4 remain too big to fail and too essential to regulate aggressively.

Sources: Firm disclosures

**Market concentration:** The Big 4's dominance in audit is extraordinary—they audit approximately 99% of S&P 500 companies. This concentration raises concerns about systemic risk (what if a Big 4 firm failed?) and competitive dynamics (limited choice for large companies needing auditors).

**Service lines:** The Big 4 are not just auditors. Revenue breaks down roughly as: - Audit and assurance: 35-40% - Tax services: 25-30% - Consulting/advisory: 30-40%

The mix has shifted toward consulting, which offers higher margins and faster growth than commoditized audit work.

**Regulatory environment:** Auditing is quasi-regulated. The SEC requires public companies to have audited financial statements; the PCAOB (Public Company Accounting Oversight Board) inspects audit quality; Sarbanes-Oxley (2002) restricted auditors from providing certain consulting services to audit clients.

**Key tensions:** - Independence vs. client service (auditors are paid by the companies they audit) - Quality vs. cost (audit fees are under constant pressure) - Consulting growth vs. audit independence (conflicts of interest)

## **Management Consulting**

The management consulting industry (\$330 billion in the US) advises corporations on strategy, operations, technology, and organization.

**Market structure:** More fragmented than accounting, but with clear tiers:

**Strategy consulting** (the elite tier): - McKinsey & Company (roughly \$16B global revenue, roughly 6,000 US consultants) - Boston Consulting Group (roughly \$12B global, roughly 5,000 US) - Bain & Company (roughly \$6B global, roughly 3,500 US)

**Big 4 consulting arms** (volume and technology): - Deloitte Consulting, PwC Advisory, EY-Parthenon, KPMG Advisory

**Technology/implementation consultants:** - Accenture (roughly \$65B global, massive scale) - IBM Consulting, Capgemini, Cognizant

**Boutiques and specialists:** Thousands of smaller firms focusing on specific industries or functions.

**Business model:** Strategy consultants sell “thought leadership”—frameworks, analyses, recommendations delivered by teams of bright MBAs working 80-hour weeks. The output is typically a PowerPoint deck presented to executives, though implementation support has become more common.

**Why do companies hire consultants?** Bloom and Van Reenen’s research (JEP, 2010) suggests consultants spread best practices across firms, improving management quality. But critics argue consulting often provides “legitimacy” for decisions executives have already made, or serves as an expensive form of benchmarking that could be done more cheaply.

## Computer Systems Design and IT Services

The largest professional services subsector by revenue (\$550 billion) encompasses:

- Custom software development
- Systems integration
- IT outsourcing
- Cloud services implementation

**Market structure:** Highly diverse, from global giants to small development shops.

**Major players:** - Accenture: \$65B global revenue, 740,000 employees (the largest) - IBM Consulting: roughly \$20B (spun from IBM’s services arm) - Infosys, TCS, Wipro: Indian-headquartered firms with large US operations - Cognizant: \$19B, US-headquartered but India-delivery model - Thousands of smaller system integrators and consultancies

**Offshore delivery:** Much IT services work is performed offshore (India, Philippines, Eastern Europe) with US-based client management. This “global delivery model” dramatically lowered costs and enabled the industry’s growth, but also limited US employment growth in this subsector.

**Cloud transformation:** The shift to cloud computing (AWS, Azure, Google Cloud) has restructured the industry. Implementation of cloud solutions is now a major revenue stream.

## Advertising and Marketing Services

The advertising industry (\$280 billion) creates and places marketing communications across media channels.

**Market structure:** Consolidated at the top into four major holding companies:

Holding Company	Headquarters	Revenue	Major Agencies
WPP	London	\$18B	Ogilvy, Grey, GroupM
Omnicom	New York	\$14B	BBDO, DDB, OMD
Publicis	Paris	\$14B	Saatchi, Leo Burnett, Starcom
IPG	New York	\$11B	McCann, FCB, UM

These holding companies own dozens of individual agencies, allowing them to serve competing clients through different subsidiaries.

**The agency model:** Traditional agencies combine: - Creative services (developing ad concepts and content) - Media buying (purchasing ad space/time) - Account management (client relationships)

**Digital disruption:** The rise of Google and Meta (Facebook) transformed the industry. These platforms now capture over 50% of US digital ad spending, disintermediating traditional media buying. Agencies have responded by building digital capabilities, but their role in a programmatic, algorithm-driven ad market is uncertain.

**The attention economy:** Tim Wu's *The Attention Merchants* (2016) traces the business model of capturing and selling attention from 19th-century newspapers through modern social media. Advertising agencies are intermediaries in this attention market—and increasingly squeezed between powerful platforms and cost-conscious clients.

## Architecture and Engineering Services

A&E services (\$380 billion) design buildings, infrastructure, and industrial facilities.

**Market structure:** Highly fragmented. No firm dominates; the largest (AECOM, Jacobs) have market shares under 5%.

**Largest firms (by US revenue):**

Firm	US Revenue	Specialty
AECOM	\$8B	Infrastructure, government
Jacobs	\$7B	Government, industrial
WSP	\$4B	Transportation, buildings
Stantec	\$3B	Environmental, buildings
HDR	\$2.5B	Healthcare, transportation

**Business model:** Fee-based professional services, typically as a percentage of construction cost (5-15% depending on project complexity). Work is project-based and highly cyclical—architecture billings are a leading indicator of construction activity.

**The AIA Architecture Billings Index:** The American Institute of Architects publishes a monthly index tracking billings at architecture firms. Because design precedes construction by 9-12 months, the ABI serves as an early warning system for construction downturns.

## Geographic Distribution

Professional services are among the most geographically concentrated industries in the American economy.

### Metropolitan Concentration

The top 10 metropolitan areas account for over 50% of professional services employment:

Metro Area	Prof. Services Employment	Specialization
New York-Newark	1.8 million	Law, finance services, advertising
Los Angeles	900,000	Entertainment law, tech
Chicago	700,000	Consulting, accounting
Washington DC	680,000	Government consulting, law
Dallas	550,000	Energy consulting, accounting
San Francisco Bay	520,000	Tech consulting, VC law
Boston	450,000	Consulting, life sciences
Houston	400,000	Energy engineering
Atlanta	380,000	Regional services hub
Philadelphia	340,000	Pharma consulting, law

Source: BLS Quarterly Census of Employment and Wages

### Why Services Concentrate

Agglomeration economies explain the clustering:

**Knowledge spillovers:** Professionals learn from proximity to other professionals. A lawyer in New York encounters more deal structures, a consultant in Boston more strategic frameworks, than counterparts in smaller markets.

**Thick labor markets:** Concentrated markets make job matching easier. Firms can find specialized talent; workers can find firms matching their expertise.

**Client proximity:** Professional services require intensive client interaction. Lawyers need to be near corporate headquarters; consultants near executive suites. This creates a virtuous cycle: firms locate near clients; sophisticated clients demand sophisticated firms; more firms arrive.

**Signaling and status:** A Manhattan address signals prestige. Clients perceive firms in elite locations as higher quality, allowing them to charge premium fees.

## The Workforce

### Education and Credentials

Professional services employs the most educated workforce in the economy:

Occupation	Typical Education	Credential
Lawyer	J.D. (3 years post-college)	Bar admission
CPA	Bachelor's + 150 credit hours	CPA license
Management consultant	MBA common, not required	None required
Architect	B.Arch or M.Arch	State license
Engineer (PE)	B.S. Engineering	Professional Engineer license

Credentialing creates barriers to entry that limit competition and support high wages. The bar exam, CPA exam, and architectural licensing exam all restrict supply of practitioners.

### Compensation

Professional services wages span an enormous range:

**Entry level:** - First-year BigLaw associate: \$215,000 + bonus - Big 4 audit associate: \$65,000-80,000 - Entry management consultant (MBA): \$175,000 + bonus - Junior architect: \$55,000-70,000

**Senior/Partner level:** - BigLaw equity partner: \$2-10+ million - Big 4 partner: \$500,000-2+ million - McKinsey senior partner: \$2-5+ million - Principal architect: \$150,000-300,000

**Wage inequality:** Professional services exhibits extreme within-industry inequality. Partners at elite firms earn 20-50x what junior staff earn. This tournament structure provides strong incentives but creates brutal competition.

### Working Conditions

Professional services is notorious for long hours:

- BigLaw associates: 2,000-2,400 billable hours/year (implying 2,500-3,000 hours worked)
- Investment banking analysts: 80-100 hours/week during deals
- Management consultants: 60-80 hours/week, heavy travel
- Big 4 audit staff: 50-70 hours/week during busy season (January-April)

These hours create work-life balance challenges and contribute to high attrition. Most professionals leave their first employer within 5-7 years—either for partner-track positions elsewhere, in-house roles at corporations, or career changes.

# **Regulation and Policy**

## **Professional Licensing**

Most professional services are regulated through state licensing:

- **Lawyers:** State bar associations (under state supreme court supervision)
- **CPAs:** State boards of accountancy
- **Architects:** State licensing boards
- **Engineers:** State boards of professional engineers

Licensing requirements typically include education, examination, and experience. Critics argue licensing restricts competition and raises prices; defenders argue it protects consumers from incompetent practitioners. Hadfield (2022) documents how legal profession regulations limit innovation and access to justice.

## **Antitrust and Competition**

Professional services historically enjoyed antitrust exemptions (the “learned professions” doctrine). This changed with Goldfarb v. Virginia State Bar (1975), which held that lawyers are subject to antitrust law.

Current issues include: - **Non-compete clauses:** Restrict worker mobility; FTC has proposed banning them - **Professional association rules:** May limit advertising, fee structures, unauthorized practice - **Big 4 concentration:** Regulators periodically consider whether audit market concentration harms competition

## **Sarbanes-Oxley and Audit Reform**

The Enron and WorldCom scandals led to the Sarbanes-Oxley Act (2002), which:  
- Created the PCAOB to oversee auditors  
- Restricted auditor consulting services to audit clients  
- Required CEO/CFO certification of financial statements  
- Strengthened audit committee independence requirements

SOX increased audit costs substantially but arguably improved audit quality and corporate governance.

# **Trade Associations and Lobbying**

## **Major Associations**

Association	Members	Focus
American Bar Association	400,000 lawyers	Legal profession standards, lobbying
AICPA	430,000 CPAs	Accounting standards, licensing

Association	Members	Focus
Management Consultancies Association	Major consulting firms	Industry promotion
American Institute of Architects	98,000 architects	Licensing, building codes
4A's	Advertising agencies	Industry standards, self-regulation

## Political Activity

Professional services firms are major political donors and lobbyists:

- Law firms rank among the largest political contributors (lawyers skew Democratic)
- Accounting firms lobby heavily on tax policy and audit regulation
- Tech companies (including IT services) have become major lobbying forces

The revolving door between professional services and government is well-traveled: lawyers become judges and regulators; consultants advise campaigns and enter administrations; accountants staff the SEC and IRS.

## Recent Trends

### 1. Technology and Automation

**LegalTech** promises to automate routine legal work—document review, contract analysis, due diligence. Tools like Kira Systems and Luminance use machine learning. So far, adoption has been slow; lawyers remain skeptical and clients haven't demanded change.

**AI in consulting:** McKinsey and others have invested heavily in data analytics and AI capabilities. The question is whether AI enhances consultant productivity or eventually replaces it.

### 2. Alternative Service Providers

**Alternative Legal Service Providers (ALSPs)** like Axiom and UnitedLex offer legal work at lower cost than law firms, using technology and lower-cost labor. The Big 4 accounting firms have also entered legal services (where permitted).

**Gig economy:** Platforms like Upwork and Toptal connect clients directly with freelance professionals, bypassing traditional firms for some work.

### 3. Remote Work

COVID-19 proved that much professional services work can be done remotely. This has implications for: - Geographic concentration (can firms hire anywhere?) - Office

real estate (do firms need expensive urban space?) - Work-life balance (or work-life blur?)

The industry is still sorting out the new equilibrium.

## 4. ESG and Purpose

Professional services firms face pressure to demonstrate social responsibility—declining certain clients (fossil fuels, tobacco), improving diversity, addressing climate impact. McKinsey faced reputational damage from opioid-related consulting; law firms have been criticized for representing controversial clients.

## Firm Profiles

### McKinsey & Company

**Quick Facts** - Headquarters: New York, NY - Founded: 1926 - Revenue: roughly \$16 billion (2023, estimated) - Employees: 45,000 globally, roughly 6,000 US consultants

McKinsey is the world's most prestigious management consulting firm, known for advising CEOs on strategy and for producing many corporate and government leaders (current and former clients include numerous Fortune 500 CEOs, cabinet secretaries, and central bank governors).

The firm pioneered many practices now standard in consulting: the case interview, the "up or out" promotion system, and the emphasis on structured problem-solving. McKinsey consultants are known for their frameworks, their PowerPoint decks, and their willingness to render confident judgments on industries they've just encountered.

McKinsey's influence is both celebrated and criticized. The Lords of Strategy (Kiechel, 2011) credits McKinsey with inventing modern corporate strategy. Critics argue the firm spreads management fads, enables corporate cost-cutting that harms workers, and has advised authoritarian governments. Recent controversies include work for opioid manufacturers and the Saudi government.

The firm is a partnership; there are no public financial disclosures. But it is believed to be highly profitable, with senior partners earning \$5+ million annually.

### Deloitte

**Quick Facts** - Headquarters: New York, NY (US entity) - Founded: 1845 (London), US practice established 1890s - Revenue: \$65 billion globally, roughly \$28 billion US (2023) - Employees: 175,000 US, 450,000 globally

Deloitte is the largest professional services firm in the world, offering audit, tax, consulting, and advisory services. In the US, it is the largest of the Big 4 by revenue and headcount.

Unlike consulting boutiques, Deloitte's scale allows it to serve the full range of corporate needs—from annual audits to massive technology implementations to tax planning across dozens of jurisdictions. This breadth is both a strength (one-stop shopping) and a challenge (managing conflicts between audit independence and consulting revenue).

Deloitte has invested heavily in technology and industry specialization. Its consulting arm competes directly with McKinsey and Accenture; its tax practice is the largest in the country. The firm recruits heavily from top universities and business schools, employing a substantial fraction of each year's accounting and MBA graduates.

## AECOM

**Quick Facts** - Headquarters: Dallas, TX - Founded: 1990 (through mergers)  
- Revenue: roughly \$14 billion (2023) - Employees: 50,000

AECOM is the largest architecture and engineering firm in the United States, providing design, construction management, and operations services for infrastructure, buildings, and industrial facilities.

The firm exemplifies the consolidation trend in A&E: it was built through dozens of acquisitions, assembling capabilities across transportation, water, environment, energy, and buildings. Major projects include Los Angeles International Airport modernization, New York's Second Avenue Subway, and numerous military installations.

AECOM's business is heavily tied to government infrastructure spending. It ranks among the largest federal contractors and derives substantial revenue from state and local transportation departments. This makes it sensitive to public sector budget cycles but provides relative stability compared to private-sector-focused competitors.

## Data Sources and Further Reading

### Key Data Sources

- **BLS Quarterly Census of Employment and Wages (QCEW)**: Employment and wages by detailed industry and geography
- **Census Service Annual Survey**: Revenue and expenses for service industries
- **BEA GDP by Industry**: Value added for professional services sectors
- **American Lawyer**: Law firm financial data (subscription)
- **Vault.com**: Consulting and professional services firm rankings
- **AIA Architecture Billings Index**: Monthly leading indicator

### Further Reading

**Academic:** - Gillian K. Hadfield, "Legal Markets," Journal of Economic Literature (2022) — Comprehensive survey of legal services economics - Nicholas Bloom and John Van Reenen, "Why Do Management Practices Differ across Firms and Countries?" JEP (2010) — Economic rationale for consulting - David S. Evans, "The Online Advertising Industry," JEP (2009) — Two-sided market analysis

**Books:** - Walter Kiechel III, *The Lords of Strategy* (2010) — History of McKinsey, BCG, Bain - Duff McDonald, *The Firm* (2013) — McKinsey deep dive - Marc Galanter and Thomas Palay, *Tournament of Lawyers* (1991) — Classic on law firm economics - Tim Wu, *The Attention Merchants* (2016) — History of advertising business model - Ian D. Gow and Stuart Kells, *The Big Four* (2018) — Accounting industry structure

**Industry:** - American Lawyer, "Am Law 100" (annual) — Law firm rankings and financials - Vault Guide to Consulting (annual) — Consulting firm profiles and rankings

## Exercises

### Review Questions

1. The chapter describes the “leverage model” in professional services: partners bill at \$1,000–2,000/hour while associates bill at \$300–600/hour, and partners capture the spread. Explain why a law firm with a leverage ratio of 4 associates per partner is more profitable per partner than one with 2 associates per partner, assuming similar billing rates. What are the risks of pursuing ever-higher leverage?
2. Kirkland & Ellis generates \$7.2 billion in revenue with 3,600 lawyers and Profits Per Partner (PPP) of \$7.5 million. DLA Piper generates \$3.7 billion with 4,500 lawyers and PPP of \$2.1 million. What differences in specialization, leverage ratio, billing rates, or client mix explain this gap? Why does the AmLaw PPP ranking create competitive pressure among firms?
3. The Big 4 accounting firms (Deloitte, PwC, EY, KPMG) audit 99% of S&P 500 companies. The chapter warns this is a potential systemic risk. What happened when Arthur Andersen collapsed after the Enron scandal? Why couldn’t the remaining firms simply absorb a failed Big 4 firm’s clients? What structural reforms have regulators considered?
4. The chapter argues that when a company hires McKinsey, it is “partly buying analysis but also buying legitimacy.” Explain how this credentialing function relates to the information asymmetry problem in professional services. Why might a CEO pay \$5–10 million for a consulting project whose recommendations they could have developed internally?
5. Professional services employment more than doubled from 1980 to 2023 while manufacturing shed 6 million jobs over the same period. What does this shift reveal about the transformation from a goods-producing to a knowledge-based economy? Is a professional services job a direct substitute for a manufacturing job in terms of skills, geography, or wages?
6. Google and Meta now capture over 50% of U.S. digital ad spending, disintermediating traditional media buying by advertising agencies. How has the rise of programmatic, algorithm-driven advertising changed the role of agencies like WPP, Omnicom, and Publicis? What services can agencies still provide that platforms cannot?

## **Data Exercises**

7. Using the BEA's GDP by Industry data ([bea.gov/data/gdp/gdp-industry](http://bea.gov/data/gdp/gdp-industry)), compare the value added of "Professional, Scientific, and Technical Services" (NAICS 54) with "Manufacturing" (NAICS 31-33) from 2000 to the most recent year available. In what year did professional services value added surpass manufacturing? What has been the growth rate differential between the two sectors?
8. Go to the BLS Quarterly Census of Employment and Wages ([data.bls.gov/cew](http://data.bls.gov/cew)) and look up employment in NAICS 5411 (Legal Services) for the New York-Newark-Jersey City metro area and for the nation as a whole. What share of national legal services employment is concentrated in New York? Compare this to New York's share of total nonfarm employment. What does the difference tell you about the geographic concentration of legal services?
9. Using FRED ([fred.stlouisfed.org](http://fred.stlouisfed.org)), pull the series "CES6000000001" (All Employees: Professional and Business Services) and "MANEMP" (All Employees: Manufacturing). Plot both from 1990 to the present. Identify the crossover point. How did the 2008 recession and the COVID-19 pandemic affect each series differently? What does the relative resilience of professional services employment suggest about its business cycle sensitivity?

## **Deeper Investigation**

10. Research the potential impact of large language models and generative AI on one professional services subsector: legal services, accounting and audit, management consulting, or advertising. Identify specific tasks within that subsector that are most susceptible to automation (e.g., document review in law, data analysis in consulting, copywriting in advertising). What tasks require human judgment, client relationships, or creativity that current AI cannot replicate? Drawing on the chapter's discussion of the leverage model and tournament structure, assess whether AI will primarily eliminate junior positions, augment senior productivity, or fundamentally restructure how the subsector delivers value.

# Chapter 8. Finance and Insurance

The four largest American banks hold more assets than the annual GDP of Japan. BlackRock manages \$10 trillion—more than the GDP of every country except the United States and China. The finance and insurance sector accounts for only 8% of GDP but touches every transaction in the economy: mortgages that fund housing, loans that capitalize businesses, insurance that makes risk manageable, and the payment systems that enable commerce. American finance is both remarkably concentrated at the top and remarkably fragmented at the bottom, with a handful of global giants coexisting with 4,500 community banks serving small towns across the country.

## Overview

**Size and Scope** - GDP contribution: roughly \$1.8 trillion (8% of GDP) - Banking: roughly \$900 billion - Insurance: roughly \$600 billion - Securities and investment: roughly \$300 billion - Employment: roughly 6.5 million workers - Establishments: roughly 500,000 (including insurance agencies, bank branches, investment offices) - Key subsectors: Commercial banking, investment banking, insurance (life, property/casualty, health), asset management, private equity, payments

Finance and insurance is the fifth-largest sector of the American economy by GDP, smaller than real estate, healthcare, or professional services, but wielding influence far beyond its size. The sector intermediates the flow of funds from savers to borrowers, transforms risk through insurance, and operates the payment infrastructure that enables economic activity.

The sector has consolidated dramatically since the 1990s. Deregulation (the Gramm-Leach-Bliley Act of 1999, which repealed Glass-Steagall's separation of commercial and investment banking) enabled the creation of financial supermarkets. The 2008 crisis accelerated consolidation as failing institutions were absorbed by survivors. Today, the four largest banks control nearly half of all US banking assets.

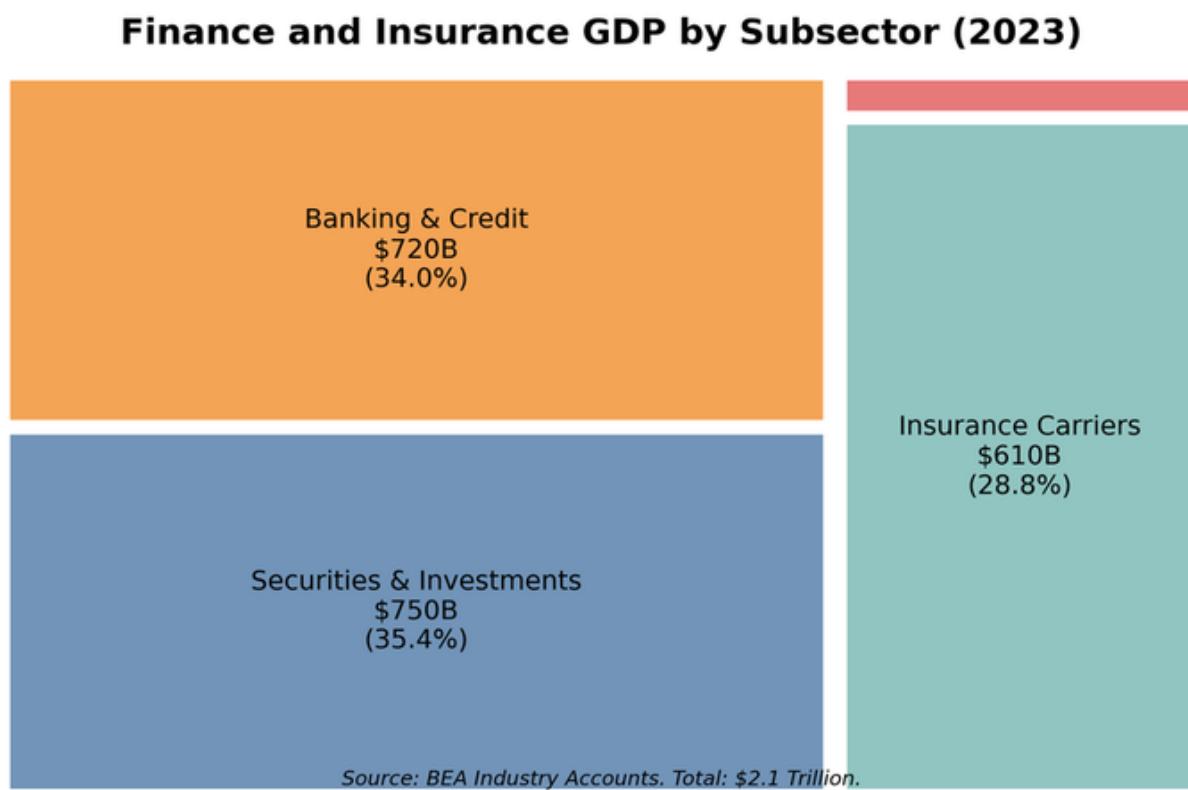


Figure 28: Figure 8.1: Finance and insurance GDP by subsector. Banking dominates, followed by insurance and securities. Source: BEA (2023)

# How the Industry Works

## Commercial Banking: The Core Business

Banks perform **maturity transformation**: they borrow short (deposits that can be withdrawn on demand) and lend long (30-year mortgages, multi-year business loans). This is socially valuable—it funds long-term investment while providing liquidity to savers—but inherently fragile.

### The bank balance sheet:

Assets	Liabilities
Cash and reserves: 10%	Deposits: 80%
Securities: 20%	Wholesale funding: 10%
Loans: 65%	Equity capital: 10%
Other: 5%	

Banks make money on the **net interest margin (NIM)**—the spread between what they earn on loans and what they pay on deposits. Historical NIM for US banks has declined from 4-4.5% in the 1990s to 2.5-3.5% today, reflecting lower interest rates, competition from fintech, and regulation requiring more liquid (low-yield) assets. For a deeper explanation of how banks actually create money and how the payment system works, see Chapter 18.

## Revenue Streams

**Commercial banking:** - Net interest income (loan yields minus deposit costs) - Fee income (overdraft fees, ATM fees, account maintenance) - Service charges (wire transfers, foreign exchange) - Wealth management fees

**Investment banking:** - Advisory fees (M&A, restructuring) - Underwriting fees (IPOs, bond issuance) - Trading revenue (market-making, proprietary positions) - Asset management fees

**Insurance:** - Premiums collected - Investment income on “float” (premiums held before claims paid) - Underwriting profit (premiums minus claims minus expenses)

**Asset management:** - Management fees (typically 0.1-2% of assets under management) - Performance fees (hedge funds, private equity: “2 and 20”) - Distribution fees (12b-1 fees, loads)

## The Shadow Banking System

Beyond traditional banks, a parallel system of credit intermediation operates with less regulation and no deposit insurance. Money market funds (roughly \$6 trillion), repo markets (roughly \$5 trillion), and private credit (roughly \$1.5 trillion) perform bank-like functions without bank-like protections. The 2008 crisis was fundamentally a run on shadow banking. For detailed treatment of how shadow banking works and its role in financial crises, see Chapter 18.

# Industry Structure

## Commercial Banking: Concentration at the Top

The US banking system is simultaneously concentrated and fragmented:

**The Big Four** (by total assets, 2024):

Rank	Bank	Total Assets	Deposits	US Branches
1	JPMorgan Chase	\$3.9 trillion	\$2.4T	4,700
2	Bank of America	\$3.2 trillion	\$1.9T	3,800
3	Citigroup	\$2.4 trillion	\$1.3T	650
4	Wells Fargo	\$1.9 trillion	\$1.4T	4,600

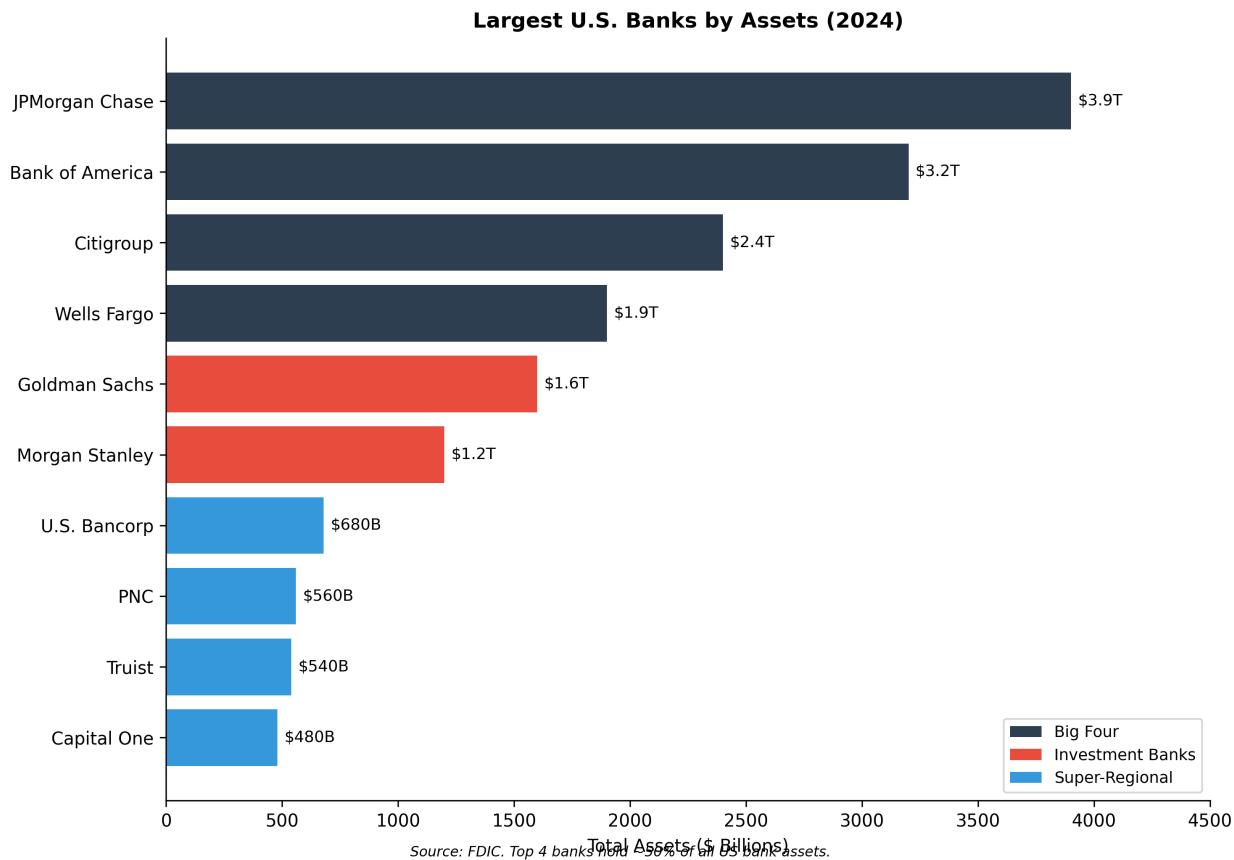


Figure 29: Figure 8.2: The Big Four banks by total assets. JPMorgan Chase dominates, with assets approaching \$4 trillion. Source: FDIC (2024)

These four banks hold approximately 45% of all US banking assets. Add the next four (Goldman Sachs, Morgan Stanley, US Bancorp, PNC), and eight banks control over 60%.

**The long tail:** Below the giants: - roughly 20 “super-regional” banks (\$100B-\$500B assets): Truist, Capital One, TD Bank, Fifth Third - roughly 100 regional banks (\$10B-

\$100B): Huntington, Regions, M&T, Zions - roughly 4,500 community banks (<\$10B): Serving local markets, often focused on small business and agricultural lending

Community banks hold only roughly 12% of industry assets but operate roughly 30% of branches and provide the majority of small business loans in rural areas.

## **Investment Banking: The Bulge Bracket**

Investment banking is dominated by a handful of global firms:

Rank	Firm	2023 Revenue	Primary Business
1	JPMorgan	\$50B (IB segment)	Full service
2	Goldman Sachs	\$46B	Trading, advisory
3	Morgan Stanley	\$54B	Wealth management, trading
4	Bank of America	\$22B (IB segment)	Underwriting, advisory
5	Citigroup	\$20B (IB segment)	Global markets

The traditional “bulge bracket” (Goldman, Morgan Stanley, JPMorgan, Bank of America, Citi) dominates M&A advisory, securities underwriting, and institutional trading. Boutique advisory firms (Evercore, Lazard, Centerview, PJT) have gained share in M&A but lack the capital markets capabilities of the giants.

## **Insurance: Three Distinct Markets**

**Life Insurance** (roughly \$900 billion in premiums):

Rank	Company	Premiums	Business Focus
1	MetLife	\$68B	Group and individual life
2	Prudential	\$64B	Retirement, life
3	New York Life	\$35B	Mutual (policyholder-owned)
4	Northwestern Mutual	\$33B	Mutual, wealth management
5	Lincoln Financial	\$18B	Annuities, life

**Property & Casualty Insurance** (roughly \$800 billion in premiums):

Rank	Company	Premiums	Business Focus
1	State Farm	\$90B	Auto, home (mutual)
2	Berkshire Hathaway	\$85B	Geico, reinsurance
3	Progressive	\$62B	Auto
4	Allstate	\$55B	Auto, home
5	Liberty Mutual	\$50B	Commercial, personal

**Health Insurance** (roughly \$1.3 trillion in premiums):

Rank	Company	Premiums	Enrollment
1	UnitedHealth	\$320B	50M+
2	Elevance (Anthem)	\$160B	45M
3	CVS/Aetna	\$130B	35M
4	Cigna	\$120B	20M
5	Humana	\$100B	20M

### U.S. Insurance Premiums by Major Line (2023)

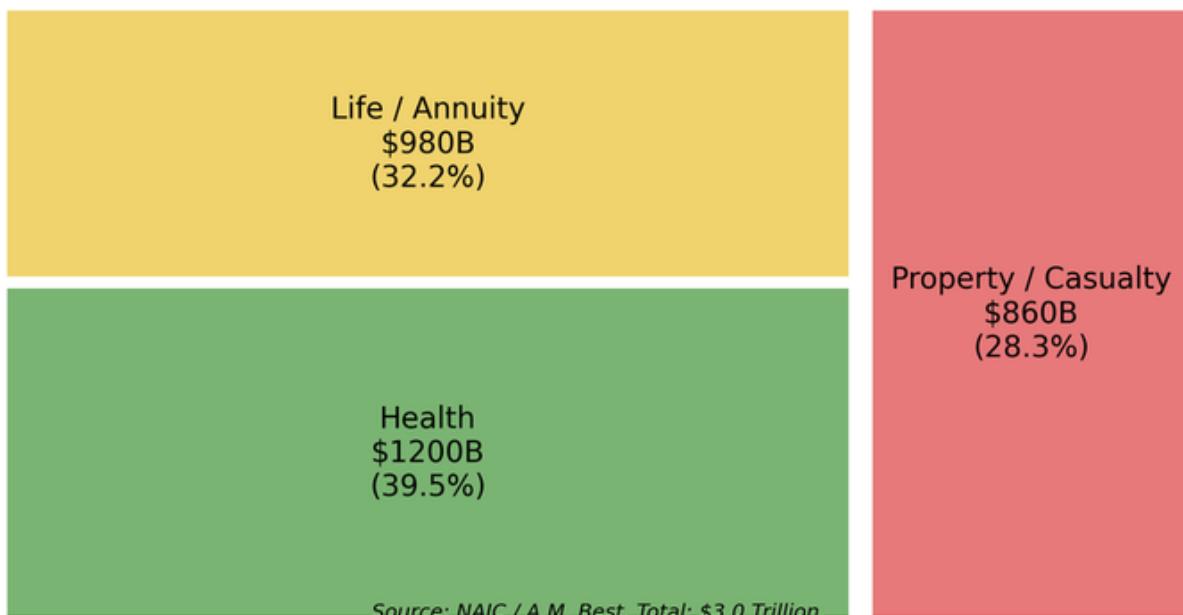


Figure 30: Figure 8.3: Insurance premiums by segment. Health insurance dominates, followed by life and property/casualty. Source: NAIC, company data (2023)

Health insurance is increasingly dominated by vertically integrated conglomerates (UnitedHealth owns Optum; CVS owns Aetna and pharmacies; Cigna merged with Express Scripts). This integration raises antitrust concerns but also enables care coordination.

### Asset Management: The Passive Revolution

Asset management has been transformed by the shift from active to passive (index) investing:

Rank	Firm	AUM	Business Model
1	BlackRock	\$10.0T	Index funds, ETFs, active
2	Vanguard	\$8.6T	Index funds (mutual structure)
3	Fidelity	\$4.5T	Active and index, brokerage

Rank	Firm	AUM	Business Model
4	State Street	\$4.1T	ETFs (SPDRs), institutional
5	Capital Group	\$2.5T	Active (American Funds)

The “Big Three” (BlackRock, Vanguard, State Street) collectively manage roughly \$23 trillion and are the largest shareholders in most S&P 500 companies. This concentration raises governance questions: these firms vote the shares they manage, giving them enormous influence over corporate decisions.

#### **Alternative asset managers** (private equity, hedge funds, real estate):

Rank	Firm	AUM	Primary Strategy
1	Blackstone	\$1.0T	Private equity, real estate
2	Apollo	\$650B	Credit, private equity
3	KKR	\$550B	Private equity, infrastructure
4	Carlyle	\$420B	Private equity, credit
5	Bridgewater	\$125B	Hedge fund (macro)

Private equity has grown from a niche strategy to a major force, with implications across the economy. PE firms own companies employing millions of workers, from hospital systems to retail chains to single-family rental homes.

**The Roll-Up Strategy:** Beyond headline acquisitions, PE has quietly consolidated thousands of small businesses in fragmented industries. The playbook is straightforward: buy a “platform” company in a fragmented sector, then aggressively acquire smaller competitors (“add-ons”), achieving economies of scale while extracting synergies. Examples span the economy:

- **Healthcare:** Dental practices (Heartland Dental, Aspen Dental), dermatology clinics, veterinary practices (Mars Petcare owns 2,500+ clinics), emergency rooms (Envision, TeamHealth)
- **Home Services:** HVAC contractors, plumbing companies, pest control, lawn care
- **Professional Services:** Accounting firms, engineering consultancies, IT service providers
- **Consumer Services:** Car washes, funeral homes, self-storage facilities

For a dentist or plumber who sells to PE, the exit provides liquidity and retirement funds. For consumers, the consolidation often means higher prices, standardized service, and corporate rather than owner-operator management. For workers, it can mean new management pressure on wages and staffing levels. The roll-up wave has transformed industries that were historically fragmented into surprisingly concentrated markets—often without the antitrust scrutiny that large horizontal mergers attract, since each individual acquisition is small.



Figure 31: Figure 8.4: Largest U.S. asset managers by assets under management. BlackRock and Vanguard together manage nearly \$20 trillion—more than the GDP of every country except the U.S. and China. Source: Company reports, Pensions & Investments (2024)

## Fintech and Neobanks

Digital-native financial companies have disrupted traditional banking:

**Payments:** - PayPal/Venmo: \$1.4 trillion payment volume - Square/Block: \$200 billion payment volume - Stripe: Dominant in online merchant processing

**Consumer banking:** - Chime: 15+ million accounts (no-fee banking) - SoFi: Student loans, banking, investing - Robinhood: Commission-free trading, crypto

**Business lending:** - Kabbage (American Express): Small business loans - OnDeck: Small business lending - Various "buy now pay later" providers (Affirm, Klarna)

Most fintechs operate through bank partnerships (chime uses Bancorp Bank's charter) rather than obtaining their own banking licenses. This creates regulatory complexity and raises questions about consumer protection.

## Geographic Distribution

### Money Center: New York

New York is the undisputed capital of American finance: - Headquarters of JPMorgan, Citigroup, Goldman Sachs, Morgan Stanley, BlackRock - NYSE and NASDAQ (though NASDAQ is technically in DC) - roughly 330,000 finance and insurance employees in NYC metro - roughly \$70 billion in annual wages in finance

The concentration reflects agglomeration economics: proximity to clients, counterparties, regulators, and talent. Despite remote work, New York's dominance has persisted.

### Regional Banking Hubs

**Charlotte, NC:** Second-largest banking center - Bank of America headquarters - Truist headquarters (BB&T + SunTrust merger) - Wells Fargo East Coast hub - roughly 75,000 banking employees

Charlotte's rise reflects deliberate strategy: North Carolina's banking laws were permissive, allowing NCNB (later NationsBank, then Bank of America) to grow through acquisition.

**San Francisco Bay Area:** Fintech and venture - Wells Fargo headquarters - Charles Schwab headquarters (relocated from SF to Dallas) - Visa, Stripe headquarters - Dominant in fintech venture capital

**Hartford, CT:** Insurance capital - Historical headquarters of major insurers - The Hartford, Travelers, Aetna (now CVS-owned) roots - Decline as consolidation moved headquarters elsewhere

**Des Moines, IA:** Life insurance hub - Principal Financial headquarters - Major operations for Athene, Sammons - roughly 25,000 insurance employees

## State-Level Variation

Banking presence varies dramatically by state:

High Concentration	Finance % of State GDP
New York	19%
Delaware	14% (credit card banks)
Connecticut	11%
South Dakota	9% (credit card banks)

Low Concentration	Finance % of State GDP
Wyoming	3%
Montana	3%
West Virginia	4%

Delaware and South Dakota host major credit card operations due to favorable usury laws (no interest rate caps), illustrating how state regulation shapes financial geography.

## The Workforce

### Employment by Segment

Segment	Employment	Avg Wage	Trend
Commercial banking	1.9 million	\$75,000	Declining (automation)
Insurance carriers	1.5 million	\$85,000	Stable
Insurance agencies	1.1 million	\$60,000	Growing
Securities/commodities	950,000	\$180,000	Growing
Other finance	1.0 million	\$90,000	Growing

### Occupational Mix

**Front office (client-facing, revenue-generating):** - Investment bankers, traders, portfolio managers - Highest compensation (often 50%+ of revenue as comp) - New York-concentrated

**Middle office (risk, compliance, operations):** - Risk managers, compliance officers, operations analysts - Growing rapidly due to post-2008 regulation - More geographically dispersed

**Back office (processing, support):** - Transaction processing, IT, HR - Subject to automation and offshoring - Increasingly located in lower-cost centers (Tampa, Jacksonville, India)

## Compensation Patterns

Finance is notorious for extreme compensation: - Average Goldman Sachs comp: roughly \$400,000 (including bonus) - Average JPMorgan comp: roughly \$160,000 - Average community bank comp: roughly \$65,000

The gap reflects both skill premiums and rent extraction. Top performers in trading and investment banking can earn \$1-10 million annually; back-office workers earn middle-class wages.

**Bonus culture:** Investment banking and trading compensation is heavily weighted toward year-end bonuses (often 50-200% of base salary), creating volatility and encouraging risk-taking.

## Regulation and Policy

### The Regulatory Alphabet Soup

American financial regulation is notoriously fragmented:

**Banking regulators:** - **Federal Reserve:** Supervises bank holding companies, systemically important institutions - **OCC (Office of the Comptroller of the Currency):** Charters and supervises national banks - **FDIC:** Insures deposits, resolves failed banks - **State banking departments:** Charter and supervise state-chartered banks

A bank may be supervised by multiple regulators depending on its charter and structure.

**Securities regulators:** - **SEC:** Securities markets, investment advisers, broker-dealers - **FINRA:** Self-regulatory organization for broker-dealers - **CFTC:** Derivatives markets (futures, swaps)

**Insurance regulators:** - **State insurance commissioners:** Primary regulators (no federal insurance regulator) - **NAIC:** Coordinates state regulation (not a regulator itself)

**Consumer protection:** - **CFPB (Consumer Financial Protection Bureau):** Consumer lending, created post-2008 - **FTC:** Broader consumer protection, some financial overlap

### Post-2008 Regulatory Framework

The Dodd-Frank Act (2010) reshaped financial regulation:

**Capital requirements:** Banks must hold more equity (10-15% vs. 6-8% pre-crisis)

**Liquidity requirements:** Banks must hold liquid assets to survive 30 days of stress (Liquidity Coverage Ratio)

**Stress testing:** Annual Fed tests assess whether banks can survive hypothetical crises

**Resolution planning:** Large banks must submit “living wills” showing how they could fail without bailouts

**Volcker Rule:** Limits proprietary trading by banks

**Systemically important designation:** Large banks and some non-banks face enhanced supervision

## The “Too Big to Fail” Problem

The 2008 crisis revealed that some institutions are “too big to fail”—their failure would damage the broader economy, forcing government bailouts. Despite Dodd-Frank reforms, this problem persists:

- The largest banks are larger than before 2008
- The March 2023 crisis (SVB, Signature, First Republic) showed regulators still extend implicit guarantees
- Market discipline is weakened when creditors expect bailouts

## Trade Associations and Lobbying

### Major Trade Associations

Association	Members	Focus
American Bankers Association	Banks of all sizes	Banking industry interests
Bank Policy Institute	Large banks	Regulatory advocacy
Independent Community Bankers	Community banks	Small bank interests
SIFMA	Securities firms	Capital markets
American Council of Life Insurers	Life insurers	Life/annuity industry
American Property Casualty Insurance	P&C insurers	Property/casualty

### Lobbying Activity

Financial services is among the largest lobbying spenders: - roughly \$600 million annually in federal lobbying - Major issues: Capital requirements, CFPB oversight, cryptocurrency regulation, ESG requirements - Finance PACs are major campaign contributors to both parties

The industry's lobbying success is evident in its ability to weaken or delay post-2008 regulations, though the political environment has become more skeptical post-2016.

# Recent Trends

## 1. The March 2023 Banking Stress

The failures of Silicon Valley Bank, Signature Bank, and First Republic revealed vulnerabilities in regional banking:

**SVB's problem:** The bank invested deposits in long-duration bonds when rates were low. When the Fed raised rates, these bonds lost value—but losses were hidden by accounting rules (held-to-maturity classification). When depositors learned the bank needed to raise capital, a social-media-accelerated run withdrew \$42 billion in a single day.

**Lessons:** Uninsured deposits are vulnerable; interest rate risk can destroy capital; digital banking and social media accelerate runs; regulators will extend implicit guarantees to prevent contagion.

## 2. Private Credit Explosion

Private credit—direct lending by funds rather than banks—has grown from under \$500 billion (2015) to over \$1.5 trillion (2024). Companies that previously borrowed from banks now borrow from Apollo, Ares, and other alternative managers. This shift moves credit risk outside the regulated banking system, creating potential systemic blind spots.

## 3. Fee Compression in Asset Management

The shift to passive investing has crushed fees: - Average equity mutual fund fee: 0.44% (down from 0.99% in 2000) - Index fund fees: Often <0.10% - Active managers have lost \$5 trillion in assets to passive over 15 years

Winners: Vanguard, BlackRock, low-cost providers Losers: Traditional active managers, stock pickers

## 4. Fintech Maturation and Consolidation

After explosive growth (2015-2021), fintech faces headwinds: - Higher interest rates reduce lending profitability - Regulatory scrutiny increasing (Chime, Synapse issues) - Consolidation: M&A activity rising - “Embedded finance”: Banks partnering with fintechs rather than being disrupted

## 5. Insurance Market Stress

Property insurance is in crisis in some regions: - Climate-related losses rising (hurricanes, wildfires) - Insurers withdrawing from California, Florida - State Farm, Allstate non-renewing policies - Insurance becoming unaffordable or unavailable in high-risk areas

This has implications for housing markets, migration patterns, and government disaster relief.

## Firm Profiles

### JPMorgan Chase

**Quick Facts** - Headquarters: New York, NY - Founded: 2000 (merger); predecessor firms date to 1799 - Revenue: roughly \$160 billion (2023) - Employees: roughly 300,000 - CEO: Jamie Dimon (since 2005)

JPMorgan Chase is the largest bank in the United States and among the largest in the world. The firm resulted from a series of mergers: Chemical Bank and Manufacturers Hanover (1991), Chemical and Chase Manhattan (1996), Chase and J.P. Morgan (2000), and JPMorgan Chase and Bank One (2004). The 2008 crisis added Bear Stearns (fire-sale purchase arranged by the Fed) and Washington Mutual (largest bank failure in history, acquired from FDIC).

The firm operates across all major financial services: - **Consumer and Community Banking**: 4,700 branches, 85 million customers, Chase credit cards - **Corporate and Investment Bank**: Top-3 in M&A advisory, securities underwriting, trading - **Commercial Banking**: Middle-market lending - **Asset and Wealth Management**: roughly \$3 trillion in client assets

JPMorgan's scale creates advantages (cheap funding, technology investment capacity) and challenges (regulatory intensity, "too big to manage" risk). Under CEO Jamie Dimon, the bank has generally outperformed peers, navigating the 2008 crisis and 2020 pandemic better than competitors.

The bank exemplifies the "universal bank" model that emerged after Glass-Steagall repeal: commercial banking, investment banking, asset management, and payments under one roof.

### Berkshire Hathaway Insurance Operations

**Quick Facts** - Headquarters: Omaha, NE - Founded: 1839 (as textile company); insurance from 1967 - Insurance Revenue: roughly \$85 billion in premiums - Float: roughly \$165 billion - CEO: Warren Buffett (since 1965)

Berkshire Hathaway is technically a conglomerate, but insurance is its engine. Warren Buffett's insight was that insurance generates "float"—premiums collected before claims are paid—that can be invested for decades. If underwriting breaks even, the float is essentially free leverage.

Berkshire's insurance operations include: - **Geico**: Second-largest auto insurer, known for direct-to-consumer model and gecko advertising - **Berkshire Hathaway Primary Group**: Commercial insurance - **Berkshire Hathaway Reinsurance**: One of the world's largest reinsurers, insuring other insurance companies against catastrophic losses - **General Re**: Global reinsurance

The combined float (roughly \$165 billion) funds Berkshire's investments in stocks, entire companies (BNSF railroad, Precision Castparts, Dairy Queen), and cash reserves. This structure is difficult to replicate: it requires exceptional underwriting discipline and investment skill sustained over decades.

Succession planning is underway: Greg Abel (non-insurance operations) is designated as Buffett's successor, with Ajit Jain running insurance. How Berkshire's unique culture survives Buffett's eventual departure is one of corporate America's most-watched questions.

## **BlackRock**

**Quick Facts** - Headquarters: New York, NY - Founded: 1988 - AUM: roughly \$10 trillion - Employees: roughly 20,000 - CEO: Larry Fink (co-founder)

BlackRock is the world's largest asset manager, having grown from a fixed-income shop in 1988 to a financial industry titan. Key growth drivers:

**iShares acquisition (2009):** BlackRock bought Barclays Global Investors, gaining the iShares ETF platform. iShares is now the largest ETF provider (roughly \$3 trillion), making BlackRock the primary beneficiary of the passive investing revolution.

**Aladdin platform:** BlackRock's risk management technology, originally built for internal use, is now licensed to other asset managers, insurers, and pensions. Over \$20 trillion in assets are analyzed on Aladdin, giving BlackRock unparalleled visibility into global financial markets.

**Institutional relationships:** Pension funds, sovereign wealth funds, and central banks use BlackRock for outsourced asset management.

BlackRock's scale creates influence beyond pure asset management. The firm is among the top shareholders of most large public companies, creating governance power. CEO Larry Fink's annual letters on ESG and stakeholder capitalism shape corporate behavior—and generate controversy from both left (insufficient action) and right (overreach beyond fiduciary duty).

The firm also advises governments: BlackRock helped the Fed design its corporate bond-buying programs in 2020, raising questions about conflicts of interest.

## **Data Sources and Further Reading**

### **Key Data Sources**

- **FDIC:** Bank financial data (call reports), failed bank list, deposit insurance statistics
- **Federal Reserve:** Flow of Funds (Z.1), bank holding company data, stress test results
- **SEC:** Investment company data, Form 13F holdings, broker-dealer FOCUS reports
- **NAIC:** Insurance industry data (by state)
- **BLS:** Employment by industry (QCEW, OES)
- **S&P Global Market Intelligence:** Bank and insurance company data (subscription)

## **Further Reading**

**Accessible** - Admati, Anat, and Martin Hellwig (2013). *The Bankers' New Clothes*. Why banks should hold more capital—clearly argued. - Lewis, Michael (2010). *The Big Short*. The 2008 crisis told through characters who saw it coming.

**Intermediate** - Gorton, Gary (2010). *Slapped by the Invisible Hand*. The 2008 crisis as a shadow banking run—essential. - Lowenstein, Roger (1995). *Buffett: The Making of an American Capitalist*. How Berkshire Hathaway was built. - Bernanke, Ben (1995). “Inside the Black Box: The Credit Channel of Monetary Policy.” *Journal of Economic Perspectives*. How banking transmits monetary policy.

**Industry** - Financial Stability Board. *Global Monitoring Report on Non-Bank Financial Intermediation*. Annual report on shadow banking worldwide. - Federal Reserve. *Financial Stability Report*. Semi-annual assessment of systemic risks. - McKinsey Global Banking Annual Review. Industry trends and performance benchmarking.

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Chapter 8 | Finance and Insurance The American Economy: A Structural Geography  
Draft v1 — January 2026

## **Exercises**

### **Review Questions**

1. Banks perform “maturity transformation”—borrowing short (demand deposits) and lending long (30-year mortgages). Explain why this is socially valuable and why it is inherently fragile. How did Silicon Valley Bank’s failure in March 2023 illustrate this fragility? What role did held-to-maturity accounting, uninsured deposits, and social media play in accelerating the bank run?
2. The four largest banks (JPMorgan Chase, Bank of America, Citigroup, Wells Fargo) hold approximately 45% of all U.S. banking assets, yet roughly 4,500 community banks still operate. What functions do community banks perform that the Big Four cannot or do not? Why haven’t community banks been consolidated entirely despite their small scale?
3. The “Big Three” asset managers (BlackRock, Vanguard, State Street) collectively manage roughly \$23 trillion and are the largest shareholders in most S&P 500 companies. What governance concerns does this concentration of ownership create? How does passive index investing—where a single fund owns shares in competing companies like Delta and United Airlines—raise “common ownership” antitrust questions?
4. Berkshire Hathaway’s insurance operations generate roughly \$165 billion in “float”—premiums collected before claims are paid—which Warren Buffett invests for decades. The chapter describes this as “essentially free leverage.” Why is this model difficult for competitors to replicate? What combination of underwriting discipline and investment skill is required?

5. Private credit has grown from under \$500 billion in 2015 to over \$1.5 trillion in 2024, as companies that previously borrowed from banks now borrow from alternative managers like Apollo and Ares. What are the implications for systemic risk when credit intermediation moves outside the regulated banking system? How does this relate to the “shadow banking” vulnerabilities that contributed to the 2008 crisis?
6. Delaware and South Dakota host major credit card operations because their usury laws impose no interest rate caps. The chapter notes this “illustrates how state regulation shapes financial geography.” Explain the mechanism: how does a credit card company based in South Dakota apply South Dakota law to a cardholder in New York? What does this regulatory arbitrage reveal about the fragmented structure of American financial regulation?
7. Average equity mutual fund fees fell from 0.99% in 2000 to 0.44%, while index fund fees are often below 0.10%. What drove this fee compression? Who are the winners (firms and investors) and losers? Why have active managers struggled to justify their higher fees?

## **Data Exercises**

8. Go to the FDIC’s BankFind Suite ([fdic.gov/analysis/bankfind](http://fdic.gov/analysis/bankfind)) and look up the financial data for JPMorgan Chase and a community bank in your area. Compare total assets, number of domestic branches, and total deposits. Calculate deposits per branch for each institution. What does the difference reveal about how a global money-center bank and a community bank serve their customers differently?
9. Using FRED ([fred.stlouisfed.org](http://fred.stlouisfed.org)), pull the series “FEDFUNDS” (Effective Federal Funds Rate) and “USNIM” (Net Interest Margin for all U.S. banks, available via FRED or FDIC Quarterly Banking Profile). Plot them together from 2000 to the present. How does the interest rate environment affect the net interest margin? What happened to NIM during the zero-rate period (2008–2015 and 2020–2022), and how did it respond when rates rose sharply in 2022–2023?
10. Visit the NAIC’s Insurance Information Institute ([iii.org](http://iii.org)) or use data from the Federal Reserve’s Financial Stability Report to find the combined ratio for the U.S. property-casualty insurance industry over the past five years. (The combined ratio equals claims plus expenses divided by premiums; a ratio above 100% means underwriting losses.) Has the P&C industry been profitable on underwriting alone? How do investment returns on float compensate for underwriting losses?

## **Deeper Investigation**

11. Research the private equity “roll-up” strategy in one specific fragmented industry mentioned in the chapter—dental practices, veterinary clinics, HVAC contractors, car washes, or funeral homes. How many independent operators have been acquired by PE-backed platforms? What has happened to prices charged to consumers after consolidation? What evidence exists on changes in service quality and worker compensation? Assess whether this quiet consolidation of

fragmented industries is likely to attract antitrust scrutiny, and explain why individual add-on acquisitions often escape the regulatory review that large horizontal mergers trigger.

# Chapter 9: Manufacturing

American manufacturing occupies a paradoxical position in the national imagination. Politicians of both parties invoke factory jobs as the backbone of the middle class, yet manufacturing employment has declined relentlessly for decades. Commentators lament “deindustrialization,” yet American factories produce more output than ever before. The manufacturing sector commands policy attention far exceeding its share of employment—roughly 8% of the workforce—because of its perceived strategic importance, its geographic concentration in politically pivotal states, and nostalgia for an era when a high school graduate could support a family on assembly-line wages. This chapter examines manufacturing as it actually exists: a high-productivity sector that generates substantial economic value with an ever-shrinking workforce, concentrated in specific subsectors and regions, and increasingly subject to industrial policy intervention.

## Overview: Size and Scope

### Info:

#### **The Manufacturing Paradox**

American manufacturing presents a paradox: output has roughly doubled since the 1980s, but employment has fallen by a third. The divergence reflects extraordinary productivity growth—automation, computerization, and process improvements enable factories to produce more with fewer workers. This is economically valuable but means manufacturing will not return as a mass employer regardless of trade policy or reshoring efforts.

Manufacturing contributed roughly \$3 trillion in value added to GDP in 2023—about 11% of the total economy. This share has declined from roughly 25% in the 1960s, but the decline primarily reflects the faster growth of services, not an absolute contraction of industrial output. Real manufacturing output has roughly doubled since the 1980s. American factories produce more aircraft, pharmaceuticals, chemicals, and vehicles than they did a generation ago.

The employment picture tells a different story. Manufacturing employed approximately 12.8 million workers as of early 2024—down from 17.3 million in 2000 and 19.4 million at the 1979 peak. This represents roughly 8% of total nonfarm employment, compared to 22% in 1970. The decline has been persistent across business cycles: manufacturing employment briefly recovered after the 2008-2009 recession

and again after the pandemic disruption, but the long-term trajectory remains downward.

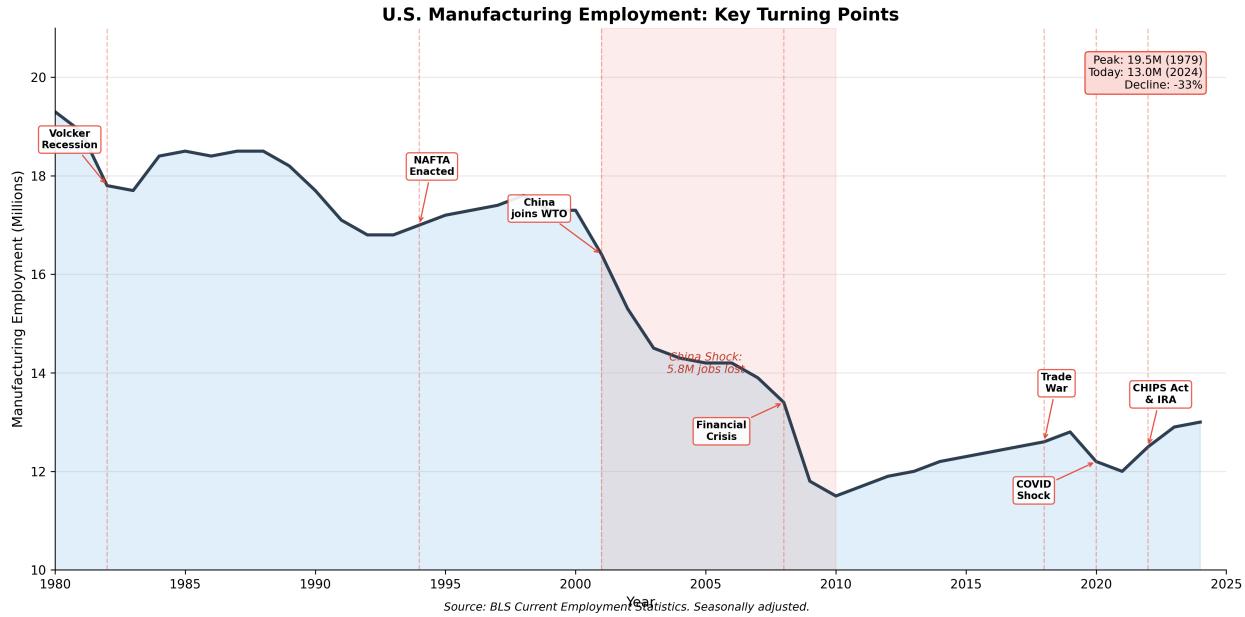


Figure 32: Figure 9.1: Manufacturing employment with key turning points, 1980-2024. Key events—NAFTA, China’s WTO accession, the financial crisis, and the CHIPS Act—mark turning points in the sector’s long employment decline. Source: BLS CES

The divergence between rising output and falling employment represents manufacturing’s central economic fact: extraordinary productivity growth. Output per worker has increased dramatically as automation, computerization, and process improvements enabled factories to produce more with fewer hands. A modern automobile assembly plant requires a fraction of the labor that similar facilities needed in the 1970s. Pharmaceutical manufacturing, semiconductor fabrication, and food processing have undergone similar transformations. This productivity growth is economically valuable—it means more goods at lower real cost—but it also means that manufacturing will not return as a mass employer regardless of trade policy, reshoring efforts, or industrial subsidies.

## How the Industry Works

### The Production Network

Manufacturing encompasses an extraordinarily diverse set of activities united only by the physical transformation of materials into products. The sector spans petrochemical refineries processing crude oil, pharmaceutical plants synthesizing complex molecules, food processing facilities converting agricultural inputs into packaged goods, and electronics factories assembling components into devices. These industries share some common features—capital intensity, quality control requirements, supply chain complexity—but differ enormously in their economics, workforce

requirements, and competitive dynamics.

Modern manufacturing is characterized by fragmented production networks rather than vertically integrated facilities. The automobile industry exemplifies this structure: a single vehicle contains approximately 30,000 parts sourced from hundreds of suppliers across multiple tiers. Original equipment manufacturers (OEMs) like General Motors or Toyota assemble final vehicles, but the majority of value-added occurs upstream in the supply chain. Tier 1 suppliers provide major systems (transmissions, electronics modules), which themselves incorporate components from Tier 2 and Tier 3 suppliers. This structure extends globally: a “American-made” vehicle may contain engines from Mexico, transmissions from Japan, and electronics from multiple Asian countries.

This production network model emerged from the pursuit of efficiency and specialization. Suppliers develop expertise in specific components, achieving scale economies across multiple customers. OEMs focus on design, assembly, and brand management rather than component manufacturing. Just-in-time inventory systems minimize working capital requirements. The system works remarkably well under normal conditions but proved fragile during disruptions: the COVID-19 pandemic, the 2011 Japanese tsunami, and various supply chain crises demonstrated how single-point failures could cascade through interconnected networks.

## **Business Models**

Manufacturing business models vary enormously by subsector:

**Process manufacturing** (chemicals, petroleum refining, pharmaceuticals) involves continuous or batch production of materials and compounds. These industries are capital-intensive, with high fixed costs and significant scale economies. A world-scale petrochemical facility or pharmaceutical manufacturing plant requires billions in investment. Companies compete on process efficiency, feedstock costs, and capacity utilization. Geographic advantages—access to cheap natural gas for petrochemicals, proximity to agricultural inputs for food processing—strongly influence plant location.

**Discrete manufacturing** (vehicles, machinery, electronics) produces countable units through assembly operations. These industries combine components into finished products, with value creation distributed across design, component sourcing, assembly, and distribution. Business models range from pure assembly (importing components for final assembly) to vertical integration (manufacturing key components in-house). Apple exemplifies the former: the company designs products in California but contracts manufacturing almost entirely to Asian suppliers, primarily Foxconn in China. Boeing represents more integration, manufacturing aircraft structures and assembling aircraft at company-owned facilities while sourcing engines and avionics from suppliers.

**Contract manufacturing** has grown as brand-name companies outsource production. Electronics manufacturing services (EMS) companies like Foxconn, Flex, and Jabil assemble products for multiple brands. This model allows brand owners to focus on design and marketing while contractors achieve scale across customers. The

arrangement works well for standardized products but creates dependency on manufacturing partners with their own strategic interests.

## Industry Structure

### Subsector Composition

Manufacturing's roughly \$3 trillion GDP contribution distributes unevenly across sub-sectors:

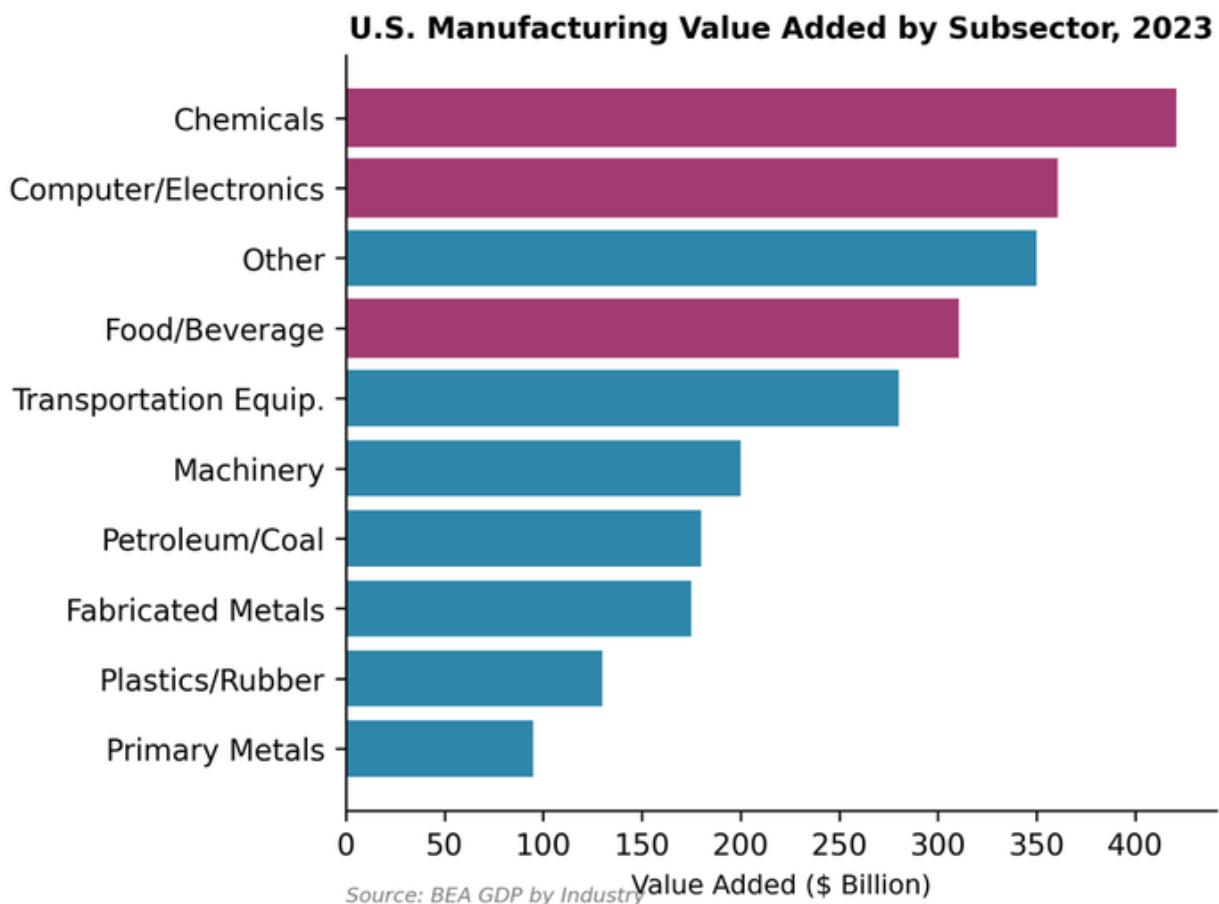


Figure 33: Figure 9.2: Manufacturing value added by subsector. Chemicals (including pharmaceuticals) lead, followed by computers/electronics and food products. Source: BEA (2023)

**Chemical products** (including pharmaceuticals) constitute the largest subsector by value-added, contributing approximately \$420 billion. This category spans industrial chemicals (basic organic and inorganic compounds), specialty chemicals (catalysts, additives), and pharmaceuticals. The petrochemical industry clusters along the Gulf Coast, exploiting cheap natural gas as feedstock. Pharmaceutical manufacturing concentrates in New Jersey, Massachusetts, and North Carolina, near research universities and biotechnology clusters. Major players include Dow, DuPont (now separate

companies after a merger and re-split), BASF's American operations, and pharmaceutical giants like Pfizer, Johnson & Johnson, Merck, and AbbVie.

**Computer and electronic products** contribute approximately \$360 billion in value-added. This category includes semiconductor manufacturing, computer and peripheral equipment, communications equipment, and navigational instruments. Despite offshoring of final assembly to Asia, substantial design and some fabrication remain domestic. Intel operates major fabs in Oregon, Arizona, and New Mexico. The CHIPS Act has catalyzed new investments: TSMC is building facilities in Arizona, Samsung in Texas, and Intel is expanding in Ohio. Defense electronics manufacturing remains largely domestic for security reasons.

**Food and beverage products** contribute approximately \$310 billion. This essential industry processes agricultural outputs into consumer products—meat packing, dairy processing, beverage manufacturing, grain milling, and packaged foods. The industry is geographically dispersed, located near both agricultural inputs and consumer markets. Major players include Tyson Foods, JBS USA (Brazilian-owned), Cargill (privately held), PepsiCo, and Kraft Heinz.

**Transportation equipment** (vehicles, aerospace, ships) is the largest manufacturing employer, though not the highest in value-added. The automobile industry remains centered in Michigan, with assembly plants extending through the Midwest and increasingly into Southern states. The “Detroit Three”—General Motors, Ford, and Stellantis (formed from the Fiat Chrysler-PSA merger)—compete with transplant operations from Toyota, Honda, Hyundai, BMW, and others. Aerospace manufacturing clusters in the Seattle area (Boeing commercial aircraft), Southern California (defense contractors), and South Carolina (Boeing’s second 787 line, now primary). Defense contractors Lockheed Martin, RTX (formerly Raytheon), Northrop Grumman, and General Dynamics operate facilities nationwide, located near military customers and test facilities.

**Machinery** encompasses agricultural equipment (Deere, AGCO, CNH Industrial), construction equipment (Caterpillar, Komatsu's American operations), and industrial machinery. These industries concentrate in the Midwest, near both agricultural customers and the historical manufacturing belt. Caterpillar, headquartered in Texas after relocating from Illinois, remains the iconic American machinery manufacturer.

**Primary and fabricated metals** include steel production, aluminum smelting, and metal parts manufacturing. Once-dominant American steel has contracted dramatically, with integrated steel mills largely replaced by electric arc furnace “mini-mills” that recycle scrap. Nucor pioneered this model and remains the largest domestic producer. Fabricated metal products—stamped parts, forgings, castings—serve as inputs to other manufacturing industries.

## **Concentration and Competition**

Manufacturing concentration varies dramatically by subsector. Commercial aerospace is essentially a duopoly: Boeing and Airbus divide the large commercial aircraft market, with smaller competitors (Embraer, Bombardier's former operations) serving regional jets. Defense contracting concentrates among five

"primes" (Lockheed Martin, RTX, Northrop Grumman, Boeing, General Dynamics) that win major contracts and manage subcontractor networks.

Automobiles exhibit moderate concentration with intense competition. The Detroit Three collectively hold roughly 40% of the American market, competing with Asian (Toyota, Honda, Hyundai-Kia) and European (Volkswagen, BMW, Mercedes) manufacturers. Tesla has disrupted the industry, growing from niche producer to America's most valuable automaker by market capitalization.

Pharmaceuticals combine brand-name concentration with generic competition. Major pharmaceutical companies possess temporary monopolies through patents, but face generic entry upon expiration. The industry has consolidated through mergers (Pfizer-Warner Lambert-Pharmacia, Bristol-Myers Squibb-Celgene), leaving a handful of large diversified pharmaceutical companies competing with biotechnology specialists.

Food processing varies by category. Meat packing has consolidated into an oligopoly: four companies (Tyson, JBS, Cargill, National Beef) control over 80% of beef processing. Beverage production concentrates in Coca-Cola, PepsiCo, and Anheuser-Busch InBev. Packaged foods remain more fragmented, with large players (Kraft Heinz, General Mills, Kellogg) competing with private-label manufacturers and specialty producers.

## **Major Manufacturers**

The largest American manufacturers by revenue (excluding pure energy companies):

Company	Sector	2023 Revenue	Notes
Apple	Electronics	\$383B	Design in US, manufacturing contracted to Asia
Ford	Automobiles	\$176B	Detroit Three; EV transition underway
General Motors	Automobiles	\$171B	Detroit Three; Ultium battery investments
Tesla	Automobiles	\$96B	EV-native; Fremont, Austin, Nevada plants
Johnson & Johnson	Pharma/Medical	\$85B	Diversified healthcare company

Company	Sector	2023 Revenue	Notes
Boeing	Aerospace	\$77B	Commercial and defense aircraft
RTX	Defense	\$68B	Formed from Raytheon-United Technologies merger
GE Aerospace	Aerospace	\$68B	Spun off from General Electric
Lockheed Martin	Defense	\$67B	Largest defense contractor; F-35 program
Caterpillar	Machinery	\$67B	Construction and mining equipment
Deere & Co	Machinery	\$61B	Agricultural equipment
Pfizer	Pharmaceuticals	\$58B	Largest pharma; COVID vaccine producer
Intel	Semiconductors	\$54B	Leading US chip manufacturer
Dow	Chemicals	\$45B	Commodity and specialty chemicals

Source: Company 10-K filings and annual reports, FY 2023

Apple's position at the top illustrates manufacturing's complexity: the company designs products in California and captures enormous value through brand, design, and software, but contracts virtually all physical manufacturing to suppliers in China. As Patrick McGee documents in *Apple in China* (2025), this arrangement reflects deliberate strategic choices over decades. Foxconn's Zhengzhou facility alone employs over 200,000 workers assembling iPhones—a workforce concentration that would be impossible to replicate in the United States given labor costs, supply chain proximity, and the sheer density of component suppliers within a few hours' drive. Apple's China dependence has become a geopolitical vulnerability, prompting modest diversification toward India and Vietnam, but China remains the center of gravity for iPhone production. Whether Apple is a "manufacturer" depends on definition—it captures the lion's share of value while owning none of the factories.

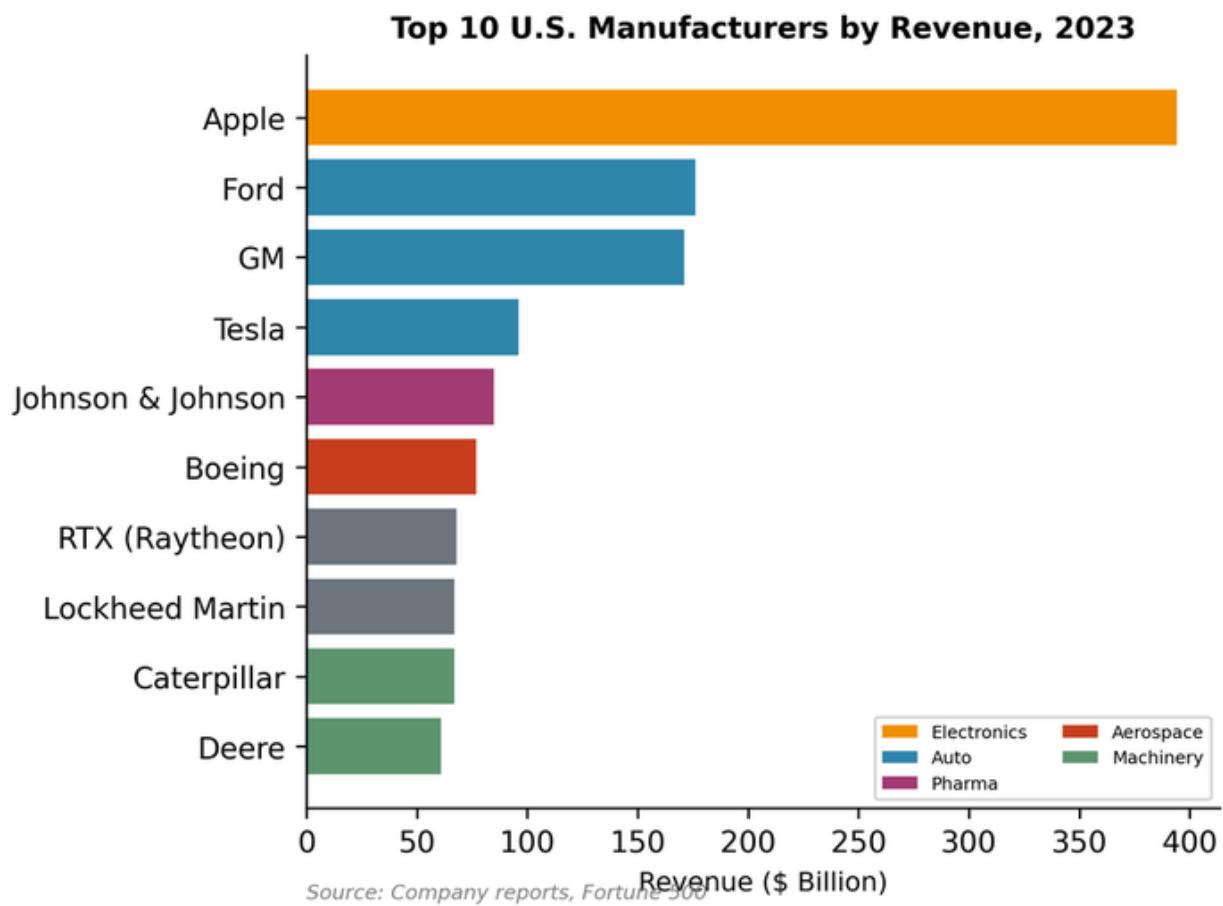


Figure 34: Figure 9.3: Top U.S. manufacturers by revenue. Apple leads by a wide margin, though its manufacturing is contracted out. Source: Company data (2023)

## **Geographic Distribution**

Manufacturing employment concentrates in specific regions, shaped by historical path dependence, resource endowments, and policy choices.

### **The Manufacturing Belt**

The traditional manufacturing belt stretches from the Upper Midwest through the Great Lakes states: Michigan, Ohio, Indiana, Wisconsin, and Illinois. This region developed during the late nineteenth and early twentieth centuries, combining access to iron ore (via Great Lakes shipping), coal (from Appalachia), and agricultural inputs. Detroit emerged as the automobile capital; Chicago as a machinery and food processing center; the steel industry clustered around Pittsburgh, Cleveland, and Gary.

This region has experienced substantial employment decline but remains the country's manufacturing heartland. Michigan alone hosts over 600,000 manufacturing workers, concentrated in automotive suppliers and assembly plants. Ohio, Indiana, and Wisconsin each employ over 400,000 in manufacturing. The workforce has aged and shrunk, but the industrial ecosystem—suppliers, skilled workers, engineering universities—persists.

The region is now pivoting toward electric vehicle production. General Motors' Ultium battery joint ventures have established facilities in Ohio and Michigan. Ford's investments concentrate in Michigan and Kentucky. The hope is that EV transition will revitalize rather than further erode Midwestern manufacturing, though battery production requires fewer workers than engine and transmission manufacturing.

### **Southern Growth**

The most dynamic manufacturing growth has occurred in the Southeast, stretching from South Carolina through Georgia, Alabama, Tennessee, and Kentucky. Foreign automakers established this "Southern Auto Corridor" beginning in the 1980s, attracted by lower labor costs, right-to-work laws limiting union power, and generous state incentives.

BMW's Spartanburg, South Carolina plant is now the company's largest globally. Mercedes-Benz manufactures SUVs in Tuscaloosa, Alabama. Hyundai-Kia operates plants in Alabama and Georgia. Toyota and Nissan built Tennessee facilities. Volkswagen chose Chattanooga for its American assembly plant. These transplants developed their own supplier networks, creating an alternative automotive cluster outside Detroit's traditional orbit.

The South has captured the majority of recent manufacturing investment announcements. Ford's \$11 billion BlueOval City complex in Tennessee will produce electric trucks and batteries. Hyundai's new Georgia EV plant represents a \$7.6 billion investment. SK Battery is building facilities in Georgia. This "Battery Belt" extends the Southern advantage into the EV era.

The Southern manufacturing model relies on lower labor costs—manufacturing wages average 15-20% below Midwestern levels—and the absence of unions. The United

Auto Workers has repeatedly failed to organize Southern transplants, most recently losing a high-profile campaign at Volkswagen's Chattanooga plant in 2019 before finally succeeding in 2024. Whether unionization will spread through the Southern auto industry remains uncertain.

## Aerospace Clusters

Aerospace manufacturing concentrates in distinct clusters:

**Seattle/Puget Sound** hosts Boeing's commercial aircraft operations, though the company has diversified production. The 737 assembles in Renton; the 777 and remaining 787 production in Everett. Boeing's headquarters relocated to Chicago (later Virginia), but engineering and production remain substantially in Washington.

**Southern California** houses the historical aerospace-defense complex. Northrop Grumman, Lockheed Martin's Skunk Works, and numerous suppliers cluster in Los Angeles County. SpaceX manufactures rockets in Hawthorne.

**South Carolina** gained Boeing's second 787 line, a controversial decision driven partly by labor relations conflicts in Washington. The Charleston facility has become Boeing's primary 787 production site.

**Wichita, Kansas** remains the center of general aviation manufacturing. Spirit AeroSystems (formerly Boeing's structures division) produces fuselages and components. Textron Aviation manufactures Cessna and Beechcraft aircraft.

## Pharmaceutical Geography

Pharmaceutical manufacturing clusters along the Northeast Corridor and in specific inland locations:

**New Jersey** earned the nickname "Medicine Chest of the World" in the early twentieth century. Johnson & Johnson, Merck, and numerous smaller companies headquartered there, establishing research and manufacturing facilities. The cluster has shrunk as companies consolidated and offshored some production, but substantial capability remains.

**Boston/Cambridge** has emerged as the biotechnology capital, hosting Moderna, Biogen, and research facilities for most major pharmaceutical companies. Manufacturing often follows R&D, with biologics production requiring proximity to scientific talent.

**Research Triangle (North Carolina)** combines research universities (Duke, UNC, NC State) with pharmaceutical manufacturing. GSK, Pfizer, and Merck operate significant facilities.

**Indiana** hosts Eli Lilly's headquarters and manufacturing complex in Indianapolis, along with substantial pharmaceutical supply chain operations.

# The Workforce

## Employment Characteristics

Manufacturing workers earn above-average wages—median hourly earnings of approximately \$23 compared to \$21 for all workers—but the premium has eroded over time. The historical manufacturing wage advantage reflected union bargaining power, now largely diminished, and the concentration of manufacturing in higher-wage regions.

The manufacturing workforce has transformed from predominantly production workers to a more diverse occupational mix. Modern factories require engineers, technicians, programmers, quality specialists, and logistics coordinators alongside traditional assembly and machine operator roles. Educational requirements have increased: many manufacturing jobs now require post-secondary training or certification, though four-year degrees remain less common than in professional services.

Manufacturing employment skews male (approximately 70%) and older (median age above 44) compared to the overall workforce. This demographic profile reflects both the historical composition of industrial work and recruitment challenges as younger workers pursue other occupations.

## The Productivity Paradox

Manufacturing productivity has grown faster than most other sectors, a trend economists generally celebrate. Higher productivity means more output per worker, enabling higher wages, lower prices, or both. Yet productivity growth has been manufacturing's employment curse: as each worker produces more, fewer workers are needed to meet any given level of demand.

International comparisons reveal that American manufacturing productivity leads most competitors, undermining the narrative that manufacturing decline reflects competitive weakness. American factories produce roughly twice as much output per hour worked as those in China, a gap that persists despite Chinese wage increases. The challenge is not that American manufacturing is unproductive but that productivity reduces labor demand.

## Automation and Robots

Industrial robots represent the most visible face of manufacturing automation. The United States has approximately 295 robots per 10,000 manufacturing workers—a substantial deployment but below leaders like South Korea (1,000), Singapore, Japan, and Germany (all above 400). China has rapidly increased robot density to 470 per 10,000 workers, surpassing the United States.

Automotive manufacturing has the highest robot penetration, with welding, painting, and material handling extensively automated. Electronics assembly increasingly uses robots, though the dexterity required for complex assembly still exceeds robot capabilities for many tasks. Pharmaceutical manufacturing is highly automated but with specialized equipment rather than general-purpose robots.

## Robot Density in Manufacturing, 2023

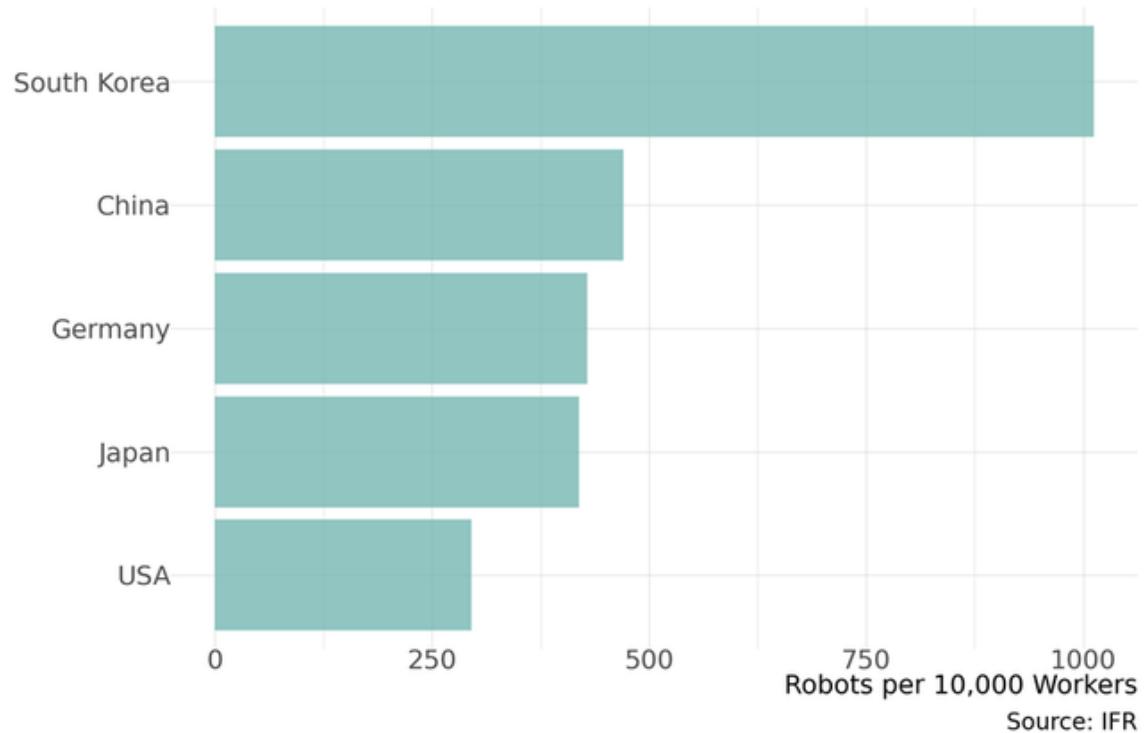


Figure 35: Figure 9.4: Industrial robot density (robots per 10,000 manufacturing workers). The U.S. lags South Korea and Germany; China has surpassed U.S. density. Source: IFR (2023)

The automation trajectory suggests continued manufacturing employment pressure. Advances in robotics, machine vision, and artificial intelligence expand the range of automatable tasks. Collaborative robots (“cobots”) that work alongside humans, rather than in caged workcells, enable automation of tasks previously requiring human flexibility. While alarmist predictions of mass technological unemployment have repeatedly proven premature, manufacturing employment will continue its long-term decline.

## The China Shock and Its Aftermath

While automation provided steady pressure on manufacturing employment, the period from 2000 to 2010 delivered a concentrated blow that economists now call “the China shock.” China’s accession to the World Trade Organization in December 2001 provided permanent normal trade relations with the United States, eliminating the annual uncertainty over tariff renewal that had constrained Chinese exports. What followed was an import surge of unprecedented speed and scale.

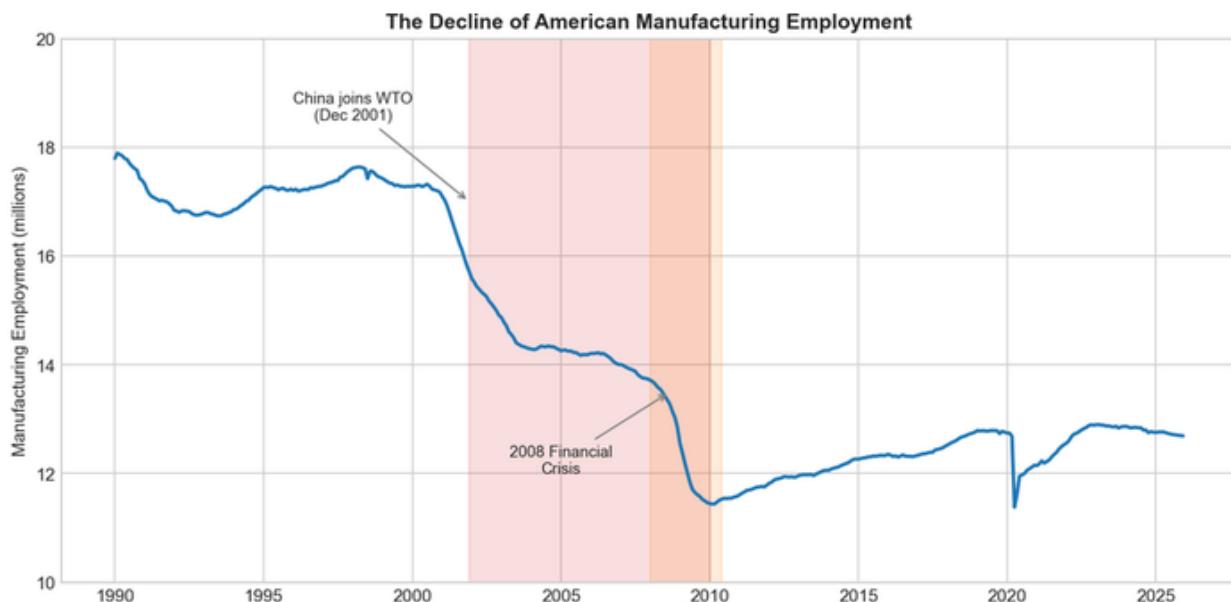


Figure 36: Figure 9.5: Manufacturing employment fell sharply from 17.3 million in 2000 to 11.5 million in 2010—a loss of 5.8 million jobs in a single decade. The China shock contributed substantially to this decline. Source: BLS

Between 2000 and 2010, American manufacturing employment fell from 17.3 million to 11.5 million—a loss of 5.8 million jobs, or one-third of the manufacturing workforce. While automation and the 2008 financial crisis contributed, economists David Autor, David Dorn, and Gordon Hanson demonstrated that import competition from China accounted for a substantial share—perhaps 2 to 2.4 million jobs directly displaced by Chinese imports, with additional losses through supply chain linkages.

The transmission mechanism worked through product market competition. As Chinese factories scaled up production of labor-intensive manufactured goods—furniture, textiles, apparel, toys, electronics assembly—American producers faced a

stark choice: match Chinese costs (impossible given wage differentials), automate (capital-intensive and not always feasible), shift to higher-value products (requiring capabilities not all firms possessed), or exit. Many exited. The furniture industry in North Carolina, textile mills in the Southeast, and electronics assembly facilities across the country shuttered as Chinese imports captured market share.

**Geographic Concentration:** The shock did not fall evenly. Communities that had specialized in the goods China now produced suffered disproportionately. The research by Autor, Dorn, and Hanson documented that commuting zones with industries more exposed to Chinese import competition experienced larger employment losses, slower wage growth, and higher rates of disability enrollment, food stamp uptake, and mortality. The pain concentrated in:

- **Appalachian furniture corridor:** North Carolina, Virginia, and Tennessee communities built around furniture manufacturing saw plant closures cascade through the 2000s
- **Rust Belt manufacturing:** Ohio, Michigan, Indiana communities already stressed by automotive restructuring faced additional pressure
- **Textile South:** South Carolina, Georgia, and Alabama textile towns that had survived earlier competitive pressures succumbed to Chinese competition
- **Electronics assembly:** California, Texas, and other hubs of circuit board assembly and component manufacturing

**Labor Market Transmission:** Perhaps most striking was how poorly labor markets absorbed the displaced workers. Economic theory predicted workers would transition to other sectors or regions. In practice, many displaced manufacturing workers never found comparable employment. They withdrew from the labor force, took lower-paying service jobs, applied for disability benefits, or moved into long-term unemployment. The adjustment mechanisms that had smoothed earlier trade shocks—geographic mobility, sectoral reallocation, retraining—proved inadequate for a shock of this magnitude and speed.

**Long-Run Consequences:** The China shock reshaped not just the economy but American politics. The communities most exposed to import competition showed significant shifts in voting patterns, contributing to the populist turn in trade policy that culminated in the 2018 tariffs. The bipartisan consensus favoring trade liberalization fractured. The shock demonstrated that “adjustment costs” economists had treated as temporary frictions could in fact be permanent and geographically concentrated.

The China shock has largely run its course—Chinese wages have risen substantially, and the most trade-sensitive industries have already adjusted or disappeared. But its legacy shapes contemporary industrial policy. The emphasis on supply chain resilience, the skepticism toward free trade agreements, and the willingness to deploy subsidies and tariffs all reflect lessons drawn from the 2000-2010 experience.

# Regulation and Trade

## Regulatory Environment

Manufacturing faces a complex regulatory environment spanning environmental protection, worker safety, product standards, and trade policy.

**Environmental regulation** significantly affects manufacturing operations. The Clean Air Act regulates emissions from industrial facilities. The Clean Water Act governs discharges to waterways. The Resource Conservation and Recovery Act controls hazardous waste management. These regulations impose compliance costs but have substantially reduced industrial pollution over the past fifty years. Critics argue regulations disadvantage American manufacturers relative to foreign competitors with weaker environmental standards; advocates counter that environmental protection is worth its cost and that a “race to the bottom” benefits no one.

**Occupational safety** regulation through OSHA establishes workplace safety standards. Manufacturing workplaces have become dramatically safer over time, with injury rates falling roughly 80% since OSHA’s 1971 creation, though the sector remains more hazardous than services.

**Product standards** vary by industry. Food and Drug Administration regulation governs pharmaceuticals and medical devices, imposing lengthy approval processes and manufacturing quality requirements. Consumer product safety standards apply broadly. Industry-specific standards (automotive safety, aviation certification) create additional compliance requirements.

## Trade Policy

Manufacturing lies at the center of trade policy debates. The United States runs large trade deficits in manufactured goods—approximately \$1.06 trillion in 2023—importing more manufactured products than it exports. China, Mexico, and the European Union are the largest sources of manufactured imports.

Trade economists generally view this deficit as reflecting macroeconomic factors (American consumption exceeding production, financed by capital inflows) rather than unfair trade practices. Manufacturing advocates argue that trade agreements disadvantaged American workers, that currency manipulation and subsidies distort competition, and that strategic industries require protection.

Trade policy has shifted toward protection under both Trump and Biden administrations. Tariffs on Chinese goods, imposed starting in 2018, remain largely in place. The Biden administration added targeted tariffs on strategic goods (semiconductors, batteries, electric vehicles, solar panels) while maintaining the broader Trump-era tariffs. The USMCA agreement (replacing NAFTA) tightened automotive content requirements, aiming to increase North American production.

Whether protectionist policies will increase manufacturing employment remains uncertain. Tariffs raise input costs for downstream manufacturers, potentially destroying more jobs than they create. Reshoring requires years of investment to develop domestic supply chains. The most optimistic case is that strategic investments (CHIPS

Act, IRA) combined with trade protection will establish competitive domestic industries; the pessimistic case is that protection raises costs for consumers and businesses without reviving employment.

## Industrial Policy and Strategic Investment

The Biden administration marked a dramatic shift toward active industrial policy after decades of bipartisan consensus favoring market-driven outcomes. Three major legislative initiatives—the Bipartisan Infrastructure Law, the CHIPS and Science Act, and the Inflation Reduction Act—channeled hundreds of billions toward manufacturing investment.

### The CHIPS and Science Act

The CHIPS Act committed \$52.7 billion to semiconductor manufacturing and research, responding to concerns about American dependence on Asian chip fabrication. The United States had invented the integrated circuit but watched fabrication capacity migrate to Taiwan (TSMC), South Korea (Samsung), and increasingly China. By 2020, the U.S. share of global semiconductor manufacturing had fallen to roughly 12%, down from 37% in 1990.

The CHIPS Act provides grants and tax credits for domestic semiconductor fabrication. Major commitments include: - **Intel**: \$8.5 billion in direct grants supporting expansions in Arizona, Oregon, Ohio, and New Mexico - **TSMC**: \$6.6 billion supporting Arizona fab construction - **Samsung**: \$6.4 billion supporting Texas expansion - **Micron**: \$6.1 billion supporting facilities in New York and Idaho

Industry announcements claim over \$200 billion in private investment catalyzed by CHIPS Act incentives. Whether these investments will restore American semiconductor leadership remains uncertain. Leading-edge fabrication requires not just facilities but the entire ecosystem of equipment suppliers, materials providers, and skilled workers that has developed in Asia over decades.

### The Inflation Reduction Act

Despite its name, the IRA is primarily climate and industrial policy legislation. The act provides extensive tax credits for clean energy manufacturing, electric vehicles, and renewable energy deployment. Manufacturing-relevant provisions include:

- **Advanced Manufacturing Production Tax Credit (45X)**: Credits for domestic production of solar cells, battery cells, and critical minerals processing
- **Advanced Energy Project Credit (48C)**: Grants for clean energy manufacturing facilities
- **Electric Vehicle Credits**: Consumer credits conditioned on North American assembly and battery content requirements

These provisions have catalyzed substantial manufacturing investment announcements—over \$86 billion in the first year—concentrated in battery manufacturing for electric

vehicles. The “Battery Belt” from Georgia through Tennessee reflects both IRA incentives and state-level subsidies.

## **Supply Chain Resilience**

The COVID-19 pandemic exposed vulnerabilities in global supply chains, generating bipartisan support for “reshoring” and “friendshoring” critical manufacturing. Personal protective equipment shortages, semiconductor shortages disrupting automobile production, and pharmaceutical supply concerns all highlighted dependence on foreign production.

The December 2024 Quadrennial Supply Chain Review documented administration efforts to strengthen supply chains in critical sectors: semiconductors, batteries, critical minerals, pharmaceuticals, and defense. The report claimed over \$1 trillion in announced private investment since 2021, with \$796 billion specifically in manufacturing.

Yet supply chain vulnerabilities persist. China dominates critical mineral processing, battery component production, and many pharmaceutical ingredients. Developing alternative supply chains requires years of investment and may never achieve cost parity with established Asian producers. The tension between supply chain resilience and cost efficiency will shape manufacturing policy for decades.

## **Recent Trends**

### **The Manufacturing Construction Boom**

Manufacturing construction spending has surged since 2021, roughly doubling to an annualized rate exceeding \$225 billion. This boom reflects CHIPS Act semiconductor investments, IRA-supported clean energy manufacturing, and broader reshoring efforts. The construction activity is real: new facilities are rising in Ohio (Intel), Arizona (TSMC, Intel), Georgia (SK Battery, Hyundai), Tennessee (Ford), and elsewhere.

Whether this construction translates into sustained manufacturing employment growth is less clear. Semiconductor fabs are highly automated, employing perhaps 3,000 workers in facilities costing \$20 billion. Battery plants similarly require fewer workers than historical manufacturing facilities of equivalent investment. The manufacturing employment boost may prove modest relative to the investment scale.

### **Electric Vehicle Transition**

The automotive industry’s transition to electric vehicles represents the most significant manufacturing shift in decades. Traditional automakers are converting plants from internal combustion to EV production while Tesla and new entrants build EV-native facilities. The transition favors the Battery Belt over the traditional auto industry heartland, though substantial investment is flowing to Michigan and Ohio as well.

EV manufacturing requires different supply chains than internal combustion vehicles. Battery cells replace engines as the critical component. Electric motors replace transmissions. The shift advantages companies with battery manufacturing relationships (often Korean and Chinese suppliers) over traditional powertrain suppliers. Employment effects remain uncertain: battery and EV assembly may require fewer workers than traditional auto manufacturing, potentially accelerating long-term employment decline even as production volumes grow.

## **The Jobs Question**

Manufacturing has regained jobs lost during the pandemic, with employment roughly flat at 12.8 million. The Biden administration cited 700,000 manufacturing jobs added since January 2021, though this substantially reflects pandemic recovery rather than structural employment growth.

The fundamental employment trajectory remains downward. Productivity growth, automation, and global competition constrain manufacturing employment regardless of policy intervention. Industrial policy may create or preserve jobs at the margin—semiconductor fabs, battery plants, and reshored production will employ some workers—but manufacturing will not return as a mass employer. The sector's importance lies in its output, its strategic value, and its role in specific communities, not in aggregate employment.

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## **Firm Profiles**

### **Caterpillar: The Machine in the Garden**

Caterpillar is America's iconic machinery manufacturer, producing the yellow construction and mining equipment visible at job sites worldwide. Founded in 1925 from the merger of Holt Manufacturing and C.L. Best Tractor, the company built its reputation on tracked vehicles (the "Caterpillar" name derives from how tracked machines crawl) and expanded into a full range of heavy equipment.

Caterpillar generated \$67 billion in revenue in 2023, selling equipment across construction, mining, energy, and transportation markets. The company operates a global manufacturing network but maintains substantial American production, with major facilities in Illinois (historically) and expanding operations in Texas, where the company relocated its headquarters in 2022.

The company exemplifies manufacturing's strategic and cyclical nature. Caterpillar equipment builds infrastructure worldwide; demand rises and falls with commodity prices and construction cycles. The company has navigated decades of global competition, particularly from Komatsu of Japan, maintaining technological leadership while managing manufacturing across multiple countries. Labor relations have been contentious, with extended strikes in the 1990s and ongoing tension over wages and benefits.

**Headquarters:** Irving, Texas (relocated from Peoria, Illinois) **Employees:** 114,000 globally **Key products:** Excavators, bulldozers, wheel loaders, mining trucks, diesel engines

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### Pfizer: The Pharmaceutical Giant

Pfizer is America's largest pharmaceutical company by revenue and among the world's largest, generating \$58 billion in 2023 (down from pandemic-era peaks when COVID-19 vaccines boosted revenue dramatically). Founded in 1849 in Brooklyn as a chemicals manufacturer, Pfizer evolved into a pharmaceutical powerhouse through internal research and aggressive acquisition.

The company's portfolio spans cardiovascular drugs, vaccines, oncology, and rare disease treatments. Pfizer's COVID-19 vaccine, developed in partnership with Germany's BioNTech, demonstrated pharmaceutical manufacturing's potential for rapid scale-up: the company manufactured billions of doses within months of approval. Beyond vaccines, the company produces treatments generating billions in annual revenue (Eliquis, Prevnar, Ibrance).

Pharmaceutical manufacturing differs from other industrial sectors in its regulatory intensity, intellectual property dependence, and high margins. Pfizer operates manufacturing facilities worldwide, with significant American production in Michigan, New York, and Puerto Rico. The company's future depends on its R&D pipeline and patent estate: blockbuster drugs eventually face generic competition, requiring continuous innovation to maintain revenue.

**Headquarters:** New York City **Employees:** 83,000 globally **Key products:** Eliquis (anticoagulant), Prevnar (vaccine), COVID-19 vaccine

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### Deere & Company: Farming the Data

Deere & Company, universally known as John Deere, dominates agricultural equipment manufacturing with approximately 60% of the North American tractor market. Founded in 1837 by blacksmith John Deere, who developed a steel plow suitable for Midwestern prairie soils, the company evolved into a comprehensive agricultural equipment manufacturer.

Deere generated \$61 billion in revenue in 2023, benefiting from strong agricultural commodity prices that enabled farmers to invest in new equipment. The company manufactures tractors, combines, planters, and specialized equipment for every stage of agricultural production. Beyond agriculture, Deere produces construction and forestry equipment, competing with Caterpillar in some categories.

The company has transformed from pure equipment manufacturer to technology company embedded in equipment. Modern John Deere machines incorporate GPS guidance, yield monitors, soil sensors, and data analytics. The company's precision agriculture platform generates detailed field data, enabling optimized planting, fertiliza-

tion, and harvesting. This technological shift has made Deere equipment increasingly sophisticated—and expensive—while creating new revenue streams from data services and software subscriptions.

Deere has sparked controversy over its equipment software policies, with farmers arguing that restrictions on repair access violate traditional ownership rights. The “right to repair” movement has targeted Deere specifically, leading to some policy concessions and ongoing legislative battles.

**Headquarters:** Moline, Illinois **Employees:** 83,000 globally **Key products:** Tractors, combines, planters, precision agriculture technology

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## Data Sources and Further Reading

### Government Sources

- Bureau of Economic Analysis, GDP by Industry
- Bureau of Labor Statistics, Current Employment Statistics
- Census Bureau, Annual Survey of Manufactures
- Federal Reserve, Industrial Production Index
- White House, Quadrennial Supply Chain Review (December 2024)

### Academic Sources

- Helper, Susan, and Rebecca Henderson. “Management Practices, Relational Contracts, and the Decline of General Motors.” *Journal of Economic Perspectives* 28, no. 1 (2014): 49-72.
- Autor, David H., David Dorn, and Gordon H. Hanson. “The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade.” *Annual Review of Economics* 8 (2016): 205-240.
- Pierce, Justin R., and Peter K. Schott. “The Surprisingly Swift Decline of US Manufacturing Employment.” *American Economic Review* 106, no. 7 (2016): 1632-1662.

### Industry Data

- International Federation of Robotics, *World Robotics Report*
- Semiconductor Industry Association, *State of the Industry Report*
- National Association of Manufacturers, *Industry Statistics*

### Books

- Vaclav Smil, *Made in the USA: The Rise and Retreat of American Manufacturing*. Cambridge: MIT Press, 2013.
- Louis Uchitelle, *The Disposable American: Layoffs and Their Consequences*. New York: Knopf, 2006.

- Steven Rattner, Overhaul: An Insider's Account of the Obama Administration's Emergency Rescue of the Auto Industry. Boston: Houghton Mifflin, 2010.

## Exercises

### Review Questions

1. American manufacturing output has roughly doubled since the 1980s, yet employment has fallen from 19.4 million (1979 peak) to 12.8 million. The chapter calls this the “manufacturing paradox.” Is this decline a sign of economic weakness or economic strength? What concept explains how a sector can produce more with fewer workers, and what are the implications for workers displaced by this process?
2. A single automobile contains approximately 30,000 parts sourced from hundreds of suppliers across multiple tiers. Why did manufacturing shift from vertically integrated facilities (where one company made everything) to fragmented production networks? What are the efficiency advantages of this structure? What vulnerabilities did the COVID-19 pandemic and the 2011 Japanese tsunami expose?
3. Apple is listed as the largest American manufacturer by revenue (\$383 billion) yet owns none of its factories—Foxconn’s Zhengzhou facility alone employs over 200,000 workers assembling iPhones. Is Apple a “manufacturer”? What does its position at the top of the revenue table reveal about where value is captured in modern manufacturing? How does this complicate the narrative about “bringing manufacturing back”?
4. The “China shock” (2000–2010) displaced an estimated 2 to 2.4 million manufacturing jobs directly. The chapter notes that displaced workers did not smoothly transition to other sectors or regions as economic theory predicted—many withdrew from the labor force, took lower-paying service jobs, or applied for disability benefits. What factors prevented the adjustment mechanisms that had worked for earlier trade shocks? What were the political consequences?
5. The CHIPS Act committed \$52.7 billion to semiconductor manufacturing, with major grants to Intel (\$8.5B), TSMC (\$6.6B), Samsung (\$6.4B), and Micron (\$6.1B). The U.S. share of global semiconductor production fell from 37% in 1990 to 12% in 2020. Will subsidies alone reverse this decline? What challenges beyond funding—the ecosystem of equipment suppliers, materials providers, and skilled workers that developed in Asia—must be addressed?
6. Four companies (Tyson, JBS, Cargill, National Beef) control over 80% of U.S. beef processing. What are the consequences of this oligopoly for cattle ranchers (who have fewer buyers for their livestock), consumers (who face less price competition), and food supply chain resilience (concentration in a small number of large facilities)?
7. The United States has approximately 295 industrial robots per 10,000 manufacturing workers, below South Korea (1,000), Germany (above 400), and China

(470). What factors explain the relatively lower U.S. robot density? Does lagging behind in automation represent a competitive disadvantage, or does it reflect different industry composition and labor market conditions?

## Data Exercises

8. Go to FRED ([fred.stlouisfed.org](http://fred.stlouisfed.org)) and pull the series “IPMAN” (Industrial Production: Manufacturing) and “MANEMP” (All Employees: Manufacturing). Plot both from 1980 to the present, using an index or normalizing to a common base year. In what decade was the divergence between rising output and falling employment most dramatic? What events (identified in Figure 9.1 of the chapter) drove the sharpest employment declines?
9. Using the BEA’s GDP by Industry data ([bea.gov/data/gdp/gdp-industry](http://bea.gov/data/gdp/gdp-industry)), find the value added for three manufacturing subsectors: chemicals (NAICS 325), computer and electronic products (NAICS 334), and transportation equipment (NAICS 336). Compare their growth trajectories since 2000. Which has grown fastest? How does the relative performance of these subsectors relate to the industrial policy priorities of the CHIPS Act and the Inflation Reduction Act?
10. Visit the Census Bureau’s Annual Survey of Manufactures ([census.gov/programs-surveys/asm](http://census.gov/programs-surveys/asm)) and find total manufacturing employment and total value of shipments for two states—one from the traditional Manufacturing Belt (e.g., Michigan, Ohio, Indiana) and one from the Southern growth corridor (e.g., South Carolina, Alabama, Tennessee). Calculate the value of shipments per manufacturing worker for each state. Which state has higher productivity per worker? What might explain the difference?

## Deeper Investigation

11. Research the electric vehicle transition’s impact on a specific manufacturing region: the Detroit Three’s operations in Michigan, the emerging “Battery Belt” in Georgia and Tennessee, or Tesla’s manufacturing footprint in Texas and Nevada. How is the transition from internal combustion to electric powertrains reshaping employment, supply chains, and community economics in your chosen region? The chapter notes that EV manufacturing may require fewer workers than traditional auto manufacturing. Assess whether the new investments (Ford’s BlueOval City, Hyundai’s Georgia plant, SK Battery’s facilities) will create enough jobs to offset losses in engine and transmission production, and evaluate what the transition means for the region’s long-term economic trajectory.

# Chapter 10. Retail and Wholesale Trade

“The consumer is boss.” — Sam Walton

Retail is the visible face of the economy—the point where production meets consumption. It is where the abstract supply chains of the global economy materialize into a gallon of milk, a smartphone, or a pair of jeans. But behind the storefront lies a vast, often invisible wholesale infrastructure that acts as the circulatory system of commerce. Together, these sectors employ over 20 million Americans and dictate not just what we buy, but how our cities are organized, how labor markets function, and how value is distributed across the supply chain. This chapter examines the mechanics of this massive distribution engine, from the “wheel of retailing” to the algorithmically optimized fulfillment centers of the digital age.

## Overview

### Size and Scope

- **Retail Sales:** Approximately **\$7.26 trillion** (2024)
- **Wholesale Sales:** Approximately **\$11.4 trillion**
- **Retail Employment:** roughly 15.5 million workers
- **Wholesale Employment:** roughly 6.1–6.3 million workers
- **Total Sector Employment:** roughly 21.5 million (roughly 14% of US employment)

Wholesale revenue exceeds retail revenue—a counterintuitive result that reflects intermediate goods changing hands multiple times before reaching consumers. A bottle of aspirin passes from manufacturer to pharmaceutical wholesaler to drugstore distribution center to individual store before finally reaching you. Each transaction counts as wholesale sales; only the final purchase counts as retail.

Retail is the nation’s largest private employer sector, though its dominance is fragmenting. Wholesale trade, while employing fewer people, generates immense turnover and acts as the critical logistical bridge between manufacturers (who make things) and retailers (who sell them). Without the wholesale infrastructure—the drug distributors, food service companies, industrial suppliers—the retail shelves would be empty.

# How the Industry Works

## □ Info:

### The Wheel of Retailing

Retail evolves in predictable cycles: new formats enter as low-cost disruptors, gradually add services and raise prices, then become vulnerable to the next wave of discounters. Department stores disrupted general stores; discount stores disrupted department stores; e-commerce now disrupts discount stores.

This cycle repeats throughout retail history. Sears rose on mail-order efficiency, added expensive department stores, and was killed by Walmart's warehouse stores. Walmart, in turn, is now fighting Amazon's even leaner e-commerce model.

## Format Evolution

The trajectory of American retail is a history of disruption, each wave driven by productivity improvements and scale economies:

1. **General Stores (Pre-1900):** The mom-and-pop establishments serving local markets with limited selection.
2. **Department Stores (1880s-1960s):** The “cathedrals of consumption” (Macy’s, Marshall Field’s, Wanamaker’s) that aggregated categories under one roof in urban centers.
3. **Mail Order (1890s-1970s):** Sears and Montgomery Ward brought consumption to rural America through catalogs—the original “e-commerce.”
4. **Supermarkets (1930s-):** Self-service grocery stores replaced clerks fetching items, dramatically cutting labor costs.
5. **Suburban Big-Box (1960s-2000s):** Category killers (Toys “R” Us, Circuit City, Borders) and mass merchants (Walmart, Target) colonized suburban sprawl with massive footprints and parking lots.
6. **E-commerce (1995-):** The digital iteration of mail order, turbocharged by search costs approaching zero. Why drive to three stores when you can compare prices in seconds?

Research by Hortaçsu and Syverson (2015) demonstrates that this format evolution, not e-commerce specifically, is the primary story of retail. The shift from small, inefficient retailers to large, productive chains accounts for nearly all productivity growth in the sector. E-commerce is simply the latest chapter.

## The Economic Model

The retailer's fundamental equation is the **Gross Margin:** the difference between the cost of goods sold (COGS) and the selling price.

- **Buy Low, Sell Higher:** Success depends on purchasing leverage. Walmart's size allows it to dictate terms to suppliers, widening its margin without raising consumer prices. A supplier that loses Walmart loses access to 25% of the American consumer market.

### The "Wheel of Retailing": Format Evolution

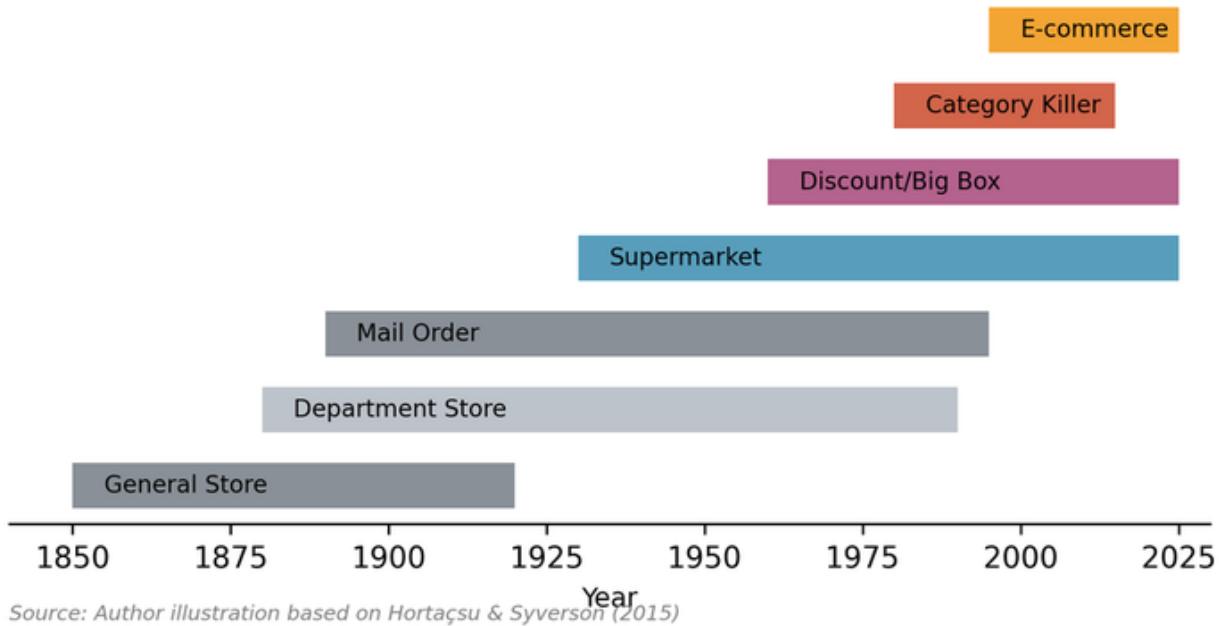


Figure 37: Figure 10.3: The wheel of retailing: format evolution over a century. Each wave entered as low-cost disruptor before maturing and becoming vulnerable to the next innovation. Source: Author compilation

- **Inventory Turnover:** Inventory is capital trapped on a shelf. The goal is to turn it over as fast as possible. Costco turns inventory about 12 times per year; a typical department store manages 3–4 turns.
- **Private Label vs. National Brands:** Retailers increasingly bypass branded manufacturers to sell their own “private label” goods (Costco’s Kirkland Signature, Amazon Basics, Target’s Good & Gather). This captures the brand margin for the retailer and builds customer loyalty that can’t be arbitrated away to competitors.
- **Real Estate:** For physical retailers, location is both strategy and cost structure. Owning versus leasing stores dramatically affects balance sheets and flexibility.

### The Omnichannel Revolution

The distinction between “online” and “offline” is evaporating. Stores now function as forward fulfillment centers. **Walmart** ships approximately 50% of its online orders directly from its 4,700 stores rather than from dedicated warehouses, leveraging its proximity to 90% of the US population to beat Amazon on speed and cost. **Target** does the same with its Drive Up and same-day delivery services. Amazon, meanwhile, bought **Whole Foods** in 2017 precisely to get physical locations closer to customers.

The winning formula is **omnichannel**: seamless integration of digital discovery, physical experience, and flexible fulfillment. Pure-play e-commerce retailers (other than Amazon) have struggled; pure-play physical retailers have struggled more.

## Wholesale: The Invisible Infrastructure

Wholesale trade is the unglamorous backbone of retail. Wholesalers aggregate products from thousands of manufacturers, maintain inventory, extend credit, and deliver to retailers who couldn't possibly manage direct relationships with every supplier.

### Key Wholesale Sectors:

- **Pharmaceutical Distribution:** A near-oligopoly. **McKesson** (\$276B revenue), **AmerisourceBergen** (\$238B), and **Cardinal Health** (\$205B) together distribute roughly 90% of all pharmaceuticals in America. They are the hidden pipes connecting drug manufacturers to your local pharmacy.
- **Food Service:** **Sysco** (\$76B) and **US Foods** (\$35B) supply restaurants, hospitals, and cafeterias across America.
- **Industrial Distribution:** **Grainger** (\$16B), **HD Supply**, and **Fastenal** supply the nuts, bolts, tools, and safety equipment that keep American industry running.
- **Electronics:** **Ingram Micro** and **Tech Data** move computer hardware and consumer electronics from Asian factories to American stores.

Wholesale margins are thin (typically 1–3% net), but volumes are enormous. These are logistics businesses, not merchandising businesses—they compete on delivery reliability, inventory depth, and supply chain technology.

## Industry Structure

The retail landscape is bifurcated: a handful of colossal “power retailers” dominate, while thousands of smaller players fight for niches.

### The Big Four (2024 US Sales)

Rank	Company	US Revenue	Market Position
1	<b>Walmart</b>	\$569B	37% of US online grocery market
2	<b>Amazon</b>	\$274B	roughly 37.6% of all US e-commerce
3	<b>Costco</b>	\$183B	54% of warehouse club segment
4	<b>Target</b>	\$107B	“Upscale discount” positioning

Source: Company 10-K filings, FY 2024

These four firms together account for over \$1.1 trillion in US retail sales—roughly 15% of the total market. Their scale advantages in logistics, technology, and purchasing power are nearly insurmountable for smaller competitors.

The dominance of these four reflects different paths to scale. Walmart won through ruthless cost discipline and geographic saturation of underserved markets. Amazon won through technology, logistics investment, and willingness to sacrifice profits for growth. Costco won through a membership model that generates loyalty and recurring revenue. Target found a “cheap chic” positioning niche between Walmart’s bare-bones efficiency and department store prestige. Each succeeded by creating cus-

## **Top 10 U.S. Retailers by Revenue, 2024**

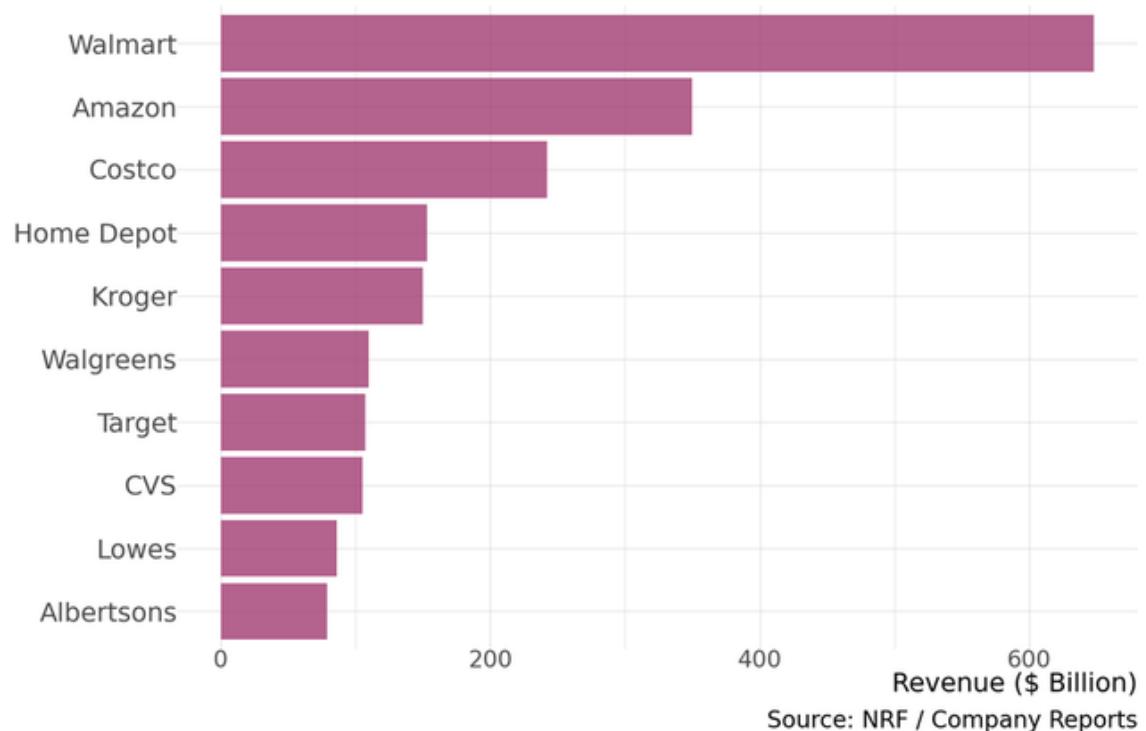


Figure 38: Figure 10.1: Top 10 retailers by US revenue. Walmart dominates, with nearly twice Amazon's retail revenue. Source: Company data (2024)

tomer lock-in that smaller competitors cannot replicate—Walmart through ubiquity, Amazon through Prime, Costco through membership psychology. A regional grocer or independent retailer cannot match any of these moats.

## Other Major Segments

**Grocery:** A brutally low-margin business (1-2% net margins typical) dominated by scale. **Kroger** (\$150B), the largest traditional grocer, operates regional banners (Ralphs, Fred Meyer, Harris Teeter). **Albertsons** (\$79B) owns Safeway, Vons, and Jewel-Osco. Strong regional chains persist: **Publix** (Florida-based, \$54B, employee-owned), **H-E-B** (Texas, privately held, cult following), **Wegmans** (Northeast, smaller but beloved).

**Home Improvement:** An effective duopoly. **Home Depot** (\$157B) and **Lowe's** (\$86B) together control roughly 80% of the market. Both benefited enormously from pandemic home improvement spending.

**Pharmacy/Drugstore:** **CVS Health** and **Walgreens** dominate but are struggling as front-of-store retail (cosmetics, snacks, household goods) declines. Their future is healthcare services, not retail.

**Dollar Stores:** The fastest-growing physical format of the past two decades. **Dollar General** operates 19,500+ stores, often the only retail presence in rural towns. **Dollar Tree** (which owns Family Dollar) operates 16,000+ stores. These are the retail equivalents of cockroaches—thriving where larger retailers won't go.

**Department Stores:** A sector in terminal decline. **Macy's**, **Nordstrom**, **Kohl's**, and **JCPenney** (now restructured) have shrunk steadily as they've lost traffic to e-commerce and specialty retailers. The department store's role as the mall anchor tenant has become a liability as malls themselves struggle.

**Concentration:** The top 10 retailers control approximately **35%** of total retail sales, up from roughly 25% two decades ago. Scale economies in logistics, technology, and supplier negotiations increasingly punish smaller competitors.

## Geographic Distribution

Retail geography reveals American settlement patterns, class stratification, and the uneven geography of opportunity.

### Walmart's Empire

With 4,700+ US stores, Walmart dominates rural and suburban geographies. In many counties, it is simultaneously the primary grocer, general merchant, pharmacist, and employer. Walmart strategically saturated small towns before competitors arrived, creating local monopolies. A map of Walmart store density is essentially a map of non-metropolitan America.

## **Amazon's Archipelago**

Amazon operates 1,000+ fulfillment centers, sortation centers, and delivery stations in the US. These facilities cluster near major metropolitan areas to enable same-day and next-day delivery. The geography is dictated by logistics: proximity to airports, highway intersections, and population density. Amazon's physical footprint is now larger than Walmart's by square footage—it's just not visible to consumers.

## **Regional Grocery Strongholds**

Unlike general merchandise, grocery retailing remains stubbornly regional:

- **Publix:** Dominates Florida and the Southeast
- **H-E-B:** A Texas institution, beloved with cult-like loyalty
- **Wegmans:** Commands devotion in the Northeast and Mid-Atlantic
- **Meijer:** A Midwest supercenter chain predating Walmart
- **WinCo, Grocery Outlet:** West Coast discount grocers

These regional players survive by knowing their local markets intimately—local products, local tastes, local real estate relationships—better than national chains.

## **The Mall Crisis**

The American mall, that cathedral of 20th-century consumerism, is bifurcating:

- **Class A Malls:** Properties in wealthy suburbs with high-end tenants (Apple, Lululemon, luxury brands) are thriving, with occupancy rates above 95%.
- **Class B/C Malls:** Properties in middle-market and secondary areas are dying. The department store anchors that sustained them (Sears, JCPenney, Macy's) have closed locations en masse. Many are being demolished or repurposed as fulfillment centers, medical facilities, or housing.

## **Dollar Stores as Infrastructure**

In rural towns and low-income urban neighborhoods where full-service grocers won't operate, **Dollar General** often stands alone. It has become de facto essential infrastructure—the only place within 30 miles to buy milk, diapers, or canned goods. Critics note these stores offer limited fresh food options, potentially exacerbating “food desert” problems. Defenders note that without Dollar General, some communities would have no retail at all.

## **The Workforce**

### **Employment Scale**

Retail employs approximately **15.5 million workers**—roughly 10% of total US employment. Add wholesale, and the distribution sector employs over 21 million Americans. Retail is the classic “entry job”—the first formal employment for millions of teenagers and the fallback for workers displaced from other sectors.

## **Wage Dynamics**

Retail was historically a minimum-wage sector. That floor has shifted dramatically:

- **Amazon's 2018 Move:** Amazon raised its minimum wage to \$15/hour, forcing competitors to respond. Research found this created 2.3–4.7% wage spillovers at nearby non-Amazon employers.
- **Current Floor:** In competitive labor markets (urban areas, tight labor markets), the effective floor is now **\$17-18/hour**.
- **Costco Exception:** Costco's average hourly wage exceeds \$28/hour, demonstrating that high-wage retail is possible (though Costco's membership model generates higher revenue per worker).

## **Working Conditions**

The industry is characterized by:

- **High Turnover:** Annual turnover rates of 60–100% are common, especially in quick-service retail.
- **Unpredictable Scheduling:** “Just-in-time” scheduling algorithms optimize labor costs for employers but create income volatility and work-life conflict for employees. Regulatory pushback (predictive scheduling laws in some cities) has emerged.
- **Part-Time Prevalence:** Many retailers keep workers below full-time thresholds to avoid benefit obligations.

## **Warehousing vs. Store Work**

Amazon's fulfillment center work is distinct from traditional retail:

- **Physical Intensity:** Workers walk 10+ miles per shift, facing algorithmic pressure to hit pick-and-pack rates.
- **Higher Pay:** FC jobs typically pay \$2-4/hour more than comparable store positions.
- **Injury Rates:** Amazon's injury rates are roughly double the warehouse industry average, attracting regulatory and union attention.

## **Automation Pressure**

The push to decouple revenue from headcount is relentless:

- **Self-Checkout:** Now ubiquitous, though theft rates are higher than traditional checkout.
- **Warehouse Robotics:** Amazon's Kiva robots (acquired for \$775M in 2012) are the model. Competing systems are proliferating.
- **Store Automation:** Automated inventory tracking, electronic shelf labels, and “smart cart” checkout systems are in various stages of deployment.

## **Regulation and Policy**

Retail is subject to a patchwork of state and federal regulations, many of which shape market structure in ways consumers don't perceive.

## **Alcohol Laws**

The US is divided into **control states** (18 states where government entities operate liquor stores) and **license states** (private sales with various restrictions). These archaic post-Prohibition laws determine whether you can buy wine at Costco or must visit a state-run store. Liberalization has been slow and politically contentious.

## **Pharmacy Regulation**

Strict licensing requirements protect incumbent pharmacy chains and complicate the entry of new players. Amazon's 2020 acquisition of PillPack and launch of Amazon Pharmacy represents a slow-motion challenge to CVS/Walgreens, but regulatory barriers remain significant.

## **Auto Dealer Franchise Laws**

Perhaps the most protectionist retail regulation in America. State laws, fiercely defended by the **National Automobile Dealers Association (NADA)**, prohibit manufacturers from selling directly to consumers. **Tesla's** ongoing battles to sell cars without dealers—winning in some states, losing in others—represents a direct challenge to this century-old carve-out. In August 2024, Tesla won a major appeals court victory in Louisiana; it is actively suing Wisconsin and North Dakota.

## **Antitrust**

The regulatory climate has shifted. The FTC's decision to **block the Kroger-Albertsons merger** in December 2024 signaled a new skepticism toward grocery consolidation. The \$24.6 billion deal was rejected on grounds that it would reduce competition in local grocery markets and harm workers. Albertsons is now suing Kroger for breach of contract. The ruling effectively freezes the grocery market structure: giants (Walmart, Costco, Amazon) vs. struggling regional chains who lack the capital to compete on technology and logistics.

## **Blue Laws**

Sunday closing laws have mostly vanished, though remnants affect car sales and alcohol purchases in some states (looking at you, Bergen County, New Jersey).

## **Trade Associations and Lobbying**

### **Major Associations**

Association	Focus
<b>National Retail Federation (NRF)</b>	"Voice of retail"—lobbies on taxes, labor laws, trade policy, shrinkage
<b>Food Marketing Institute (FMI)</b>	Grocery and food retailers
<b>National Grocers Association (NGA)</b>	Independent and regional grocers
<b>National Automobile Dealers Association (NADA)</b>	Auto dealers—extremely powerful at state level
<b>Retail Industry Leaders Association (RILA)</b>	Large retail companies

## Political Influence

Retail lobbying focuses on:

- **Labor Policy:** Opposition to minimum wage increases, predictive scheduling mandates, union organizing rules
- **Trade Policy:** Generally pro-free-trade (retailers benefit from cheap imports)
- **Taxation:** Opposition to online sales tax (historically) and retail-specific taxes
- **Shrinkage/Theft:** Increasingly vocal advocacy for prosecuting retail theft, especially organized retail crime

NADA deserves special mention as one of the most effective state-level lobbies in America. Auto dealers are typically prominent local businesspeople with political connections and campaign contribution capacity, making them formidable defenders of the franchise system against direct sales.

## Recent Trends

### 1. The E-commerce Plateau

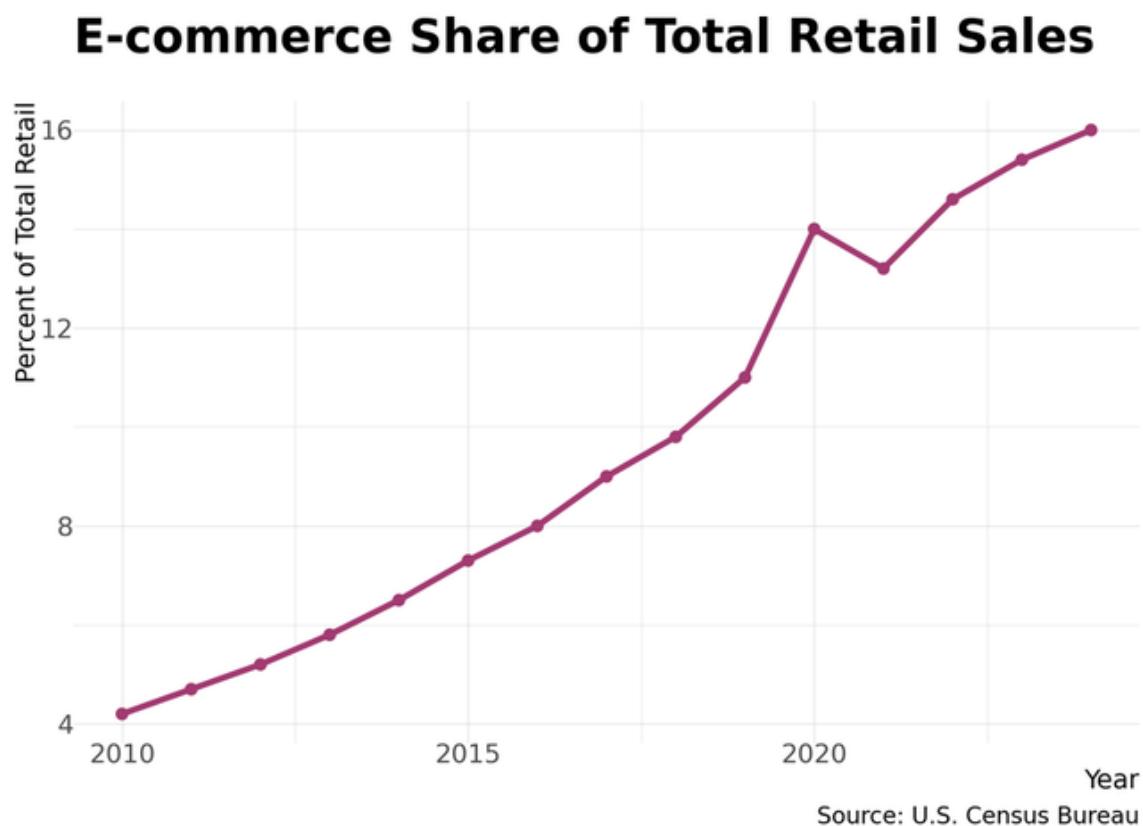


Figure 39: Figure 10.2: E-commerce as a share of retail sales, 2010-2024. Growth has plateaued near 16%, far below predictions of physical retail's demise. Source: Census Bureau

Contrary to early predictions, physical stores did not die. E-commerce penetration has plateaued at around **16%** of Census-defined retail sales (broader definitions, excluding autos, gas, and restaurants, put it near **22.7%**). The growth curve has flattened. For many categories—grocery, apparel, home goods—consumers still prefer to see, touch, and try before buying.

## **2. The “Retail Apocalypse” Myth**

While headlines trumpet store closures, the sector is churning, not dying. Though 7,000+ stores closed in 2024, retail vacancy remains at historic lows (**4.1%**). Why? Almost no new retail space has been built since 2008, and construction costs have risen 30-40%. When a Bed Bath & Beyond closes, the space is immediately leased by TJ Maxx, a gym, or a grocer—often at higher rent. Bad retailers fail; retail itself endures.

## **3. Kroger-Albertsons: The Blocked Merger**

With the \$24.6 billion merger blocked, the grocery industry structure is set: a battle of titans (Walmart, Costco, Amazon) against a fragmented tier of regional grocers who lack the capital to compete on technology and logistics. Kroger and Albertsons will need to find other strategies—likely accelerated technology investment and store optimization.

## **4. The Dollar Store “Correction”**

After years of explosive growth (Dollar General opened 1,000+ stores annually for a decade), the segment is facing headwinds. Dollar Tree/Family Dollar is closing roughly 1,000 stores; Dollar General is closing roughly 140. But the footprint remains massive, and Dollar General is still opening 575 new stores in 2025. This is optimization, not decline.

## **5. Omnichannel Convergence**

Pure-play models are dead. Amazon bought Whole Foods; Walmart weaponized its stores as fulfillment centers. Target’s same-day services (Drive Up, Shipt) generate billions. The winner is whoever can offer the most flexible fulfillment: ship to home, buy online pickup in store (BOPIS), same-day delivery, curbside pickup.

## **6. The Returns Crisis**

Free returns were the drug used to hook consumers on e-commerce. Now, the bill is due. Returns are massively costly to process—estimated at \$800+ billion in 2023 across the industry. Retailers are increasingly charging for returns (Zara, H&M) or shortening return windows. The “buy five sizes, return four” model is economically unsustainable.

## Firm Profiles

### Walmart

**Quick Facts - Headquarters:** Bentonville, AR - **Revenue:** \$648B total (roughly \$569B US, 2024) - **Employees:** 2.1 million (largest private employer in the world) - **Stores:** 4,700+ US, 10,500+ global

Walmart is the definitional firm of late 20th-century American capitalism. From Sam Walton's single store in Rogers, Arkansas (1962), it grew into a logistics empire built on the "Everyday Low Price" (EDLP) model. Walton's insight was that consistent low prices—made possible by relentless cost discipline and supplier pressure—would generate sufficient volume to compensate for thin margins. He was right.

In the 1980s and 1990s, Walmart's expansion crushed regional retailers and mom-and-pop stores across the American heartland. Research by Neumark et al. found that each Walmart opening reduced county-level retail employment by roughly 2.7% and payrolls by 1.5%—each Walmart worker replaced approximately 1.4 traditional retail workers. The company drove down consumer prices but also drove down wages.

Today, Walmart has pivoted to survive the Amazon era. Its massive store network—once seen as a liability against asset-light e-commerce—is now a strategic weapon. With 90% of Americans living within 10 miles of a Walmart, the stores function as the densest fulfillment network in the country. **Walmart+** (launched 2020) is building a subscription ecosystem to rival Prime, offering free delivery, fuel discounts, and streaming through a Paramount+ partnership. Walmart now captures 37% of the US online grocery market.

### Amazon (Retail Operations)

**Quick Facts - Headquarters:** Seattle, WA - **Revenue:** \$575B total (2023)—includes AWS, advertising, retail - **Employees:** 1.5 million - **Fulfillment Facilities:** 1,000+ US

Started as an online bookstore in Jeff Bezos's garage (1994), Amazon became the "everything store" through relentless expansion, loss-tolerant investors, and a willingness to sacrifice profit for growth. Its genius was not just selling goods, but building the infrastructure to move them. The fulfillment network—warehouses, sortation centers, last-mile delivery—is a moat so wide that few can cross it.

**Prime membership** (200M+ subscribers globally, roughly 170M in the US) creates a powerful lock-in effect. Once you pay \$139/year, Amazon becomes the default. Prime members spend roughly \$1,400/year on Amazon versus \$600 for non-members. The program transforms occasional shoppers into habitual users.

Crucially, Amazon's **Third-Party Marketplace** now accounts for 60% of units sold on the platform. Amazon is often the landlord of commerce rather than the merchant—collecting fees (advertising, fulfillment, referral) while third parties bear the inventory risk. This platform model generates margins far above traditional retail.

Physical retail experiments have been mixed. **Amazon Go** (cashierless convenience

stores) was scaled back. **Amazon Fresh** grocery stores have struggled. But the 2017 **Whole Foods** acquisition (\$13.7B) remains a key anchor, providing premium grocery access and physical pickup/return locations.

## Costco

**Quick Facts - Headquarters:** Issaquah, WA - **Revenue:** \$254B (FY2024)  
- **Employees:** 316,000 - **Warehouses:** 600+ US, 900+ global - **Members:** 130+ million cardholders

Costco is the “anti-Walmart”—proof that a high-wage, high-loyalty retail model can succeed spectacularly. The business runs on membership fees (\$65 for basic, \$130 for Executive), which generate roughly \$4.6 billion annually with renewal rates exceeding 90%. This membership revenue effectively is the profit; Costco’s merchandise margins are intentionally low (capped at roughly 14% gross margin).

While Walmart stocks 100,000+ SKUs, Costco carefully curates just **roughly 4,000 items**. This creates massive buying power per item—when Costco commits to selling a product, suppliers get enormous volume. In exchange, Costco demands the lowest possible price. If suppliers won’t deliver, Costco develops the item under its **Kirkland Signature** private label, which has become a \$60+ billion brand rivaling Coca-Cola in sales.

The stores deliberately avoid optimization. Costco doesn’t tell you where things are; the “treasure hunt” experience—wandering, discovering unexpected deals on kayaks or designer jeans—is the point. It transforms shopping from chore into entertainment for its affluent suburban customer base.

Costco’s treatment of workers is famously generous by retail standards. Average wages exceed \$28/hour; benefits are comprehensive; turnover is a fraction of industry norms. The company’s co-founder, Jim Sinegal, argued that happy, productive workers more than pay for themselves. The stock market has agreed: Costco’s share price has consistently outperformed competitors.

## Data Sources and Further Reading

### Key Data Sources

- **US Census Bureau:** Monthly Retail Trade Survey and Annual Wholesale Trade Survey provide the official sales figures.
- **Bureau of Labor Statistics:** Employment data by retail subsector (NAICS codes 44-45 for retail, 42 for wholesale).
- **National Retail Federation (NRF):** Annual rankings, industry statistics, forecasts.
- **Company Filings (10-Ks):** SEC filings provide detailed financial and operational data for public companies.
- **Euromonitor / IBISWorld:** Commercial market research with detailed category breakdowns.

## Further Reading

- **Hortaçsu, Ali, and Chad Syverson.** “The Ongoing Evolution of US Retail: A Format Tug-of-War.” *Journal of Economic Perspectives* 29, no. 4 (2015): 89–112. [The definitive academic treatment of retail format evolution and productivity.]
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- **Basker, Emeke.** “The Causes and Consequences of Wal-Mart’s Growth.” *Journal of Economic Perspectives* 21, no. 3 (2007): 177–198. [Comprehensive overview of Walmart’s economic impact.]
- **Stone, Brad.** *The Everything Store: Jeff Bezos and the Age of Amazon*. Little, Brown, 2013. [The definitive journalistic account of Amazon’s rise.]

## Exercises

### Review Questions

1. Wholesale revenue (\$11.4 trillion) exceeds retail revenue (\$7.26 trillion), even though consumers think of retail as the larger sector. Using the aspirin example from the chapter—manufacturer to pharmaceutical wholesaler to drugstore distribution center to individual store—explain why this accounting produces higher wholesale than retail totals. What does this tell you about the depth of the supply chain for everyday consumer products?
2. The “wheel of retailing” theory predicts that new retail formats enter as low-cost disruptors, gradually add services and raise prices, then become vulnerable to the next wave of discounters. Trace this pattern through three successive retail formats discussed in the chapter (e.g., general stores, department stores, discount stores, e-commerce). Where does Amazon currently sit in the cycle, and is there evidence that Amazon itself is becoming vulnerable to a newer, leaner competitor?
3. Costco stocks roughly 4,000 SKUs compared to Walmart’s 100,000+. Explain how limiting selection can be a competitive advantage, drawing on the chapter’s discussion of inventory turnover (Costco turns inventory 12 times per year versus 3-4 for department stores), the Kirkland Signature private label (\$60+ billion in sales), and the membership model (90%+ renewal rates). Why can’t Walmart simply copy this approach?
4. Amazon’s Third-Party Marketplace now accounts for 60% of units sold on the platform, with Amazon collecting fees averaging 15-20% of sale price plus fulfillment fees. How does Amazon’s dual role as both a platform (landlord of commerce) and a retailer (selling its own Amazon Basics products) create potential conflicts of interest? Connect your answer to the FTC’s ongoing antitrust case

mentioned in the chapter.

5. The FTC blocked the \$24.6 billion Kroger-Albertsons merger in December 2024. Using the chapter's discussion of grocery market structure—including the dominance of Walmart (37% of online grocery), the 1-2% net margins typical in grocery, and the regional nature of grocery competition—explain two arguments for blocking the merger and one argument for allowing it.
6. E-commerce has plateaued at roughly 16% of Census-defined retail sales, far below early predictions of physical retail's demise. Retail vacancy remains at historic lows (4.1%) and almost no new retail space has been built since 2008. What structural factors does the chapter identify that explain why physical stores have proven more resilient than predicted? Are there categories where online penetration is likely to remain low?
7. Amazon raised its minimum wage to \$15/hour in 2018, and research found this created 2.3-4.7% wage spillovers at nearby non-Amazon employers. Drawing on the chapter's discussion of retail wages and the competitive retail labor market, explain the mechanism by which a single firm's wage decision can force wage increases at competing businesses. Is this a case of monopsony power being broken, or something else?

## Data Exercises

8. Using the U.S. Census Bureau's Monthly Retail Trade Survey (<https://www.census.gov/retail/in>), download the most recent 12 months of total retail sales data and e-commerce sales data. Calculate e-commerce's share of total retail for each month. Has the roughly 16% plateau described in the chapter continued, increased, or declined? Present your findings in a line chart and discuss any seasonal patterns you observe.
9. Using the Bureau of Labor Statistics Quarterly Census of Employment and Wages (<https://www.bls.gov/cew/>), compare average weekly wages in NAICS 44-45 (Retail Trade) and NAICS 42 (Wholesale Trade) for the most recent year available. How large is the wage gap between retail and wholesale workers? How does this differential help explain the different business models described in the chapter—high-volume, low-margin merchandising in retail versus logistics-focused operations with 1-3% net margins in wholesale?
10. Visit the SEC's EDGAR database (<https://www.sec.gov/cgi-bin/browse-edgar>) and locate the most recent 10-K filings for Walmart, Costco, and Target. For each company, calculate the inventory turnover ratio (Cost of Goods Sold divided by Average Inventory). How do the differences you find relate to the chapter's discussion of inventory management as a competitive weapon? Which company's model most effectively minimizes capital trapped on shelves?

## Deeper Investigation

11. The chapter describes Dollar General as "de facto essential infrastructure" in rural communities, often the only retail presence within 30 miles, while critics

note these stores offer limited fresh food options and potentially exacerbate “food desert” problems. Research the expansion of dollar stores in rural America over the past two decades. Using county-level data from the USDA’s Food Access Research Atlas (<https://www.ers.usda.gov/data-products/food-access-research-atlas/>) and Dollar General’s store location data, investigate whether dollar store expansion has correlated with the closure of full-service grocers in rural counties. What are the implications for food access and public health in these communities? Does Dollar General function more as a lifeline or as a barrier to better retail options?

# Chapter 11: Information, Technology, and Media

The information sector occupies an anomalous position in the American economy: relatively small in employment but enormous in market capitalization, geographically concentrated yet ubiquitous in daily life, and governed by regulatory frameworks designed for technologies that no longer exist. This chapter examines the economic structure of technology, telecommunications, and media—industries that have reshaped how Americans work, shop, communicate, and consume entertainment.

## Overview: Size and Scope

### □ Info:

#### Market Cap vs. Employment

Tech's defining paradox: the five largest American companies by market value (Apple, Microsoft, Alphabet, Amazon, Meta) together employ fewer than 2 million people but are worth over \$10 trillion—roughly 25% of the entire S&P 500. No sector concentrates so much wealth in so few hands, with so few workers.

The Bureau of Economic Analysis classifies the information sector as NAICS 51, encompassing publishing, motion pictures, broadcasting, telecommunications, and data processing. By this narrow definition, the sector contributes roughly \$1.8 trillion to GDP—about 6% of the total economy—and employs approximately 3 million workers. But these official statistics dramatically understate the sector's economic footprint. Amazon, classified as retail, derives growing revenue from cloud computing. Financial services firms employ armies of software engineers. The “tech sector” as commonly understood sprawls across multiple NAICS codes.

A more revealing metric is market capitalization. As of late 2024, the five largest American companies by market value were all technology firms: Apple (\$3.0 trillion), Microsoft (\$2.8 trillion), Alphabet (\$1.8 trillion), Amazon (\$1.6 trillion), and Meta (\$900 billion). Together, these five companies—sometimes called “Big Tech” or the “Magnificent Seven” (adding Nvidia and Tesla)—account for roughly 25% of the S&P 500’s total value. No other sector comes close to this concentration of market power in so few hands.

[Figure: Figure 11.1: Big Tech market capitalization, 2024. Apple, Microsoft, and the rest of the “Magnificent Seven” account for roughly 25% of S&P 500 market value. Source: Company data]

The information sector’s economic significance lies not just in its direct output but in its role as infrastructure for everything else. Cloud computing powers businesses from startups to Fortune 500 firms. Digital advertising enables the “free” internet. Telecommunications networks carry commerce, entertainment, and increasingly, work itself.

## How the Industry Works: Business Models

### The Advertising Model

The dominant business model of the consumer internet is advertising. Google and Meta (Facebook, Instagram) together capture roughly 50% of all digital advertising spending in the United States—over \$150 billion annually. This advertising is qualitatively different from traditional media advertising: it is targeted based on user data, sold through automated auctions that occur in milliseconds, and measured with precision impossible in print or broadcast.

Google’s search advertising works on a pay-per-click model: advertisers bid on keywords, and Google charges only when users click. The average cost per click varies enormously by industry—legal services and insurance keywords can cost \$50 or more, while less competitive terms cost pennies. Google’s search advertising revenue exceeded \$175 billion in 2023.

Meta’s advertising model relies on the detailed user data collected through Facebook and Instagram. Advertisers can target users by demographics, interests, behaviors, and “lookalike audiences” similar to existing customers. Meta generated \$132 billion in advertising revenue in 2023, virtually all of its total revenue.

[Figure: Figure 11.2: Digital advertising revenue by platform. Google and Meta together capture roughly 50% of the \$300+ billion market. Source: eMarketer (2023)]

Amazon has emerged as the third major digital advertising platform, generating over \$45 billion from ads displayed in search results and product pages. Unlike Google and Meta, Amazon’s advertising appears at the point of purchase, making it especially valuable for consumer products.

### The Subscription Model

Streaming video represents the clearest example of subscription-based media. Netflix pioneered the model, disrupting both traditional television and the DVD rental business. By late 2024, the streaming landscape had consolidated into several major players:

- **Netflix:** 302 million global subscribers, the clear leader
- **Amazon Prime Video:** roughly 230 million (bundled with Prime membership)

- **Disney+**: 125 million (excluding Hotstar in India)
- **Max (HBO)**: 117 million
- **Paramount+**: 78 million
- **Peacock**: 36 million

Source: Company earnings reports and SEC filings, 2024

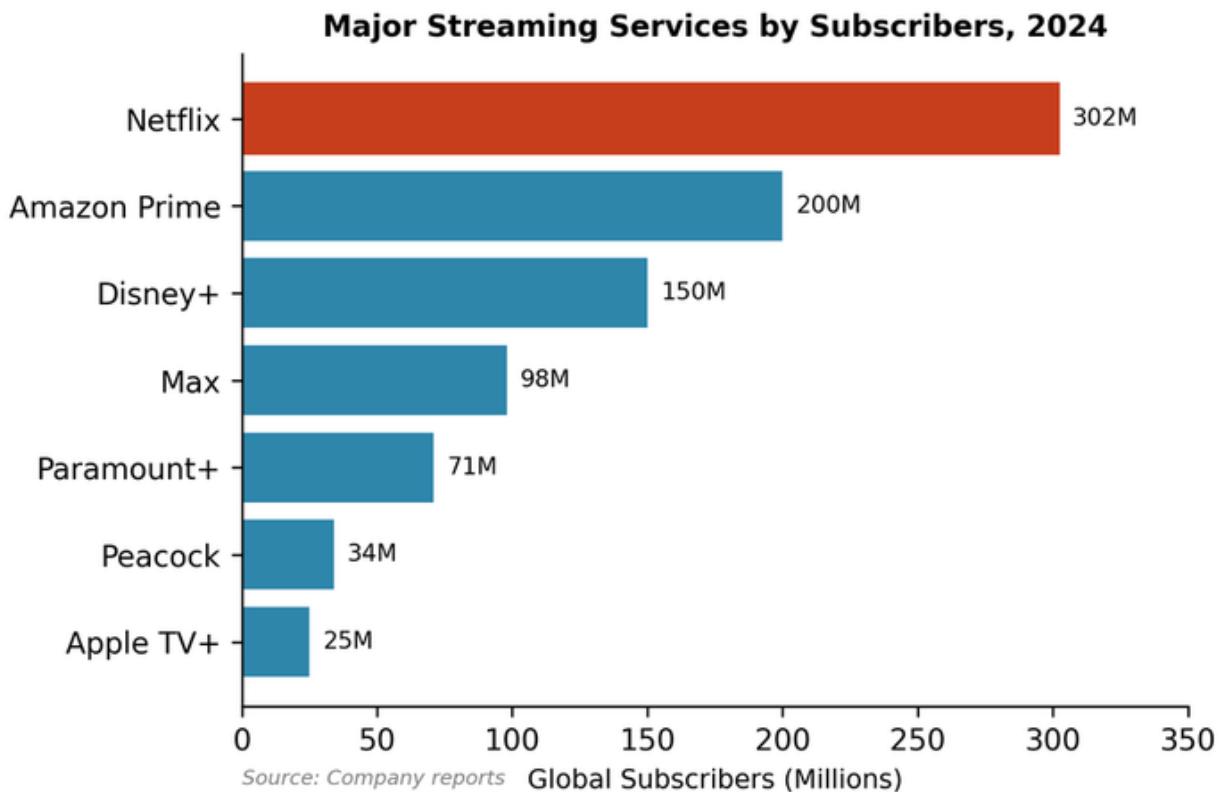


Figure 40: Figure 11.3: Streaming video subscribers by service. Netflix leads globally, but Amazon Prime Video's bundle gives it comparable reach. Source: Company data (2024)

The economics of streaming remain challenging. Content costs are enormous—Netflix spent over \$17 billion on content in 2023—and subscriber growth in mature markets has slowed. The initial promise of streaming was “cord-cutting”: consumers would save money by dropping cable. Instead, many households now subscribe to multiple services, collectively approaching or exceeding cable costs. The streaming services have responded by cracking down on password sharing, introducing ad-supported tiers, and raising prices.

Music streaming follows a similar model. Spotify dominates with roughly 600 million users (250 million paying subscribers), followed by Apple Music and Amazon Music. The economics favor the platforms over artists: Spotify pays roughly \$0.003-0.005 per stream, meaning a song needs millions of plays to generate meaningful revenue.

## The Hardware Ecosystem Model

Apple's business model combines hardware sales with an ecosystem of services that lock in customers. The iPhone generates roughly half of Apple's \$383 billion in annual revenue, but the services segment—App Store commissions, Apple Music, iCloud storage, Apple TV+—has grown to over \$85 billion and carries much higher profit margins.

The App Store's 30% commission on digital purchases (15% for small developers) has drawn antitrust scrutiny. Epic Games challenged this "Apple tax" in court, arguing it constituted anticompetitive behavior. While Epic lost the central monopoly claim, Apple was required to allow developers to direct users to external payment systems—a small but significant crack in the walled garden.

## The Cloud Infrastructure Model

Cloud computing represents the most important technological shift in enterprise IT since the personal computer. Rather than maintaining their own data centers, businesses rent computing power, storage, and services from cloud providers. The market is dominated by three players:

- **Amazon Web Services (AWS)**: roughly 32% market share, roughly \$90 billion annual revenue
- **Microsoft Azure**: roughly 23% market share
- **Google Cloud Platform**: roughly 10% market share

Cloud computing is capital-intensive—data centers cost billions to build—but generates recurring revenue with high margins once established. AWS, initially an internal project to improve Amazon's retail operations, now generates the majority of Amazon's operating profit despite representing a smaller share of revenue.

## The Telecommunications Model

Telecommunications remains a capital-intensive network business. Wireless carriers invest tens of billions annually in spectrum licenses, cell towers, and network equipment. The business model is straightforward: charge monthly fees for voice, data, and increasingly, bundled services like streaming video.

[Figure: Figure 11.4: Wireless carrier market share. T-Mobile narrowly leads after its Sprint acquisition. Source: Company data (2024)]

The wireless industry has consolidated to three national carriers: AT&T, Verizon, and T-Mobile (which acquired Sprint in 2020). T-Mobile's aggressive pricing and network investment have made it the market share leader at 35%, narrowly ahead of Verizon (34%) and AT&T (27%).

Wireline broadband is dominated by cable companies exploiting their existing infrastructure. Comcast (32 million subscribers) and Charter/Spectrum (31 million) together control more than half the market. AT&T and Verizon have largely retreated from DSL in favor of fiber, which offers faster speeds but requires expensive buildup.

AT&T's fiber network has grown to 8.3 million subscribers, concentrated in urban and suburban areas where the economics are favorable.

## Industry Structure: The Giants and the Rest

### Big Tech

The technology industry exhibits extreme concentration at the top. Five companies—Alphabet (Google), Amazon, Apple, Meta, and Microsoft—dominate their respective markets and increasingly compete with each other across market boundaries.

**Alphabet/Google** (\$307 billion revenue, 190,000 employees) controls approximately 90% of the global search market, a position the Department of Justice found to be an illegal monopoly in August 2024. Google achieved this dominance partly through product quality but also through billions in payments to be the default search engine on Apple devices and web browsers—payments that effectively foreclosed competition. Google also dominates online video (YouTube), mobile operating systems (Android, 70% global market share), web browsers (Chrome, 65%), and digital maps. The remedies phase of the antitrust case may require structural changes to this interconnected empire.

**Apple** (\$383 billion revenue, 161,000 employees) is the world's most valuable company, built on the iPhone's success and the ecosystem surrounding it. Apple's profit margins are exceptionally high for a hardware company because the company captures value across the entire stack: designing its own chips, controlling the operating system, and taking commissions on software sales. The App Store generated an estimated \$85 billion in gross revenue in 2023, with Apple keeping \$25-30 billion after its 15-30% commission.

**Amazon** (\$575 billion revenue, 1.5 million employees) straddles multiple industries. Its e-commerce marketplace hosts over 60% of its retail sales from third-party sellers, from whom Amazon collects fees averaging 15-20% of sale price plus fulfillment fees. The FTC's ongoing antitrust case alleges Amazon uses its dual role as platform and retailer to self-preference its own products and extract excessive fees. AWS remains Amazon's profit engine, generating over \$20 billion in annual operating income.

**Microsoft** (\$228 billion revenue, 221,000 employees) has reinvented itself from a Windows/Office company to a cloud-first enterprise. Azure's growth has driven Microsoft's stock price from \$40 in 2014 to over \$400 by 2024. Microsoft's \$13 billion investment in OpenAI positioned it at the center of the generative AI boom, integrating AI capabilities into Office, Bing search, and Azure services.

**Meta** (\$135 billion revenue, 67,000 employees) is the smallest of Big Tech by revenue but dominates social media with Facebook (3 billion monthly users), Instagram (2 billion), WhatsApp (2 billion), and Messenger. Meta's advertising business remains highly profitable despite Apple's iOS privacy changes, which initially disrupted targeting capabilities. The company's \$10+ billion annual investment in "Reality Labs"—virtual and augmented reality—has yet to generate significant revenue. The FTC's attempt to force divestiture of Instagram and WhatsApp failed in November 2025, with the court finding insufficient evidence of monopoly power.

## **Telecommunications**

The wireless industry's consolidation has created a stable oligopoly. The T-Mobile/Sprint merger in 2020, approved over DOJ objections, reduced national carriers from four to three. Competition has not collapsed—T-Mobile's aggressive network investment and pricing forced responses from AT&T and Verizon—but the industry's pricing power has increased.

**AT&T** (headquartered in Dallas) is the largest telecommunications company by revenue, combining wireless service, fiber broadband, and business services. AT&T's ill-fated acquisition of Time Warner in 2018 was reversed in 2022 when it spun off WarnerMedia to merge with Discovery, taking a massive loss and refocusing on its core telecommunications business.

**Verizon** (headquartered in New York) has historically positioned itself as the premium wireless carrier, though T-Mobile's 5G investment has challenged this positioning. Verizon's fiber-to-the-home service, Fios, serves 7 million subscribers in the Northeast.

**T-Mobile** (headquartered in Bellevue, Washington) emerged from its Sprint acquisition as the industry's growth leader, using spectrum assets acquired from Sprint to build out 5G faster than competitors. T-Mobile's customer growth has come partly from price-conscious consumers and partly from rural areas where its network has improved.

**Comcast** (headquartered in Philadelphia) is the largest cable company and broadband provider. Beyond connectivity, Comcast owns NBCUniversal (broadcast and cable television, film studio, theme parks) and streams content through Peacock. Comcast's broadband business benefits from limited competition—in many markets, cable is the only high-speed option.

## **Media and Entertainment**

Legacy media has undergone wrenching consolidation as streaming disrupted traditional business models.

**The Walt Disney Company** owns ABC, ESPN, the Disney Channel, Pixar, Marvel, Lucasfilm, and 20th Century Studios, plus theme parks and cruise lines. Disney+ launched in 2019 and grew quickly but has struggled to reach profitability. Disney's streaming losses exceeded \$4 billion before cost-cutting measures began showing improvement in 2024.

**Warner Bros. Discovery** was created from the 2022 merger of WarnerMedia (spun off from AT&T) and Discovery. The combined company owns HBO, CNN, Warner Bros. film studio, and cable channels including Discovery, HGTV, and Food Network. The merger has been troubled: massive debt, write-downs, and content cost-cutting have damaged morale and quality.

**Paramount Global** (formerly ViacomCBS) owns CBS, Paramount Pictures, MTV, Nickelodeon, and the streaming service Paramount+. The company has explored mergers and sales as it struggles to compete at scale with larger rivals.

**NBCUniversal** (owned by Comcast) includes NBC broadcast, cable channels (USA, Bravo, MSNBC), Universal Pictures, and theme parks. Peacock streaming has lagged competitors despite carrying valuable content.

**Netflix** stands alone as a pure-play streaming company, having successfully transitioned from DVD-by-mail to streaming dominance. Netflix's content strategy emphasizes volume and global appeal—it produces content in dozens of countries—over the prestige programming that defined early streaming. After subscriber declines in early 2022 sparked fears of market saturation, Netflix rebounded through password-sharing crackdowns and ad-supported tiers.

## Music

The recorded music industry is dominated by three major labels:

- **Universal Music Group** (French-owned, publicly traded): roughly 32% market share
- **Sony Music Entertainment** (Japanese-owned): roughly 22%
- **Warner Music Group**: roughly 16%

Together, the majors control roughly 70% of the recorded music market. Independent labels and artists have gained share through streaming, which removed the physical distribution barriers that once advantaged majors. But the majors retain power through extensive back catalogs, artist development infrastructure, and radio/playlist promotion capabilities.

Streaming has transformed music economics. Industry revenue, which collapsed from \$14 billion in 1999 to \$7 billion in 2014, has recovered to approximately \$17 billion. But revenue flows primarily to platforms (Spotify, Apple Music) and catalog holders (often the labels, not artists themselves). A hit song might generate millions of streams but only thousands of dollars for the performer.

## Newspapers and Local Media

The newspaper industry has experienced one of the most dramatic declines in American business history. Employment fell from 455,000 in 1990 to under 100,000 today. Daily newspaper circulation has declined from 62 million in 1990 to under 20 million. The Los Angeles Times, which once employed 1,200 journalists, now has fewer than 300.

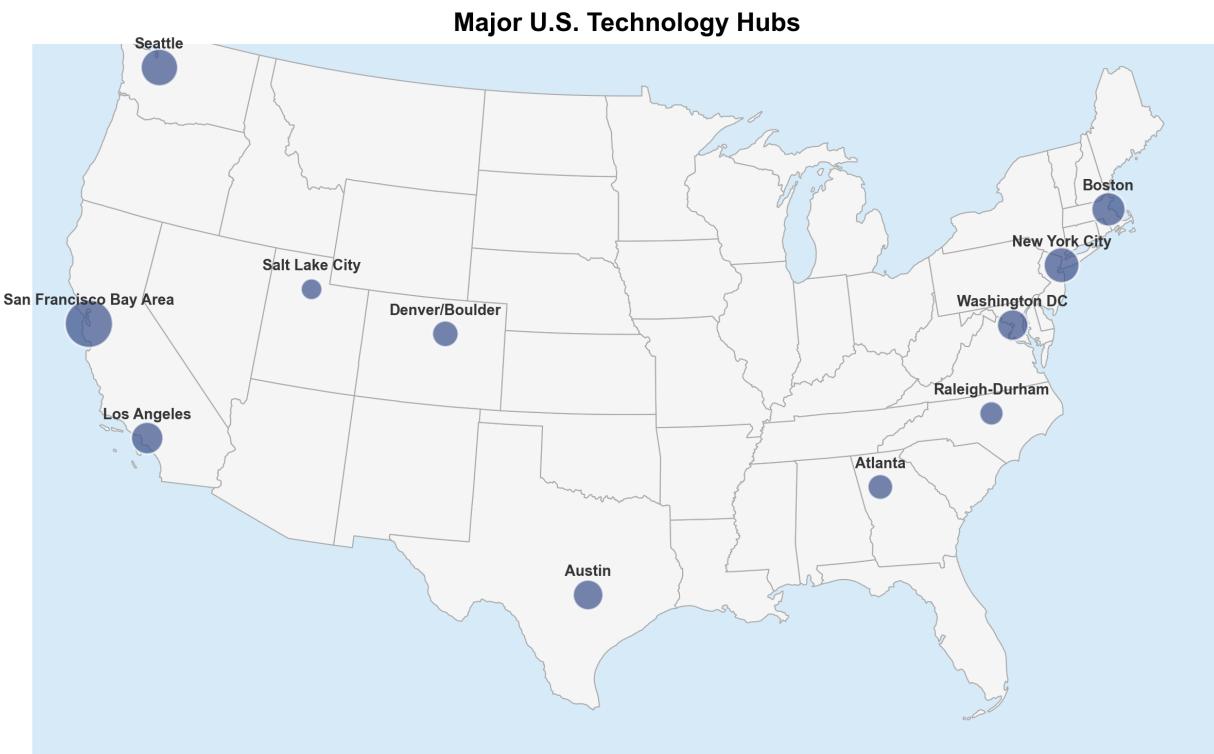
The business model collapse was sudden and severe. Classified advertising—newspapers' most profitable segment—migrated to Craigslist, then to specialized sites like Indeed (jobs) and Zillow (real estate). Display advertising followed readers to digital platforms, where Google and Facebook captured the growth.

Local television news has proven more resilient than print, benefiting from retransmission fees paid by cable companies and continued advertiser interest in reaching local audiences. But ownership has consolidated into a handful of station groups—Sinclair, Nexstar, Gray Television—that have cut staff and centralized operations.

The “local news crisis” has created information deserts in many communities. Counties without local newspapers—“news deserts”—have lower voter turnout, less government accountability, and higher municipal borrowing costs. Nonprofit and philanthropic models have emerged (The Texas Tribune, Baltimore Banner) but have not achieved scale sufficient to replace the old advertising-supported model.

## Geographic Distribution

The technology industry is extraordinarily concentrated geographically. Five metropolitan areas—San Francisco-San Jose, Seattle, New York, Boston, and Austin—account for roughly half of all software development employment.



*Source: CompTIA Cyberstates, Brookings Metro Monitor*

Figure 41: Figure 11.5: Major technology employment hubs. Silicon Valley dominates, but Seattle, Austin, and Boston have grown as secondary centers. Source: BLS QCEW

**Silicon Valley** (San Jose-San Francisco metropolitan area) remains the undisputed center of the technology industry despite decades of predictions about its decline. The region hosts the headquarters of Alphabet, Apple, Meta, and thousands of smaller companies. Stanford University and UC Berkeley provide both research and talent pipelines. Venture capital is heavily concentrated: Sand Hill Road in Menlo Park hosts the largest concentration of VC firms in the world. The region’s dysfunction—housing

costs that make \$200,000 salaries feel inadequate, traffic congestion, homelessness—has not displaced its network effects.

**Seattle** hosts the headquarters of Amazon and Microsoft, plus major engineering offices for Google, Meta, and others. The region's slightly lower cost of living (relative to the Bay Area) and strong engineering culture at the University of Washington have attracted talent. Seattle's tech employment has grown faster than Silicon Valley's in recent years.

**New York City** is the center of media, advertising, and financial technology. While lacking the density of pure technology companies found in Silicon Valley or Seattle, New York hosts engineering offices for most major tech firms plus a vibrant startup scene. The city's traditional media companies—news organizations, publishing houses, advertising agencies—have become technology companies whether they admit it or not.

**Austin** has emerged as a technology hub through deliberate strategy. Texas's lack of state income tax, lower housing costs, and business-friendly regulation attracted companies including Dell (headquartered in nearby Round Rock), Tesla (relocated from California), and Oracle (relocated from California). Austin's tech scene retains a more relaxed culture than Silicon Valley, though growth has strained housing and infrastructure.

**Boston/Cambridge** combines world-class research universities (MIT, Harvard) with strength in biotechnology and enterprise software. The Route 128 corridor was actually Silicon Valley's original competitor in the 1970s and 1980s before losing the personal computer wars.

Telecommunications geography differs from pure technology. AT&T is headquartered in Dallas, having relocated from San Antonio in 2008. Verizon is headquartered in New York City. T-Mobile is headquartered in Bellevue, Washington (a Seattle suburb), a legacy of its German parent company's acquisition of a Pacific Northwest wireless carrier. Comcast's Philadelphia headquarters reflects its founding as a local cable system.

Media remains bicoastal. Film and television production is centered in Los Angeles, though tax incentives have dispersed some production to Georgia, New York, and other states. Television news operations cluster in New York City. The music industry's major labels are headquartered in New York and Los Angeles, though Nashville dominates country music.

## The Workforce

Technology companies employ approximately 3 million workers directly, with millions more in technology roles at non-technology companies. The sector's workforce characteristics differ markedly from other industries.

**Compensation:** Technology workers earn far more than the national average. Software engineer salaries at major technology companies routinely exceed \$200,000, with senior engineers at Google or Meta earning \$500,000 or more including equity.

This compensation reflects both genuine skill scarcity and the industry's profit margins. Technology companies can afford to pay more because their businesses require relatively little labor per dollar of revenue.

**Immigration:** The technology industry relies heavily on immigrant labor, particularly through the H-1B visa program. Indian-born workers constitute roughly 70% of H-1B recipients, with technology companies as the largest sponsors. Critics argue H-1B suppresses wages for American workers; supporters argue it addresses genuine talent shortages. The debate continues even as technology companies have embraced remote work, which theoretically expands the domestic talent pool.

**Contractors and gig workers:** Beyond highly paid employees, technology companies employ large numbers of contractors, temporary workers, and gig workers. Amazon's warehouse workforce—1.5 million globally—earns far less than software engineers. Uber and Lyft drivers are classified as independent contractors, not employees, a distinction that has survived legal challenges in most states. The contrast between highly paid software engineers and precarious gig workers reflects the industry's bimodal labor market.

**Layoffs:** The technology industry experienced significant layoffs in 2022-2023 as pandemic-era hiring proved excessive. Amazon, Meta, Google, and Microsoft each cut over 10,000 employees. The layoffs, while painful for those affected, represented a small fraction of each company's workforce and were followed by resumed hiring, particularly for AI-related roles.

**Media employment decline:** The media sector has experienced sustained employment losses. Newspaper employment has fallen by over 75% since 2000. Magazine employment has declined nearly as sharply. Television news has maintained employment better but has consolidated into fewer owners with less local coverage. The workers displaced from media have not generally found equivalent employment elsewhere—journalism skills do not translate easily to technology jobs.

## Regulation and Policy

The regulatory framework for technology and telecommunications remains incomplete and contested. Agencies designed for twentieth-century industries struggle to address twenty-first-century business models.

### Federal Communications Commission

The FCC regulates communications by wire and radio, which historically meant telephone service and broadcasting. The agency allocates spectrum licenses, sets technical standards, enforces ownership limits on broadcast stations, and regulates common carriers.

The FCC's role in internet regulation has fluctuated with political leadership. Under the Obama administration, the FCC classified broadband providers as common carriers subject to net neutrality rules—requiring them to treat all internet traffic equally. The Trump administration's FCC reversed this classification, eliminating federal net

neutrality rules. Biden's FCC has attempted to restore net neutrality, though implementation remains contested.

Spectrum allocation represents the FCC's most consequential and least visible function. The electromagnetic spectrum is a finite public resource: only so many radio frequencies exist, and interference occurs when too many users occupy the same band. The FCC conducts auctions for commercial spectrum licenses, raising tens of billions of dollars for the Treasury while allocating valuable resources. The shift from administrative allocation to auctions—championed by economists including Paul Milgrom, who won the 2020 Nobel Prize partly for this work—represented a rare triumph of economic policy design.

## Section 230

Section 230 of the Communications Decency Act (1996) provides that “No provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider.” This twenty-six-word provision enables the modern internet. Without it, platforms could be sued for user-generated content, making social media, search engines, and review sites legally untenable.

Section 230 faces criticism from both political directions. Conservatives argue platforms use their moderation authority to suppress right-wing viewpoints; progressives argue platforms fail to moderate harmful content aggressively enough. Various reform proposals have emerged—limiting immunity for algorithmic amplification, requiring platforms to follow stated policies, creating transparency requirements—but no legislation has passed.

## Antitrust Enforcement

The most significant regulatory action against technology companies has come through antitrust enforcement. The Department of Justice and Federal Trade Commission have brought major cases against all of the Big Tech companies:

- **Google:** The DOJ's case against Google for search monopoly maintenance resulted in a liability finding in August 2024. Judge Amit Mehta found that Google's payments to Apple and others to be the default search engine illegally foreclosed competition. The remedies phase will determine whether Google must change its business practices or face structural remedies (such as divesting Chrome or Android).
- **Apple:** The Epic Games case challenged Apple's App Store practices. While Apple won on the core monopoly question, it must allow developers to direct users to alternative payment methods. The DOJ has filed a separate antitrust case against Apple, still in early litigation stages.
- **Amazon:** The FTC's case against Amazon alleges the company uses its marketplace dominance to disadvantage third-party sellers while self-preferencing its own products. A trial is scheduled for October 2026.

- **Meta:** The FTC's attempt to unwind Meta's acquisitions of Instagram and WhatsApp failed in November 2025, with the court finding insufficient evidence that Meta possessed monopoly power in social networking.

## **State Regulation**

States have emerged as important technology regulators, particularly regarding privacy. California's Consumer Privacy Act (CCPA) and its successor, the California Privacy Rights Act (CPRA), create data privacy rights that effectively set national standards—companies find it simpler to comply nationwide than to offer different experiences by state.

Texas and Florida have enacted laws targeting social media moderation practices, requiring platforms to explain content removal decisions and limiting their ability to remove certain political content. These laws face constitutional challenges on First Amendment grounds.

## **Trade Associations and Lobbying**

Technology companies have become major political players, collectively spending over \$100 million annually on federal lobbying.

**TechNet** represents large technology companies including Apple, Google, Meta, Amazon, and Microsoft on policy issues from immigration to taxation.

**The Computer and Communications Industry Association (CCIA)** advocates for technology companies on intellectual property, free trade, and internet policy. CCIA has been a strong defender of Section 230.

**The Information Technology Industry Council (ITI)** focuses on hardware and enterprise technology issues.

**BSA | The Software Alliance** represents enterprise software companies on intellectual property and trade issues.

Telecommunications lobbying is dominated by industry-specific groups:

**CTIA - The Wireless Association** represents wireless carriers and equipment manufacturers.

**USTelecom - The Broadband Association** represents wireline telecommunications providers.

**NCTA - The Internet & Television Association** represents cable companies.

Media lobbying groups include the **National Association of Broadcasters (NAB)**, the **Motion Picture Association (MPA)**, and the **Recording Industry Association of America (RIAA)**.

Technology lobbying has become controversial as public attitudes toward Big Tech have soured. Companies that once enjoyed bipartisan goodwill now face skepticism from both parties—Democrats concerned about market power and misinformation,

Republicans concerned about perceived anti-conservative bias. Yet lobbying spending continues to grow as regulatory threats intensify.

## Platform Economics and Network Effects

The dominance of Big Tech cannot be understood without grasping platform economics—the set of dynamics that allow a handful of companies to intermediate vast portions of economic activity. Platforms are not merely large companies; they are market structures with self-reinforcing properties that distinguish them from traditional firms.

### Network Effects

#### Info:

#### Network Effects

A network effect exists when a product or service becomes more valuable as more people use it. The telephone is the classic example: a single telephone is useless, but a telephone connected to a million others is indispensable. Network effects create powerful feedback loops—growth begets growth—and explain why digital markets tend toward concentration rather than fragmentation.

Network effects come in two varieties, each with distinct economic implications.

**Direct network effects** occur when each additional user directly increases value for existing users. Social media platforms exhibit this most clearly: Facebook is valuable because your friends are on it, and your presence makes it more valuable for your friends. Messaging apps (iMessage, WhatsApp), communication platforms (Zoom), and payment networks (Venmo) all depend on direct network effects. The strength of direct network effects varies—a social network with 10 million users is not merely ten times more valuable than one with 1 million, because users interact with a limited subset of the total network—but the competitive advantage is real.

**Indirect network effects** operate through a complementary market. Apple's iOS is valuable to consumers because developers build apps for it; developers build apps for iOS because consumers use it. This two-sided dynamic creates a virtuous cycle that is extremely difficult for competitors to replicate. Microsoft's Windows dominated personal computing for decades through indirect network effects: businesses wrote software for Windows because employees used it, and employees used it because businesses had software for it. Android and iOS now enjoy the same self-reinforcing logic in mobile, which is why no third mobile operating system has gained traction despite repeated attempts (Windows Phone, BlackBerry 10, Firefox OS).

### Multi-Sided Platforms

The most consequential business model of the twenty-first century is the multi-sided platform—a company that creates value by connecting two or more distinct user

groups who need each other but cannot efficiently connect on their own.

**Amazon Marketplace** connects buyers with over 2 million active third-party sellers, taking fees averaging 15–20% of each transaction plus fulfillment charges. Amazon subsidizes the buyer side through Prime’s fast shipping and easy returns, making the platform irresistible to consumers, which in turn forces sellers to be present on the platform regardless of fee levels. Over 60% of Amazon’s retail unit sales now come from third-party sellers.

**Uber** connects riders with drivers. Uber initially subsidized riders with below-cost fares to build the network density required for short wait times, which attracted more drivers, which further reduced wait times. The company lost billions during this growth phase—a rational strategy if the resulting network effects create durable market power.

**Airbnb** connects travelers with hosts, taking a service fee from both sides (typically 3% from hosts, under 15% from guests). The platform’s value lies in aggregating supply that would otherwise be invisible: a spare bedroom in Lisbon has no market without a global discovery platform.

The common pattern is subsidize one side to attract the other. Credit card companies pay rewards to cardholders (subsidizing consumers) so that merchants must accept the card (the side that pays). Google gives away Android for free to phone manufacturers (subsidizing the device side) to control the search and advertising pipeline (the side that pays).

## Platform Competition Dynamics

Platform markets exhibit consistent structural features that push toward concentration.

**Winner-take-most outcomes.** In markets with strong network effects, the leading platform captures a disproportionate share of value. Google holds roughly 90% of search. Meta’s platforms account for the majority of social media engagement time. These are not 60/40 markets; they are 90/10 markets. Second-place platforms survive only by occupying distinct niches (LinkedIn for professional networking, Pinterest for visual discovery) rather than competing head-to-head.

**Switching costs and lock-in.** Users accumulate data, social connections, purchase histories, and learned behaviors on platforms that do not transfer to competitors. An iPhone user with years of iCloud photos, a library of purchased apps, and an Apple Watch is unlikely to switch to Android regardless of price. Enterprise customers running workloads on AWS face significant migration costs to move to Azure or Google Cloud. These switching costs are not incidental—they are deliberately engineered into platform design.

**Data moats.** Platforms improve through usage data. Google’s search algorithm improves with every query. Uber’s routing and pricing algorithms improve with every ride. New entrants face a cold-start problem: without users they cannot generate the data needed to match incumbents’ service quality, and without matching service quality they cannot attract users.

**Multihoming costs.** When users or suppliers participate in multiple platforms simultaneously—“multihoming”—it weakens any single platform’s market power. Restaurants listing on both DoorDash and Uber Eats, or sellers listing on both Amazon and eBay, can comparison-shop across platforms. Platforms actively discourage multihoming through exclusive contracts, bundled services, and algorithmic penalties for suppliers who list elsewhere.

These dynamics explain why platform markets tend toward natural monopoly or tight oligopoly. The policy question is whether this concentration reflects genuine efficiency or market power that harms consumers and suppliers.

## The Gig Economy as Platform Economics

The gig economy is platform economics applied to labor markets. Companies including Uber, Lyft, DoorDash, and Instacart use platform architecture to connect consumers with workers who perform tasks—driving, delivering food, shopping for groceries—on demand.

Approximately 7 million Americans work in the gig economy as a primary or significant income source, a figure that has grown steadily since the mid-2010s and now represents a meaningful share of the labor force. Tens of millions more have performed gig work at least once.

### □ Info:

#### The Classification Battle

The central regulatory question in the gig economy is whether workers are employees or independent contractors. Employees receive minimum wage protections, overtime pay, unemployment insurance, workers’ compensation, and employer-provided benefits. Independent contractors receive none of these but retain flexibility over when and how much to work. Gig platforms classify workers as independent contractors, arguing that flexibility is the product’s core value proposition. Labor advocates counter that platforms exercise sufficient control over work conditions—setting prices, rating workers, deactivating accounts—to make the “independent” label a legal fiction that shifts costs from companies to workers and taxpayers.

Platform architecture determines worker conditions in ways that blur the line between marketplace and employer. Uber sets fares, Uber’s algorithm assigns rides, and Uber can deactivate drivers whose ratings fall below a threshold. DoorDash penalizes drivers who decline too many deliveries. These platforms argue they merely facilitate connections; critics argue the algorithmic management constitutes de facto employment.

California’s AB5 (2020) attempted to reclassify gig workers as employees, but Proposition 22—backed by \$200 million in spending from Uber, Lyft, and DoorDash—created a carve-out for app-based transportation and delivery workers. Other states have considered similar legislation, but the federal framework remains unsettled. The Department of Labor issued a rule in 2024 tightening the criteria for independent contractor classification, though its enforcement impact remains unclear.

The gig economy's financial results tell their own story. Uber did not report a full-year operating profit until 2023, a decade after launch. Lyft has never been consistently profitable. DoorDash swings between narrow profits and losses. The platforms' business models depend on maintaining contractor classification—reclassifying workers as employees would increase labor costs by an estimated 20-30%, erasing already-thin margins.

## Platform Regulation

The United States and the European Union have taken divergent approaches to regulating platform power.

The EU's **Digital Markets Act (DMA)**, which took effect in 2023, represents the most comprehensive platform regulation in any major economy. The DMA designates large platforms as "gatekeepers" based on revenue, market capitalization, and user thresholds, then imposes specific obligations: gatekeepers must allow third-party app stores (targeting Apple), cannot self-preference their own services in search results (targeting Google), must enable interoperability with messaging services (targeting Meta's WhatsApp), and must allow users to uninstall pre-loaded apps. Violations carry fines of up to 10% of global revenue.

The U.S. approach, by contrast, relies primarily on antitrust enforcement through case-by-case litigation—the Google search case, the Amazon marketplace case, the failed Meta divestiture case. Congress has considered but not passed legislation comparable to the DMA. The American Open App Markets Act and the Platform Competition and Opportunity Act both stalled despite bipartisan support. The result is that European consumers now have rights—sideloading apps, choosing default browsers, accessing interoperable messaging—that American consumers do not.

The regulatory divergence reflects different legal traditions: the EU favors ex ante rules that define prohibited conduct in advance, while the U.S. favors ex post enforcement that punishes anticompetitive behavior after the fact. Both approaches have weaknesses. The DMA's prescriptive rules risk becoming outdated as technology evolves. The U.S. litigation approach moves too slowly—the Google search case took four years to reach a liability finding, during which Google's dominance only deepened.

## Recent Trends

### The AI Boom

Generative AI has transformed the technology landscape since ChatGPT's November 2022 launch. Every major technology company has rushed to develop or deploy large language models:

- **Microsoft** invested \$13 billion in OpenAI and integrated GPT models into Office products, Bing search, and Azure cloud services.
- **Google** developed its Gemini family of models, competing with OpenAI while scrambling to defend its search monopoly.

- **Meta** released the open-source Llama models, betting on openness as a competitive strategy.
- **Amazon** invested \$8 billion in Anthropic, the safety-focused AI lab founded by former OpenAI researchers.
- **Apple** has been notably slower to deploy consumer-facing AI, announcing “Apple Intelligence” features in 2024 that relied partly on external models.

The AI boom has concentrated capital and talent at the largest companies. Training frontier models requires hundreds of millions of dollars in computing costs, favoring companies with cloud infrastructure and deep pockets. Whether AI will ultimately disrupt Big Tech incumbents or entrench them remains unclear.

## **The Data Economy**

Data has become a distinct economic asset—the raw material that powers AI models, targeted advertising, and algorithmic decision-making. A “data economy” has emerged alongside the traditional technology sector, often invisible but pervasive.

**Data Brokers:** Companies like Acxiom, Experian (beyond credit scores), Oracle Data Cloud, and LiveRamp aggregate consumer data from thousands of sources—purchases, location history, social media activity, browsing behavior—and sell it to advertisers, insurers, employers, and political campaigns. The industry generates an estimated \$250 billion annually.

**AI Training Data:** Large language models require massive text corpora; image generators require billions of captioned images. This has created a market for training data, raising questions about copyright (many models trained on copyrighted material without permission) and compensation (artists and writers whose work trains models receive nothing). Scale AI, a startup valued at \$14 billion, coordinates armies of human labelers who annotate data for AI training.

**Enterprise Data:** Companies increasingly treat their own data as a strategic asset. Customer transaction data, sensor readings from equipment, employee productivity metrics—all can be analyzed for insights or sold to third parties. Chief Data Officers have become common C-suite positions.

**Personal Data as Currency:** Consumers generate valuable data through their daily activities but capture almost none of its value. Proposals for “data dividends” or treating data as a property right have gained attention but not traction. The asymmetry between data generators (consumers) and data exploiters (platforms) remains a defining feature of the digital economy.

The data economy sits awkwardly between this chapter’s technology sector and Chapter 7’s professional services. Data brokers are neither traditional tech companies nor consulting firms. Yet the decisions made about data—who collects it, who owns it, how it’s used—will shape the AI-driven economy of the coming decades.

## **Streaming Consolidation**

The streaming wars have entered a mature phase characterized by consolidation, price increases, and profitability pressure. The era of easy subscriber growth has

ended in developed markets. Services have responded by:

- **Password-sharing crackdowns:** Netflix led the industry in requiring separate payments for households sharing passwords, adding millions of paying subscribers.
- **Advertising tiers:** Every major streaming service now offers a lower-priced ad-supported option, reversing the initial promise of ad-free streaming.
- **Bundling:** Disney offers a bundle combining Disney+, Hulu, and ESPN+. Verizon and T-Mobile bundle streaming services with wireless plans. The industry is recreating cable's bundle economics in streaming form.
- **Content cuts:** Warner Bros. Discovery infamously removed completed content from Max to cut costs, while Disney reduced production volume at Marvel and other studios.

## The TikTok Question

TikTok, the short-video app owned by Chinese company ByteDance, has become both a cultural phenomenon and a national security concern. With over 170 million American users, TikTok has disrupted both social media (challenging Meta's Instagram) and entertainment (especially among younger users).

Congressional legislation in 2024 required ByteDance to divest TikTok's American operations or face a ban. As of early 2025, legal challenges continue while potential American buyers evaluate the asset. The TikTok situation exemplifies broader concerns about technology competition between the United States and China—and the difficulty of disentangling globally interconnected technology platforms.

## Local News Collapse

The collapse of local journalism has accelerated. Newspaper bankruptcies, hedge fund ownership, and advertising declines have gutted newsrooms across the country. Between 2020 and 2024:

- Over 130 newspapers closed entirely
- Thousands of journalists were laid off
- Many surviving papers became "ghost newspapers"—still publishing but with skeletal staffs incapable of meaningful accountability journalism

The consequences for democracy are significant. Research has documented that loss of local news correlates with lower voter turnout, less competitive local elections, and higher costs of municipal borrowing (as investors demand premiums for reduced transparency).

## Firm Profiles

### **Alphabet/Google: The Advertising Machine**

Alphabet, Google's parent company, is the world's largest advertising company—a description that still surprises people who think of Google as a search engine. Of Alphabet's \$307 billion in 2023 revenue, approximately \$238 billion (78%) came from advertising across Google Search, YouTube, and the Google Display Network.

Google Search operates the most profitable advertising platform ever created. When users search for commercial terms—"car insurance," "personal injury lawyer," "credit cards"—Google displays ads at the top of results and charges advertisers when users click. The average cost-per-click varies enormously: legal and financial terms often exceed \$50, while less competitive terms cost pennies. Google's search advertising margin exceeds 50%.

YouTube, acquired for \$1.65 billion in 2006 (regarded as overpriced at the time), has become the world's dominant video platform. YouTube generated over \$30 billion in advertising revenue in 2023, plus substantial subscription revenue from YouTube Premium and YouTube TV. The platform has become essential infrastructure for creators, musicians, educators, and increasingly, traditional media companies that post content to reach YouTube's 2 billion monthly users.

Google Cloud, the third-largest cloud computing platform, generated \$33 billion in 2023 revenue. While dwarfed by AWS and trailing Microsoft Azure, Google Cloud has become profitable and represents Alphabet's clearest growth opportunity outside advertising.

The August 2024 antitrust verdict found that Google illegally maintained its search monopoly through default agreements—paying Apple approximately \$20 billion annually to be the default search engine on iPhones and Safari, and similar payments to browser makers and wireless carriers. The remedies phase will determine whether Google faces behavioral restrictions or structural requirements that could fundamentally alter its business model.

**Headquarters:** Mountain View, California **Employees:** 190,000 **Key executives:** Sundar Pichai (CEO), Ruth Porat (CFO)

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### **AT&T: The Surviving Bell**

AT&T's history encapsulates American telecommunications. The original AT&T was the Bell System monopoly, broken up by antitrust consent decree in 1984 into seven Regional Bell Operating Companies (RBOCs) plus a rump long-distance company. Through a series of mergers, the current AT&T is essentially one of those RBOCs (Southwestern Bell) that acquired the AT&T name and reassembled much of the former monopoly.

Today AT&T operates three primary businesses: wireless service, fiber broadband, and business telecommunications. The wireless segment generates approximately

70% of revenue, serving roughly 200 million subscribers (including wholesale and prepaid). AT&T has invested heavily in 5G deployment, though its network coverage trails T-Mobile in independent assessments.

AT&T's strategic missteps illustrate the difficulty of media-telecommunications convergence. The company acquired DirecTV in 2015 for \$49 billion, then watched satellite television subscribers evaporate. It acquired Time Warner in 2018 for \$85 billion, creating an entertainment conglomerate—then spun off WarnerMedia in 2022 to merge with Discovery, essentially admitting defeat. AT&T took a \$24 billion loss on the transaction and refocused on telecommunications.

The company has also dealt with legacy issues: lead-sheathed cables, particularly in the Northeast, have required remediation. A February 2024 network outage affected millions of customers and drew FCC scrutiny. AT&T's stock price has significantly underperformed the market over the past decade.

**Headquarters:** Dallas, Texas **Employees:** 160,000 **Key executives:** John Stankey (CEO)

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## **Netflix: Streaming Pioneer**

Netflix invented streaming video as a mass medium, then had to reinvent itself when competitors arrived. The company's strategic evolution—from DVD-by-mail to streaming aggregator to content studio to advertising platform—illustrates the technology industry's relentless pace of change.

Reed Hastings founded Netflix in 1997 as a DVD-by-mail service, undercutting Blockbuster's late fees and limited selection. The streaming service launched in 2007, initially offering a limited library of licensed content. As licensing costs rose and studios began withholding content for their own streaming services, Netflix pivoted to original content. House of Cards (2013) demonstrated that streaming-first series could achieve prestige television quality.

By 2024, Netflix had become the world's largest entertainment company by subscriber count, with 302 million paying subscribers globally. The company produces content on every continent, releasing local-language programming alongside global blockbusters. Netflix's content spending exceeded \$17 billion in 2023, more than any traditional studio.

Netflix's 2022 subscriber decline—its first ever—prompted strategic recalibration. The company cracked down on password sharing, requiring additional payments for households outside the account holder's home. It launched an advertising-supported tier at \$6.99 monthly, reversing its longstanding opposition to ads. Both initiatives succeeded: Netflix added tens of millions of subscribers through 2023-2024.

The company's challenges remain significant. Content costs continue rising. Competition from Disney+, Max, Amazon, and Apple TV+ has fragmented the market. Netflix carries no significant debt but generates modest free cash flow relative to its market capitalization. Yet no competitor has matched Netflix's global scale or algorithmic recommendation sophistication.

**Headquarters:** Los Gatos, California (Silicon Valley) **Employees:** 13,000 **Key executives:** Ted Sarandos and Greg Peters (co-CEOs), succeeding Reed Hastings

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## Data Sources and Further Reading

### Government Sources

- Bureau of Economic Analysis, GDP by Industry
- Bureau of Labor Statistics, Quarterly Census of Employment and Wages
- Federal Communications Commission, Communications Marketplace Report
- Securities and Exchange Commission, Company filings (10-K, 10-Q)

### Industry Data

- eMarketer/Insider Intelligence, Digital advertising forecasts
- Synergy Research Group, Cloud infrastructure market share
- Leichtman Research Group, Broadband subscriber data
- Ampere Analysis, Streaming subscriber estimates

### Academic Sources

- Rochet, Jean-Charles, and Jean Tirole. "Platform Competition in Two-Sided Markets." *Journal of the European Economic Association* 1, no. 4 (2003): 990-1029.
- Evans, David S., and Richard Schmalensee. "The Industrial Organization of Markets with Two-Sided Platforms." *Competition Policy International* 3, no. 1 (2007).
- Milgrom, Paul. "What the Seller Won't Tell You: Persuasion and Disclosure in Markets." *Journal of Economic Perspectives* 22, no. 2 (2008): 115-131.

### Books

- Wu, Tim. *The Attention Merchants: The Epic Scramble to Get Inside Our Heads*. New York: Knopf, 2016.
- Galloway, Scott. *The Four: The Hidden DNA of Amazon, Apple, Facebook, and Google*. New York: Portfolio, 2017.
- Srnicek, Nick. *Platform Capitalism*. Cambridge: Polity Press, 2017.
- Zuboff, Shoshana. *The Age of Surveillance Capitalism*. New York: PublicAffairs, 2019.

### Legal Documents

- United States v. Google LLC, Case No. 1:20-cv-03010 (D.D.C. 2024).
- Epic Games, Inc. v. Apple Inc., Case No. 4:20-cv-05640 (N.D. Cal. 2021).
- Federal Trade Commission v. Amazon.com, Inc., Case No. 2:23-cv-01495 (W.D. Wash. 2023).

## **Exercises**

### **Review Questions**

1. The chapter notes that Big Tech's five largest companies employ fewer than 2 million workers but are worth over \$10 trillion—roughly 25% of the entire S&P 500. What structural features of technology business models (advertising, cloud infrastructure, platform fees, ecosystem lock-in) explain how these firms generate enormous market value with relatively few employees? How does this contrast with the retail sector discussed in Chapter 10, where Walmart alone employs 2.1 million people?
2. Google and Meta together capture roughly 50% of all digital advertising spending in the United States—over \$150 billion annually. Explain the key differences between Google's search advertising model (pay-per-click keyword auctions where legal terms can cost \$50+ per click) and Meta's social media advertising model (targeted by demographics, interests, and "lookalike audiences" from detailed user data). Why might a personal injury law firm choose Google while a direct-to-consumer clothing brand might choose Meta?
3. The DOJ found that Google illegally maintained its search monopoly partly through approximately \$20 billion in annual payments to Apple to be the default search engine on iPhones and Safari. Using the concept of "default effects" in consumer behavior, explain why being the default search engine is so valuable that Google would pay this amount. What does this imply about consumer willingness to switch away from preinstalled options?
4. Section 230 of the Communications Decency Act provides that platforms cannot be treated as publishers of user-generated content. The chapter notes that this "twenty-six-word provision enables the modern internet." Explain how Section 230 makes social media, search engines, and review sites legally viable. Then explain why both conservatives (who argue platforms suppress right-wing viewpoints) and progressives (who argue platforms fail to moderate harmful content) have criticized the law, albeit for different reasons.
5. The newspaper industry has lost over 75% of its employment since 2000, falling from 455,000 workers to under 100,000. The chapter identifies classified advertising's migration to Craigslist and display advertising's migration to Google and Facebook as the causes. Explain the economic mechanism by which digital platforms captured this revenue. Why couldn't newspapers successfully transition their advertising business online?
6. The streaming video market has evolved from a "cord-cutting" promise of lower costs to a situation where households subscribing to multiple services approach or exceed cable costs. The industry has responded with password-sharing crackdowns, ad-supported tiers, and bundling (Disney offers Disney+, Hulu, and ESPN+ together). Explain how this outcome is consistent with economic theory about bundling, and evaluate whether the streaming industry is effectively recreating the cable bundle it promised to replace.
7. The wireless industry consolidated from four national carriers to three when T-

Mobile acquired Sprint in 2020, approved over DOJ objections. T-Mobile has since become the market share leader at 35%, narrowly ahead of Verizon (34%) and AT&T (27%). Using the chapter's discussion, evaluate whether this consolidation has led to the reduced competition that merger opponents feared or the network investment gains that proponents promised. Has T-Mobile's behavior been more consistent with the predictions of critics or supporters of the merger?

## Data Exercises

8. Using FRED (Federal Reserve Economic Data, <https://fred.stlouisfed.org/>), search for the GDP contribution of NAICS 51 (Information sector) and compare its growth rate over the past 10 years to overall GDP growth. Create a chart showing information sector GDP as a share of total GDP over time. Does this official measure support the chapter's claim that NAICS classifications "dramatically understate" the technology sector's economic footprint? What companies that are functionally technology firms (e.g., Amazon classified as retail) are excluded from NAICS 51?
9. Using the FCC's Communications Marketplace Report (available at [https://www.fcc.gov/report\\_research](https://www.fcc.gov/report_research)), find the most recent data on fixed broadband deployment by speed tier and geographic area (urban vs. rural). What percentage of rural Americans lack access to broadband at 100/20 Mbps? How does this "digital divide" relate to the chapter's discussion of Comcast and Charter controlling more than half the wireline broadband market and concentrating investment in areas "where the economics are favorable"?
10. Visit the SEC EDGAR database and download the most recent 10-K filings for Alphabet (Google) and Meta Platforms. Calculate what percentage of each company's total revenue comes from advertising. Compare these percentages to the figures cited in the chapter (78% for Alphabet, virtually 100% for Meta). Has advertising concentration increased or decreased? What non-advertising revenue sources have grown, and do they meaningfully diversify these companies' business models?

## Deeper Investigation

11. The chapter describes a "local news crisis" in which over 130 newspapers closed between 2020 and 2024, creating "information deserts" where research has documented lower voter turnout, less competitive local elections, and higher municipal borrowing costs. Select a state and use data from the UNC Hussman School of Journalism's "news desert" database (<https://www.usnewsdeserts.com/>) to map which counties have lost newspapers since 2004. Then, using municipal bond data from the MSRB's EMMA system (<https://emma.msrb.org/>) and voter turnout data from your state's election board, test whether the loss of local news correlates with measurable changes in municipal borrowing costs or civic participation. What policy interventions—nonprofit newsrooms, public subsidies, philanthropic models like The Texas Tribune—might address the information gap?

# 12. Transportation and Logistics

Every time you order something online and it arrives the next day, you're witnessing the culmination of a half-century revolution in American freight. The trucks, trains, planes, and ships that move goods across the country represent not just infrastructure but a complex industrial ecosystem that employs 6.5 million Americans and contributes nearly a trillion dollars to GDP. What makes American transportation remarkable isn't any single mode but how they interconnect: a container loaded in Shanghai can travel by ship to Long Beach, by rail to Chicago, and by truck to a warehouse in Ohio, with each handoff choreographed by logistics software that didn't exist a generation ago.

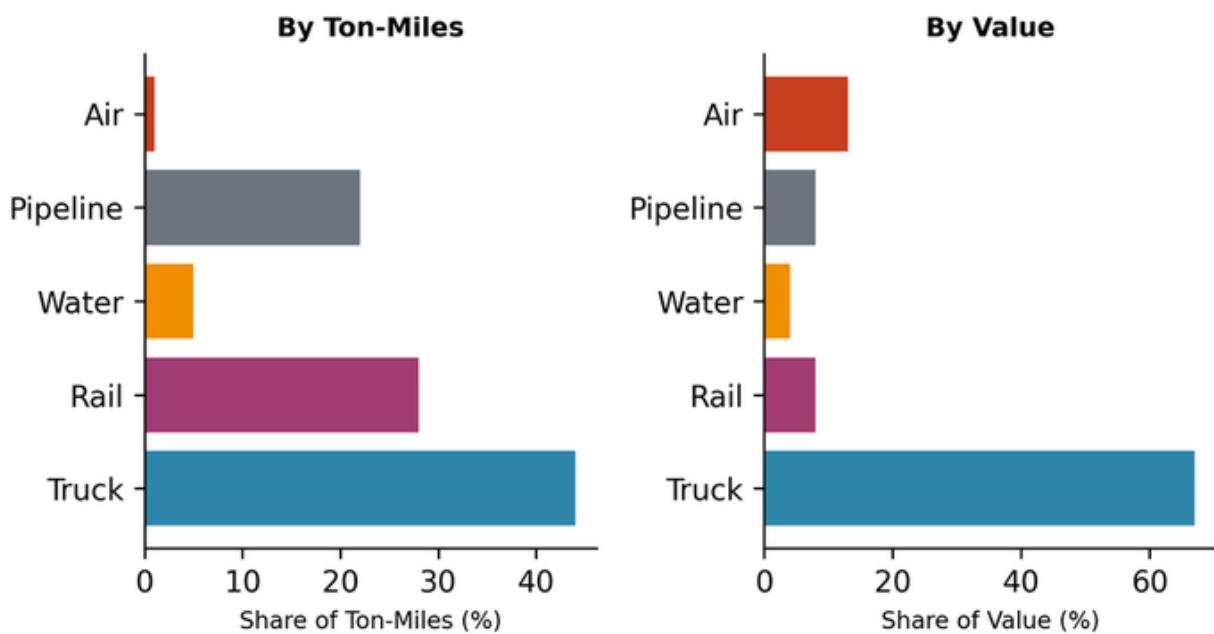
## Overview

**Size and Scope** - GDP contribution: \$935 billion (Transportation and Warehousing, NAICS 48-49) - Broader economic footprint: roughly \$1.8 trillion including private trucking fleets - Employment: 6.58 million workers - Freight moved: roughly 20 billion tons annually

The transportation sector is fundamentally shaped by two forces: geography and deregulation. American distances are vast—it's 2,800 miles from Los Angeles to New York, creating natural demand for long-haul freight that doesn't exist in smaller countries. And the regulatory reforms of 1978-1980, which deregulated airlines, trucking, and railroads in rapid succession, unleashed productivity gains that transformed how goods move.

The modal split reveals the logic of American freight. Trucking dominates, handling 44% of ton-miles and an even larger share by value, because trucks offer door-to-door flexibility that no other mode can match. Rail moves 19% of ton-miles but specializes in bulk commodities—coal, grain, chemicals, intermodal containers—where its cost advantage on long hauls is decisive. Air freight is negligible by weight (less than 1% of ton-miles) but moves high-value, time-sensitive goods: electronics, pharmaceuticals, e-commerce orders. Pipelines quietly move petroleum and natural gas, while ships handle international trade and some domestic bulk cargo.

### U.S. Freight by Mode, 2023



Source: Bureau of Transportation Statistics

Figure 42: Figure 12.1: U.S. freight by mode (ton-miles). Trucking dominates for flexibility; rail excels at bulk and long-haul. Source: BTS (2023)

# How the Industry Works

## The Freight Economy

Transportation is a derived demand—goods move because someone wants them somewhere else. This makes the sector acutely cyclical, rising and falling with economic activity. The 2021-2022 pandemic boom and subsequent 2023 softening illustrated this vividly: when consumers shifted spending to goods, freight rates soared; when inventory normalized, rates collapsed.

The business model varies dramatically by mode. Trucking is highly competitive with thin margins (5-10% operating margins for most carriers), because entry barriers are low—you can start a trucking company with one truck and a commercial driver's license. Rail is a capital-intensive oligopoly with high fixed costs but strong pricing power on routes where they face no competition. Airlines operate in a consolidated market where the Big Four can manage capacity to maintain yields. Logistics companies increasingly don't own trucks or planes at all—they're information businesses that match shippers with capacity.

## The Intermodal Revolution

The most important innovation in freight isn't a vehicle—it's the shipping container. Before containerization, loading a ship took weeks of manual labor; now it takes hours. The standardized container (20 or 40 feet long) can move from ship to rail to truck without unpacking, slashing handling costs and enabling global supply chains.

Intermodal freight—containers that move by multiple modes—has grown from a curiosity to a major segment. J.B. Hunt built a business model around trucking containers to and from rail yards, combining the line-haul efficiency of rail with the flexibility of trucks at each end. The economics work when the rail haul exceeds about 500 miles; below that, trucks are faster and cheaper door-to-door.

## Trucking: The Dominant Mode

Trucking moves America. With over 900,000 registered motor carriers and 1.5 million drivers, trucking is both the largest freight mode and one of the most fragmented industries in the economy. A Walmart store might receive deliveries from dozens of different trucking companies in a single day.

## Industry Structure

The trucking industry divides into distinct segments:

**Truckload (TL):** Full trailers moving directly from shipper to consignee. Knight-Swift, Werner, and Schneider are major players, but even the largest TL carriers have single-digit market share in this fragmented market.

**Less-than-Truckload (LTL):** Consolidated shipments from multiple shippers sharing trailer space through hub-and-spoke networks. LTL is more concentrated because

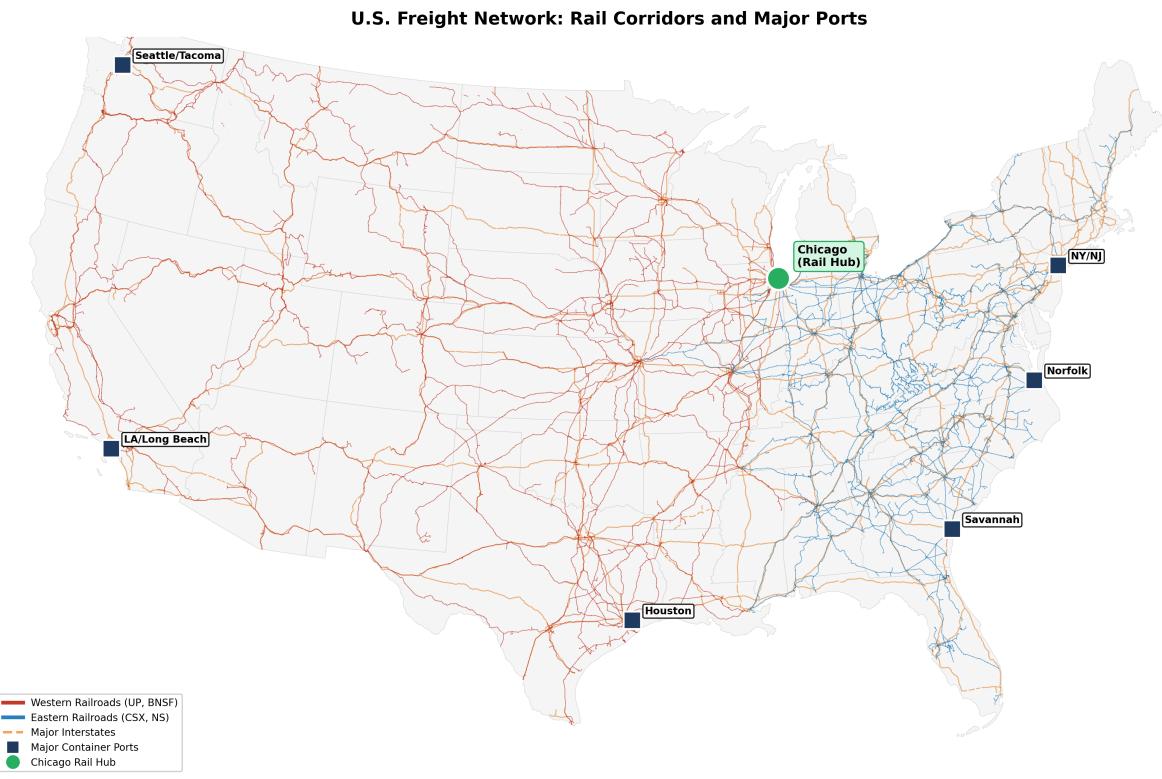


Figure 43: Figure 12.2: The U.S. freight skeleton. Major rail corridors (Class I railroads), interstate highways, and container ports form the physical infrastructure of American commerce. Chicago serves as the critical hub where eastern and western rail networks meet. Source: STB, DOT

the network economics create barriers to entry. Old Dominion, XPO, and Saia dominate, with the top ten carriers controlling about 75% of the market.

**Private Fleets:** Many large companies—Walmart, PepsiCo, Sysco—operate their own trucks. Private fleets represent roughly 50% of all trucking activity by some measures, though they don't appear in for-hire trucking statistics.

**Owner-Operators:** Independent truckers who own their rigs and either lease to carriers or operate under their own authority. Owner-operators make up 11-16% of the driver workforce and represent the entrepreneurial dream of trucking—and its economic precarity.

Rank	Company	2023 Revenue	Segment
1	UPS	\$100.3B	Integrated
2	FedEx	\$92.6B	Integrated
3	J.B. Hunt	\$12.4B	Intermodal/TL
4	Old Dominion	\$6.3B	LTL
5	Knight-Swift	\$6.1B	Truckload
6	XPO	\$4.6B	LTL/Brokerage
7	Schneider	\$5.5B	TL/Intermodal
8	Werner	\$3.0B	Truckload

## The Driver Shortage

The trucking industry has complained about driver shortages for decades. The American Trucking Associations estimates the current shortage at around 60,000 drivers, down from a peak of 80,000 during the pandemic freight boom but still significant. The shortage is concentrated in long-haul trucking, where drivers may spend weeks away from home.

Why can't the industry attract more drivers? The answer is mostly economics. Long-haul trucking offers median pay around \$50,000-60,000 for grueling work: irregular schedules, nights in truck stops, health problems from sedentary hours behind the wheel. As the labor market has tightened and competing jobs have become more attractive, trucking struggles to recruit and retain drivers.

The industry's response has been a mix of higher pay (especially signing bonuses during tight markets), improved working conditions, and technology investments. Some carriers have shifted toward regional and local routes that get drivers home more frequently. The long-term solution may be autonomous trucks—but that technology remains further away than its boosters claim.

## Freight Rail: The Duopoly

American freight rail is a remarkable success story hidden in plain sight. After decades of decline, the railroad industry was deregulated by the Staggers Act of 1980, allowing railroads to set market-based rates and abandon unprofitable lines.

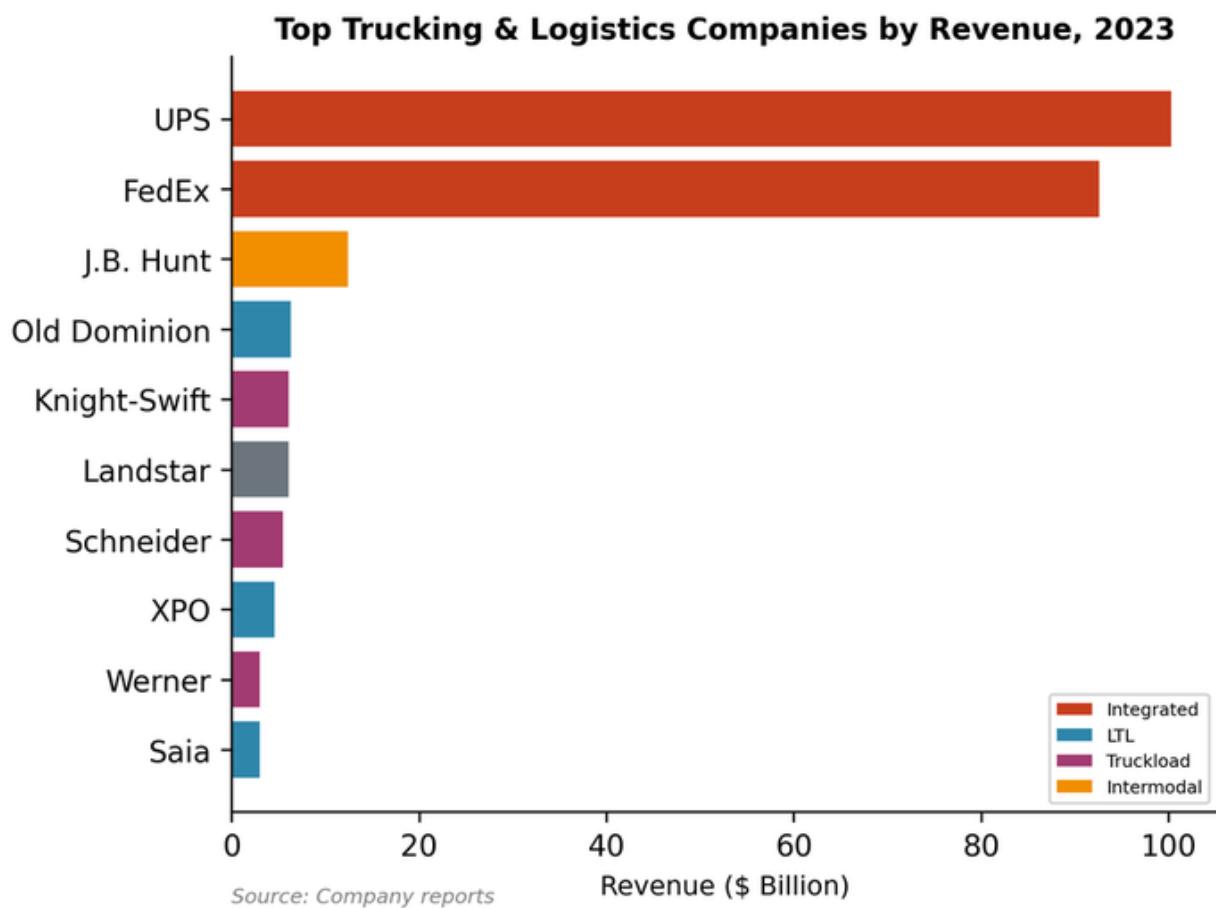


Figure 44: Figure 12.3: Top trucking companies by revenue. UPS and FedEx dominate through their integrated parcel networks. Source: Company data (2023)

The result: an industry that went from bankruptcy's edge to consistent profitability, with productivity that roughly tripled over four decades.

## The Class I Railroads

Only seven “Class I” railroads (those with over \$500 million in annual revenue) remain after decades of consolidation. The structure is a geographic duopoly:

**Western Duopoly:** - **Union Pacific:** The larger of the two western carriers, operating 32,000 route miles across 23 states west of the Mississippi - **BNSF Railway:** Owned by Berkshire Hathaway since 2010, operating 32,500 route miles with particular strength in intermodal and coal

**Eastern Duopoly:** - **CSX:** Operating 20,000 route miles primarily east of the Mississippi - **Norfolk Southern:** Operating 19,500 route miles with a strong intermodal network

Railroad	2023 Revenue	Owner	Geography
Union Pacific	\$24.1B	Public	Western US
BNSF	\$23.4B	Berkshire Hathaway	Western US
CSX	\$14.7B	Public	Eastern US
Norfolk Southern	\$12.2B	Public	Eastern US

Source: Association of American Railroads, 2024

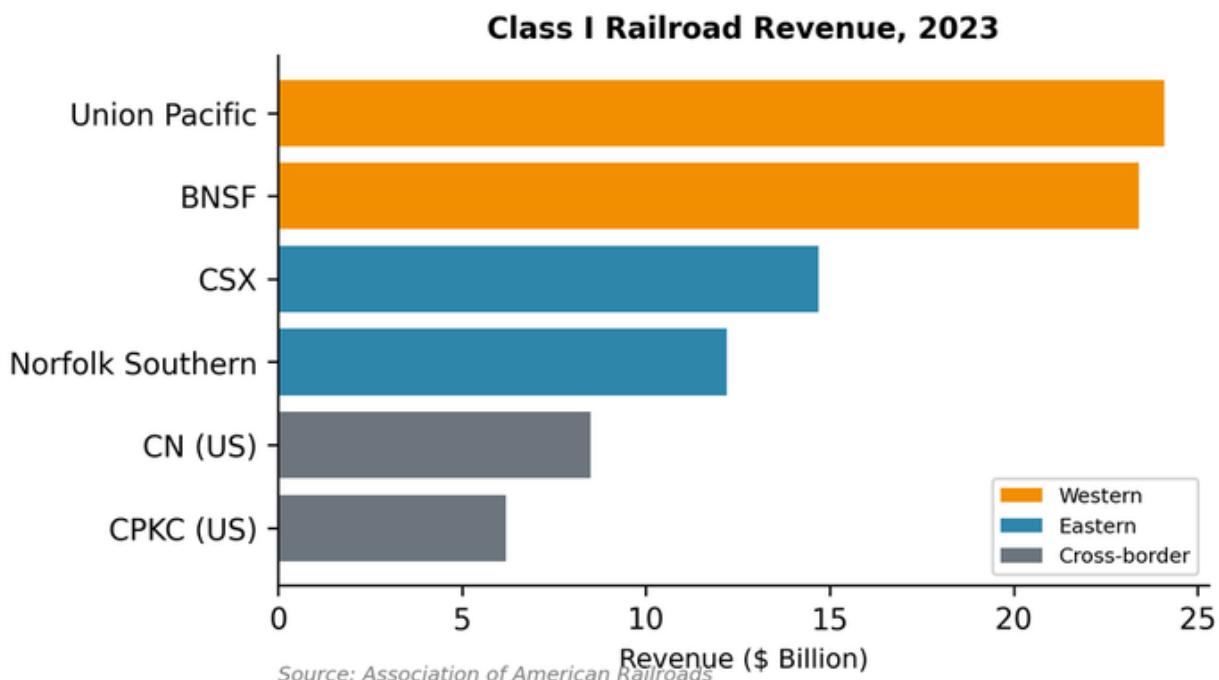


Figure 45: Figure 12.4: Class I railroad revenue. Union Pacific and BNSF (Berkshire) dominate the West; CSX and Norfolk Southern split the East. Source: AAR (2023)

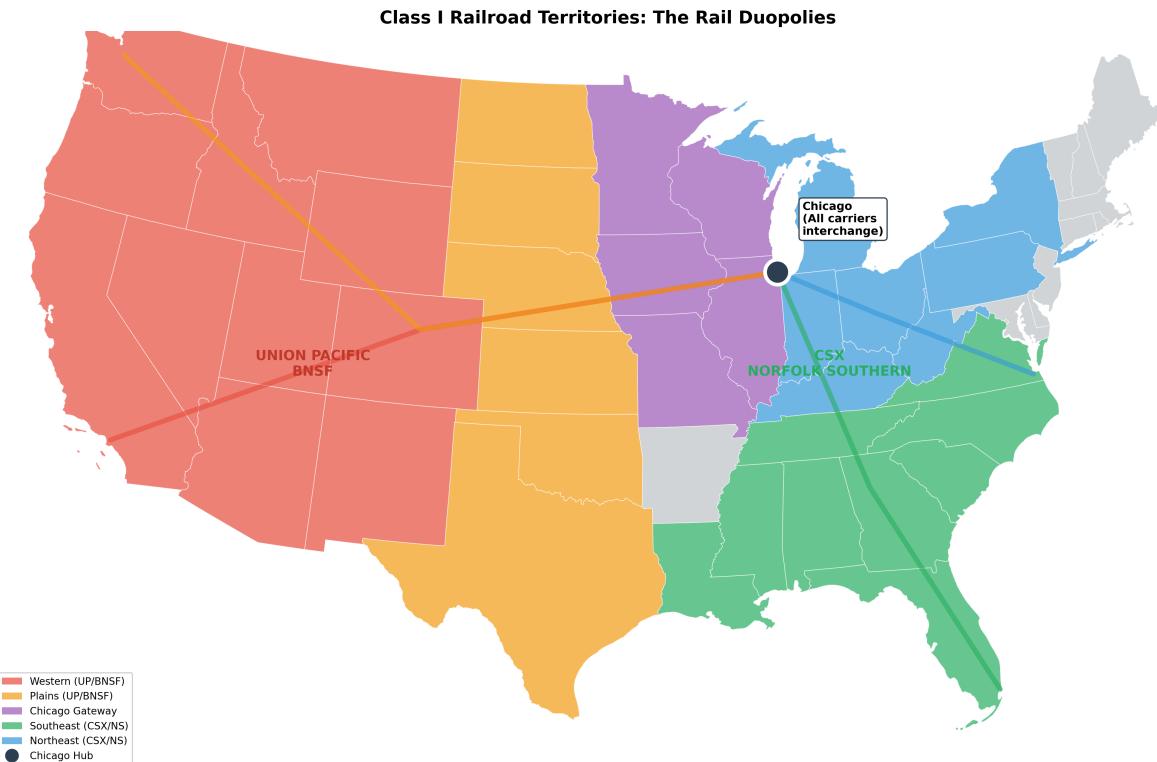


Figure 46: Figure 12.5: Class I railroad territories. The western duopoly (Union Pacific, BNSF) and eastern duopoly (CSX, Norfolk Southern) divide the country roughly at the Mississippi River. Chicago serves as the critical interchange point. Source: STB (2023)

The Canadian carriers (Canadian National and Canadian Pacific Kansas City) also operate extensively in the US, and Kansas City Southern (now part of CPKC) provides the main rail link to Mexico.

## Precision Scheduled Railroading

The railroads' profitability has come partly from a controversial operational philosophy called Precision Scheduled Railroading (PSR). Pioneered by the late Hunter Harrison at Illinois Central and later Canadian National, PSR emphasizes running trains on fixed schedules (like a bus route) rather than waiting for cars to accumulate, reducing locomotive and crew needs, and cutting costs relentlessly.

PSR has delivered stunning financial results—operating ratios (expenses as a percentage of revenue) fell from the 80s to the low 60s—but critics argue it has degraded service reliability and cut safety margins. The workforce has shrunk by about 30% since 2011. The Surface Transportation Board, which regulates rail economics, has held hearings on whether rail service has deteriorated.

## The 2022 Labor Crisis

Rail's labor relations remain contentious. In 2022, a potential national rail strike threatened to shut down freight movement across the country. Congress intervened to impose a contract settlement in December 2022, but the resolution—which initially denied paid sick leave to workers—drew widespread criticism. Through 2023, individual railroads negotiated agreements to provide paid sick days, resolving the most inflammatory issue.

## Airlines: Consolidated Skies

The airline industry that deregulation created in 1978 has consolidated into a stable oligopoly dominated by four carriers: American, Delta, United, and Southwest. Together they control about 70% of domestic passenger traffic.

## The Big Four

Airline	Domestic Share	Headquarters	Hubs
Delta	17.8%	Atlanta	ATL, MSP, DTW, SLC, SEA
American	17.5%	Fort Worth	DFW, CLT, PHX, PHL, MIA
Southwest	17.3%	Dallas	Point-to-point (major: DEN, LAS, PHX)
United	16.0%	Chicago	ORD, DEN, IAH, SFO, EWR

Source: Department of Transportation, T-100 Domestic Market Data, 2024

The Big Four emerged from a wave of mergers: Delta absorbed Northwest (2008), United merged with Continental (2010), Southwest acquired AirTran (2011), and American combined with US Airways (2013). The result is a mature industry with

## **U.S. Domestic Airline Market Share, 202**

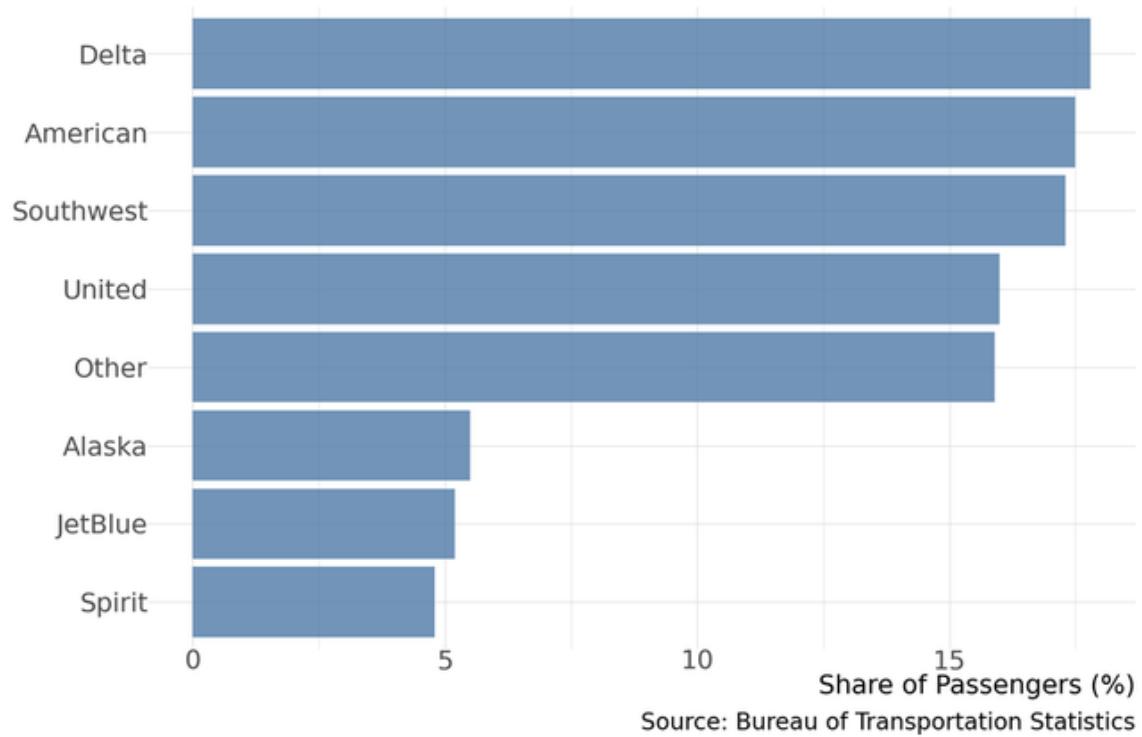


Figure 47: Figure 12.6: Domestic airline market share. The Big Four control roughly 70% of passengers after decades of consolidation. Source: DOT (2024)

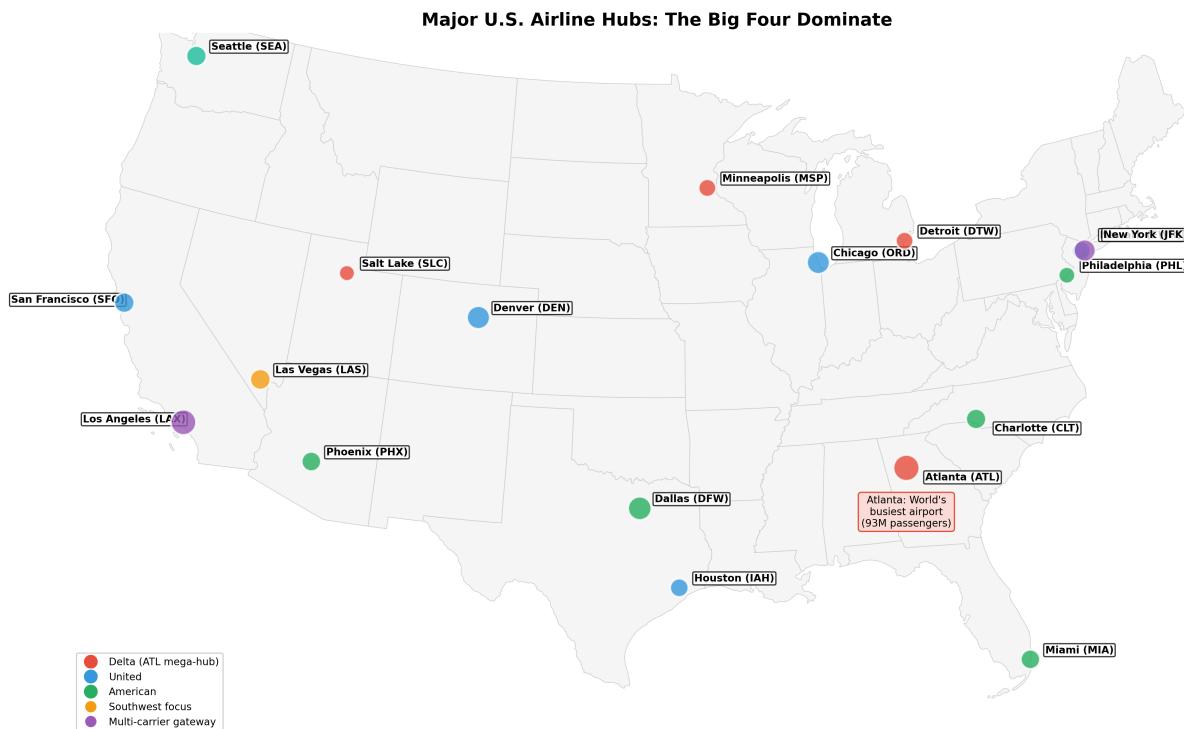


Figure 48: Figure 12.7: Major airline hub locations. Delta (blue) dominates Atlanta; American (red) hubs in Dallas and Charlotte; United (navy) in Chicago and Denver; Southwest (orange) operates point-to-point from multiple cities. Source: DOT (2024)

disciplined capacity management and consistent profitability—a stark contrast to the boom-bust cycles of the 1990s and 2000s.

Southwest remains distinctive with its point-to-point network, single aircraft type (Boeing 737), and no-frills approach, though it has increasingly converged with legacy carriers on pricing. The ultra-low-cost carriers (Spirit, Frontier) compete on price in leisure markets but remain small.

## Air Cargo

Passenger airlines also carry significant cargo in their belly holds, but the air freight industry is dominated by integrators—companies that operate their own planes and delivery networks.

**FedEx** operates the world's largest cargo airline from its Memphis superhub, which handles over 40% of US air cargo by weight. FedEx essentially invented the overnight delivery business model in the 1970s.

**UPS** operates a comparable air network from its Louisville hub, integrated with its vast ground network.

**Amazon Air** has emerged as a major force, growing its fleet to over 90 aircraft. Amazon's logistics ambitions have fundamentally disrupted the parcel delivery market.

## Ports and Maritime Shipping

America's seaports are the gateways for international trade. Container ports handle the manufactured goods that stock retail shelves; bulk ports move grain, coal, and petroleum.

### Major Container Ports

Port	2023 TEUs	Key Trade Lane
Los Angeles	10.7 million	Trans-Pacific (Asia)
New York/New Jersey	9.5 million	Trans-Atlantic, Asia
Long Beach	9.1 million	Trans-Pacific (Asia)
Savannah	5.9 million	Asia, Atlantic
Houston	4.0 million	Latin America, Gulf

The San Pedro Bay ports (Los Angeles and Long Beach) together form the nation's largest port complex, handling about 40% of containerized imports. Their dominance reflects proximity to Asia—the great circle route from Shanghai to LA is several days shorter than to East Coast ports via the Panama Canal.

The 2021-2022 port congestion crisis exposed the fragility of this concentration. Ships anchored for weeks waiting to unload, contributing to supply chain disruptions that raised prices nationwide. The crisis accelerated a shift toward East Coast and Gulf ports, with Savannah in particular gaining share.

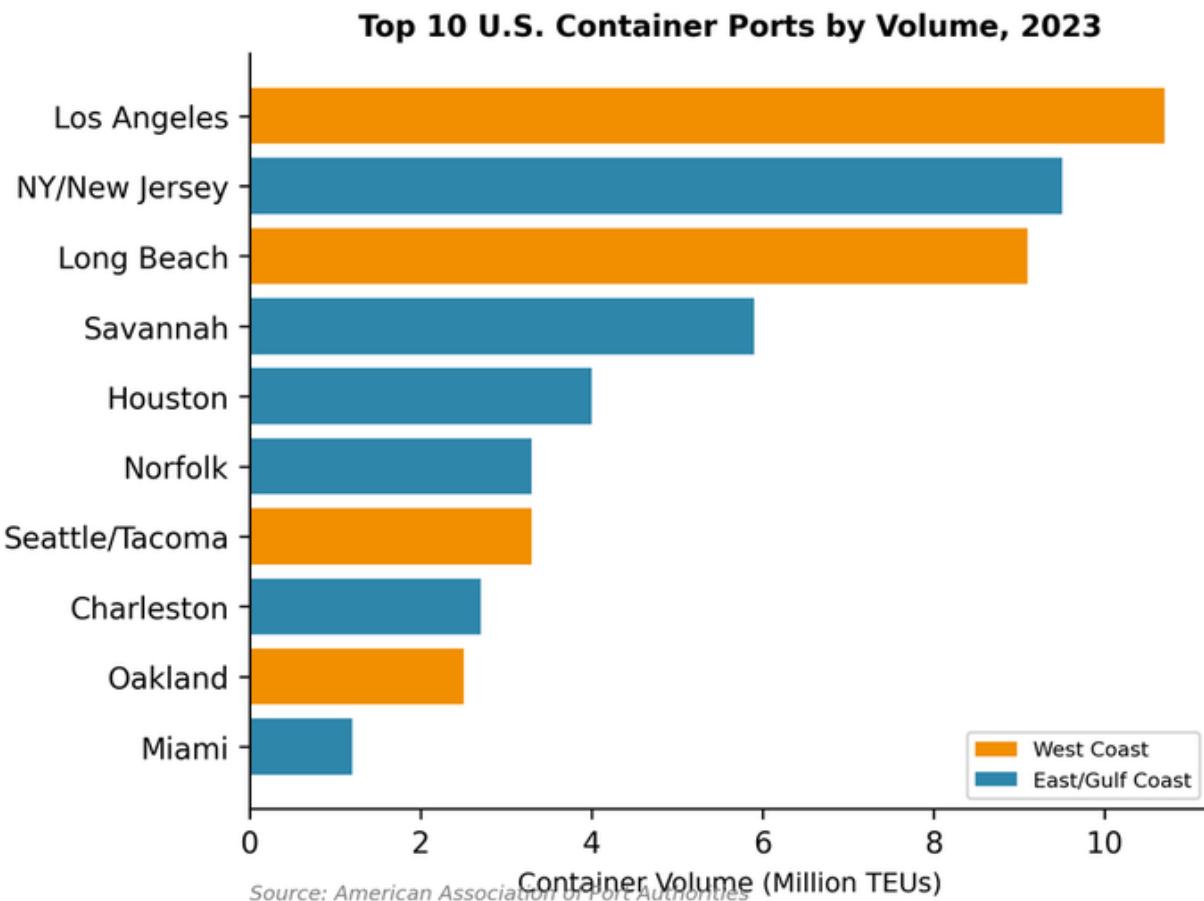


Figure 49: Figure 12.8: Top U.S. container ports by TEUs. Los Angeles-Long Beach dominates trans-Pacific trade; Savannah has gained share since the 2021 congestion crisis. Source: AAPA (2023)

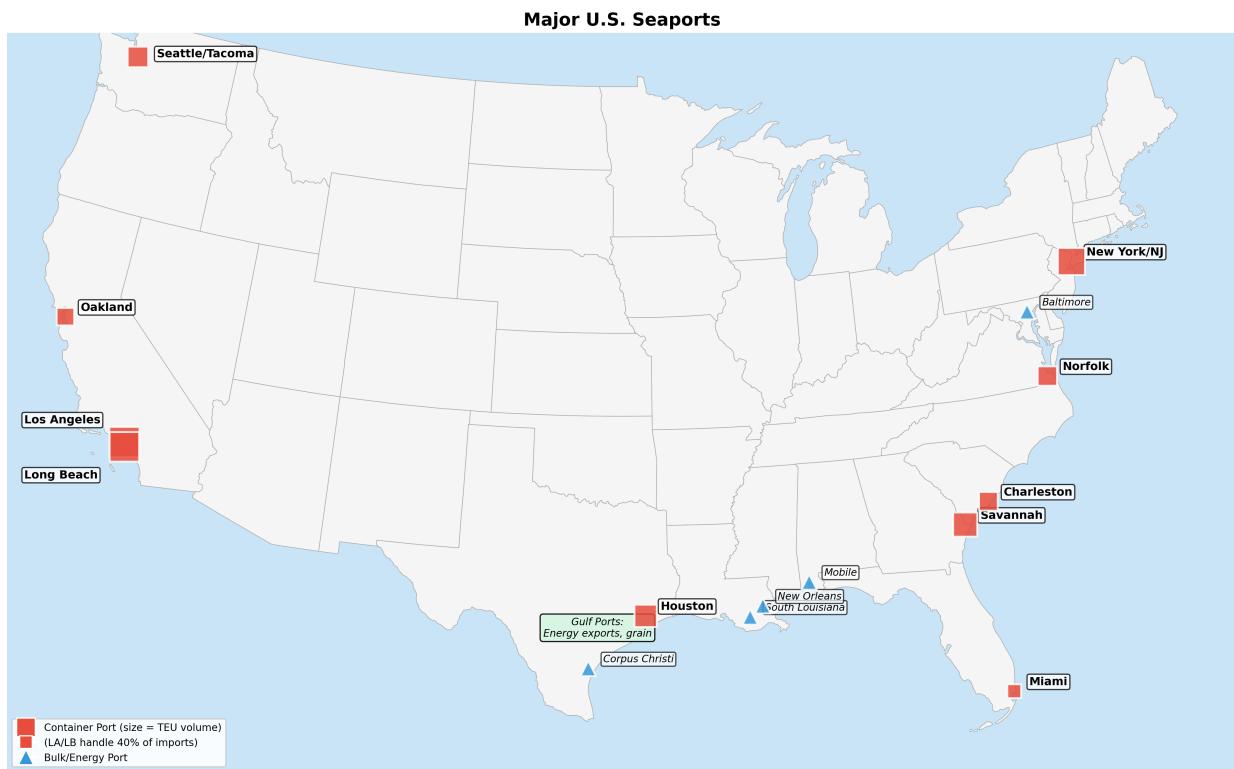


Figure 50: Figure 12.9: Major U.S. seaports. Container ports (red squares) cluster on coasts, with LA/Long Beach dominating Pacific trade. Bulk ports (blue triangles) along the Gulf handle grain and energy exports. Source: AAPA (2023)

## The Jones Act

The Merchant Marine Act of 1920, known as the Jones Act, requires that goods shipped between US ports travel on ships that are American-built, American-owned, and American-crewed. The law was intended to maintain a domestic shipbuilding industry and merchant marine for national security.

The economic effects are substantial. American-built ships cost three to four times as much as foreign-built equivalents. The result: essentially no domestic container shipping and limited domestic tanker capacity. Hawaii, Alaska, and Puerto Rico bear the highest costs, paying more for goods that must arrive by sea.

Estimates suggest the Jones Act costs Puerto Rico about \$1.4 billion annually. Yet the law persists, defended by domestic shipbuilders, maritime unions, and national security hawks who argue (with diminishing plausibility) that a domestic merchant marine is strategically essential.

## Logistics and Warehousing

The logistics industry has transformed from a back-office function to a strategic capability. Companies that can move goods faster, cheaper, and more reliably gain competitive advantage. This has fueled the growth of third-party logistics providers (3PLs) and a warehousing boom unprecedented in scale.

### Third-Party Logistics

The 3PL market reached approximately \$247 billion in 2023. These companies offer services ranging from freight brokerage (matching shippers with carriers) to comprehensive supply chain management.

**C.H. Robinson** is the largest freight broker, connecting shippers with trucking capacity without owning trucks. **GXO Logistics** (spun off from XPO) operates warehouses and manages distribution for major retailers. **Kuehne+Nagel** and **DHL Supply Chain** bring global reach.

But the most disruptive force is Amazon. What started as a retailer's logistics department has become a competitor to traditional 3PLs and parcel carriers. Amazon Logistics now handles about 27% of US parcel volume, surpassing UPS (21%) and FedEx (15%) in package count. Amazon has built its own air cargo network, leases thousands of delivery vans, and operates a fleet of delivery partners who are nominally independent but largely Amazon-dependent.

### The Warehouse Boom

E-commerce has driven explosive growth in warehouse construction. Total industrial real estate reached approximately 17.7 billion square feet, with construction adding 3% to stock in 2023 alone—the fastest pace in 30 years.

The Inland Empire of Southern California (Riverside and San Bernardino counties) has become the “Warehouse of America,” with hundreds of millions of square feet

dedicated to processing imports from the LA/Long Beach ports. Similar warehouse clusters have grown around every major port and population center.

The warehousing workforce has grown from about 700,000 in 2010 to 1.4 million today. These jobs are physically demanding, often involve shift work, and increasingly require workers to keep pace with robotic systems. Amazon's fulfillment centers have drawn particular attention—and criticism—for their working conditions and injury rates.

## Geographic Patterns

### The Freight Corridors

American freight flows along predictable corridors shaped by population, ports, and history:



Figure 51: Figure 12.10: Major freight corridors. Interstate highways, rail mainlines, and ports form an interconnected network with Chicago at the center. Source: BTS

**East-West Trunk Routes:** I-80 and I-90 form the primary cross-country truck corridors, paralleled by Union Pacific and BNSF rail lines. These routes connect West Coast ports to Midwest distribution centers and Eastern markets.

**North-South Coastal Routes:** I-95 on the East Coast and I-5 on the West Coast move goods between population centers. The I-35 corridor connects Mexico through Texas to the Midwest.

**The Chicago Hub:** Chicago sits at the center of the American rail network. All major Class I railroads either serve Chicago directly or connect there, making it the crucial interchange point for transcontinental freight. This geographic centrality is why Chicago remains essential despite its congestion and operational complexity.

## Regional Logistics Centers

**Inland Empire (California):** The warehouse zone serving LA/Long Beach ports  
**Memphis:** FedEx superhub plus major rail and truck crossroads **Dallas-Fort Worth:** Central location serves national distribution **Atlanta:** Southeast distribution hub with Norfolk Southern and CSX rail service **Columbus, Ohio:** Emerging logistics center with good highway access

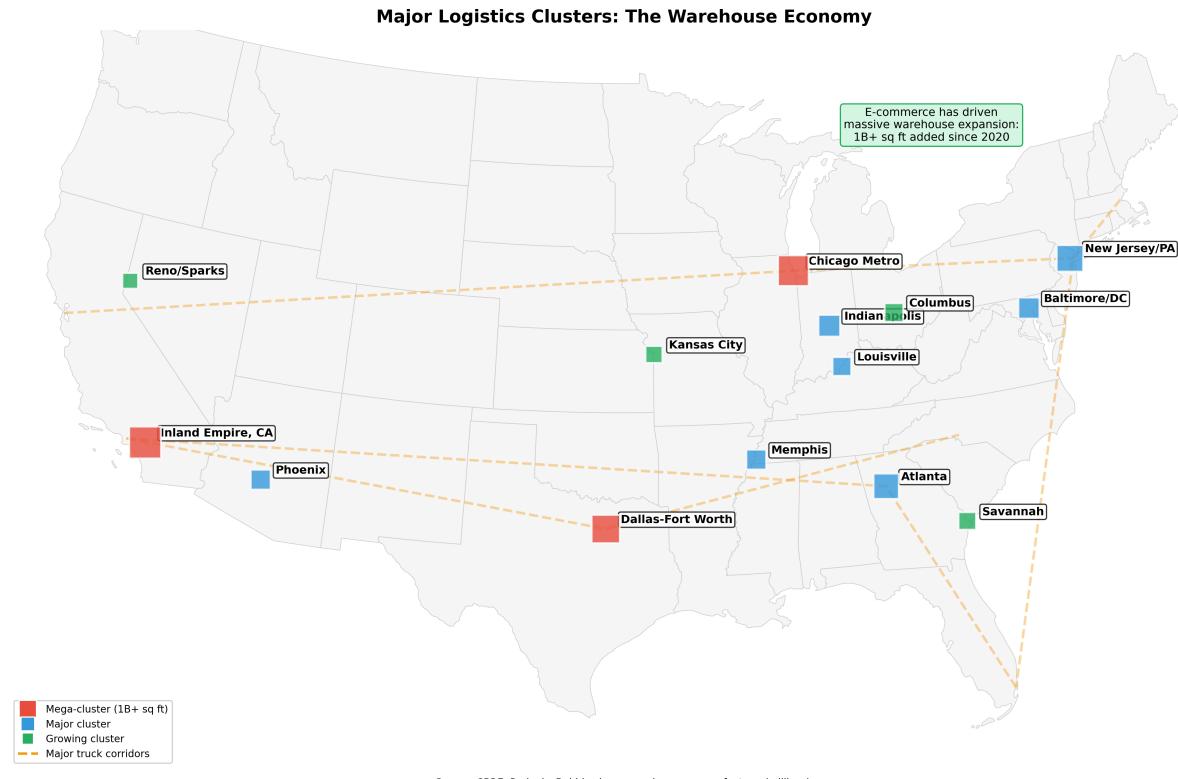


Figure 52: Figure 12.11: Major logistics and warehouse clusters. The Inland Empire dominates as the gateway for trans-Pacific imports; Memphis, Dallas-Fort Worth, and Atlanta serve as major regional distribution hubs. Source: CBRE Industrial Report (2023)

## Regulation and Policy

### The Deregulation Revolution

The late 1970s and early 1980s brought revolutionary changes to transportation regulation:

**Airlines (1978):** The Airline Deregulation Act eliminated the Civil Aeronautics Board's control over routes and fares. Airlines could now fly where they wanted and charge what they wanted. The result was lower fares, hub-and-spoke networks, and eventually the consolidation into today's Big Four.

**Trucking (1980):** The Motor Carrier Act of 1980 removed Interstate Commerce

Commission restrictions on trucking routes and rates. Entry became essentially free—anyone with a truck could become a carrier. Competition intensified, rates fell, and the industry fragmented.

**Rail (1980):** The Staggers Rail Act gave railroads freedom to set rates, enter into contracts with shippers, and abandon unprofitable lines. This saved an industry on the brink of collapse. Conrail, the government-created consolidation of bankrupt Northeast railroads, was eventually privatized and split between CSX and Norfolk Southern.

## Current Regulatory Structure

**Department of Transportation (DOT):** Oversees transportation policy and houses modal administrations.

**Federal Motor Carrier Safety Administration (FMCSA):** Regulates trucking safety, including hours-of-service rules that limit drivers to 11 hours of driving within a 14-hour window after 10 hours off duty.

**Federal Railroad Administration (FRA):** Regulates rail safety, including track standards, crew size, and hazmat transport.

**Surface Transportation Board (STB):** Regulates rail economics—rates, service, and mergers. The STB has faced criticism for failing to address declining rail service.

**Federal Aviation Administration (FAA):** Regulates aviation safety and manages air traffic control.

**Federal Maritime Commission (FMC):** Regulates ocean shipping, with new authority under the Ocean Shipping Reform Act of 2022 to address carrier practices that contributed to the port congestion crisis.

## Trade Associations and Lobbying

Association	Membership	Focus
American Trucking Associations	Trucking carriers	Safety regs, driver rules, infrastructure
Association of American Railroads	Class I railroads	Rail policy, Positive Train Control
Airlines for America (A4A)	Major airlines	Aviation policy, slots, taxes
American Association of Port Authorities	Seaports	Port development, dredging
Transportation Intermediaries Association	Freight brokers	Broker regulation

The trucking lobby is particularly influential in state legislatures, fighting fuel taxes and defending against rail competition. The railroad lobby focuses on federal policy, including preserving the Staggers Act framework and limiting re-regulation. Airlines lobby intensively on slot allocation, international routes, and consumer protection rules.

## **Recent Trends**

### **1. E-Commerce Transformation**

The rise of e-commerce has fundamentally changed freight patterns. Traditional retail supply chains were “push” systems: manufacturers shipped pallets to distribution centers, which shipped cases to stores, which sold to consumers. E-commerce requires “pull” systems: individual parcels moving directly to consumers.

This shift has massive implications. Parcel volumes have soared, putting pressure on UPS and FedEx while creating opportunity for Amazon. Warehouses have moved closer to population centers to enable faster delivery. The “last mile” from warehouse to doorstep has become the most expensive and competitive segment of logistics.

### **2. Amazon’s Logistics Empire**

Amazon has built a logistics network that rivals UPS and FedEx in scale while remaining technically a “shipper.” Amazon Logistics now delivers more packages in the US than either traditional parcel carrier. The company operates its own air cargo fleet (Amazon Air, 90+ aircraft), its own sorting centers, and a network of delivery partners (independent contractors who operate fleets of Amazon-branded vans).

This vertical integration serves Amazon’s e-commerce business while potentially threatening to handle freight for other shippers. Amazon has already begun offering fulfillment services to third-party sellers that compete with traditional 3PLs.

### **3. Autonomous Trucking**

Self-driving trucks have been “five years away” for a decade, but the technology continues to advance. Companies like Aurora, Kodiak Robotics, and Waymo Via are conducting autonomous trucking operations on limited routes in the Southwest, where weather is favorable and highways are relatively simple.

The likely path is “hub-to-hub” autonomy: self-driving trucks handle the long-haul highway segment while human drivers manage pickup and delivery at each end. This could address the driver shortage on the least attractive long-haul routes while avoiding the complexity of urban driving.

Full autonomy remains distant. Regulatory frameworks are incomplete, edge cases are innumerable, and the trucking industry’s fragmentation makes technology adoption slow. But some form of autonomous trucking will likely emerge within the decade.

## **□ Warning:**

### **The 2021-2022 Supply Chain Crisis**

The supply chain disruptions of 2021-2022 demonstrated how transportation constraints cascade through the entire economy. At the peak, over 100 container ships anchored off the California coast waiting weeks to unload. Container shipping rates rose 10x. The semiconductor shortage alone cut auto production by 3.5 million units.

## **4. The 2021-2022 Supply Chain Crisis: A Shock Transmission Case Study**

What began as a mismatch between pandemic-shifted demand and logistics capacity became a shock that raised prices, disrupted production, and sparked a fundamental rethinking of global supply chain design.

### **The Initial Shock: Port Congestion**

The crisis began at the ports. When American consumers—stuck at home, flush with stimulus checks—shifted spending from services to goods, import volumes surged beyond anything the logistics system could handle. The San Pedro Bay ports (Los Angeles and Long Beach) became the bottleneck.

At the peak in late 2021, over 100 container ships anchored off the Southern California coast, waiting days or weeks to unload. The ports operated 24/7 but couldn't clear the backlog. Containers sat on docks for weeks instead of the normal 3-4 days. The entire logistics chain—trucks, chassis, rail connections, warehouses—was overwhelmed simultaneously.

### **Price Transmission: Container Rates**

The scarcity of shipping capacity sent container rates into orbit. The cost to ship a 40-foot container from Shanghai to Los Angeles rose from roughly \$1,500 pre-pandemic to over \$15,000 at the peak—a 10x increase. Shipping lines like Maersk and MSC reported record profits while shippers scrambled for capacity at any price.

These costs passed through supply chains with a lag. The Producer Price Index for transportation and warehousing rose 15% in 2021 alone. Eventually, higher shipping costs contributed to the broader inflation surge, showing up in everything from furniture to electronics to food.

### **The Semiconductor Shortage**

The most economically damaging element was the semiconductor shortage, which revealed the fragility of just-in-time supply chains in auto manufacturing. When COVID shut down chip foundries in early 2020, automakers canceled orders. When demand recovered faster than expected, they found themselves at the back of the queue behind smartphone and electronics companies.

The transmission was devastating for auto production: - New vehicle production fell roughly 3.5 million units in 2021 due to chip shortages - Auto plants idled workers for

weeks at a time, waiting for semiconductors - New car inventory collapsed to historically low levels - Used car prices rose 40%+, contributing significantly to measured inflation - Rental car companies, which had sold fleets during the pandemic, couldn't replenish them

## Geographic and Sectoral Impacts

The shock's effects varied enormously by location and industry:

**Inland Empire (California):** Warehouses filled beyond capacity as containers cleared the ports but couldn't move fast enough to final destinations. Trucking rates from LA to Midwest cities doubled.

**Auto Manufacturing (Midwest):** Plants in Michigan, Ohio, and Indiana faced repeated production shutdowns. The supply chain shock became a demand shock for auto workers.

**Retailers:** Store shelves emptied of goods from toys to appliances. Major retailers like Walmart and Target chartered their own container ships—a dramatic departure from normal practice.

**I-O Linkages:** The disruptions cascaded through supply chains. A missing semiconductor idled an entire assembly line. A delayed container of components held up production of goods dependent on those parts.

## Policy Response and Structural Shift

The crisis prompted government action. The Biden administration established a Supply Chain Disruptions Task Force, pressured ports to expand operations, and worked with trucking and rail operators to clear backlogs. The Ocean Shipping Reform Act of 2022 gave the Federal Maritime Commission new authority to address shipping line practices.

More fundamentally, companies began rethinking decades of supply chain optimization:

- **Inventory rebuilding:** After years of lean inventory, companies increased buffer stocks. The “just-in-case” model began supplementing “just-in-time.”
- **Nearshoring:** Manufacturing investment in Mexico surged as companies sought to reduce dependence on trans-Pacific shipping.
- **Diversification:** Shippers spread volumes across more ports (Savannah and Gulf ports gained share) and more carriers.
- **Visibility investment:** Demand soared for supply chain visibility platforms that could track containers and predict disruptions.

## Lessons for Shock Transmission

The supply chain crisis illustrated several principles:

- **Optimization creates fragility:** Systems designed for efficiency in normal times lack resilience to shocks
- **Bottlenecks amplify disruptions:** The LA/LB concentration meant a single point of congestion affected national supply chains

- **Transmission takes time but persists:** Shipping cost increases from 2021 showed up in consumer prices through 2022
- **Policy response matters but has limits:** Government intervention helped at the margin, but fundamentally, the system needed to work through the backlog

## 5. Sustainability Pressures

Transportation accounts for about 29% of US greenhouse gas emissions, the largest sector. Trucking and aviation are particularly challenging to decarbonize because batteries are heavy and energy-dense fuels are needed for long hauls.

Electric trucks are emerging for short-haul and urban delivery. Tesla's Semi has begun limited production; competitors include Freightliner (eCascadia) and Volvo. But long-haul trucking will likely require alternative fuels—hydrogen, renewable diesel, or synthetic fuels—given battery weight limitations.

Rail is already relatively efficient (about 4x more fuel-efficient than trucking per ton-mile), and electrification is technically feasible though capital-intensive. Airlines face the steepest challenge, with sustainable aviation fuel (SAF) the primary near-term option but production remaining tiny.

## Firm Profiles

### UPS (United Parcel Service)

**Quick Facts** - Headquarters: Atlanta, Georgia - Founded: 1907 - Revenue: \$100.3 billion (2023) - Employees: roughly 500,000

UPS began as a Seattle messenger company and grew into the world's largest package delivery company. The "Big Brown" trucks and uniformed drivers are ubiquitous in American life. UPS delivers about 25 million packages daily worldwide.

The company's competitive advantage is its integrated network. UPS operates its own fleet of aircraft (the world's third-largest cargo airline) from its Louisville Worldport hub, which can sort 416,000 packages per hour. This air network connects to a ground fleet of over 125,000 vehicles and a workforce represented by the Teamsters union.

UPS faces existential pressure from Amazon. As Amazon has built its own delivery network, it has shifted packages away from UPS even as e-commerce volumes grew. UPS's response has been to focus on the profitable segments Amazon doesn't want: healthcare logistics, business-to-business delivery, and international trade. The company has invested heavily in automation and announced plans to cut 12,000 jobs in 2024.

The 2023 Teamsters contract negotiation nearly resulted in a strike that would have crippled the company. The eventual settlement included substantial wage increases, making UPS drivers among the best-paid in trucking. But the contract's cost, combined with volume losses to Amazon, has pressured UPS's historically strong margins.

## **Union Pacific Railroad**

**Quick Facts** - Headquarters: Omaha, Nebraska - Founded: 1862 (Pacific Railroad Acts) - Revenue: \$24.1 billion (2023) - Employees: roughly 32,000

Union Pacific traces its origins to the transcontinental railroad, completed in 1869 at Promontory Summit, Utah. Today it operates the largest railroad in North America by route miles, serving 23 western states from Chicago to the Pacific.

UP moves an astonishing variety of freight: intermodal containers from West Coast ports, grain from the Plains, chemicals from the Gulf Coast, coal from Wyoming's Powder River Basin (though this business is declining with coal plant retirements), and automobiles from assembly plants throughout its territory.

The railroad has embraced Precision Scheduled Railroading, delivering improved financial performance but facing criticism for service lapses. In 2022, the Surface Transportation Board held unprecedented hearings on rail service failures, and UP's CEO testified about plans to improve reliability.

UP's western duopoly with BNSF creates strong pricing power but limited competition. Shippers often have access to only one railroad, giving that carrier significant leverage. Proposals to increase rail competition—through “open access” rules or required trackage rights—have repeatedly failed, but shipper frustration continues to build.

## **Amazon Logistics**

**Quick Facts** - Headquarters: Seattle, Washington (Amazon overall) - Launched: 2015 - Parcel Volume: roughly 27% of US market - Employees: roughly 275,000 (delivery operations)

Amazon Logistics isn't a company—it's a division of Amazon that has grown into one of the largest delivery operations in the world. What began as an effort to reduce dependence on UPS and FedEx has become a competitive threat to both.

The network includes Amazon Air (90+ leased cargo aircraft), hundreds of sortation centers and delivery stations, and a fleet of approximately 100,000 delivery vans operated by Delivery Service Partners (DSPs). DSPs are nominally independent contractors but operate Amazon-branded vehicles, wear Amazon uniforms, and follow Amazon routing.

Amazon's logistics investment serves multiple purposes: it enables faster delivery (often same-day or next-day) that drives customer loyalty; it reduces shipping costs that had become Amazon's largest expense after fulfillment; and it creates strategic optionality to offer logistics services to other companies.

The model has drawn criticism for its treatment of workers. DSP drivers face intense time pressure, with algorithms monitoring their performance and routes optimized to minimize seconds per stop. Injury rates at Amazon fulfillment centers and among delivery drivers exceed industry averages. Amazon argues its pay (starting at \$16-18/hour for drivers) exceeds competitors and notes ongoing safety investments.

Amazon's logistics ambitions extend beyond its own packages. The company offers fulfillment services to third-party sellers on its marketplace and has begun handling small amounts of external freight. Whether Amazon becomes a full-fledged 3PL competitor or remains focused on its own e-commerce remains to be seen.

## Data Sources and Further Reading

### Key Data Sources

- **Bureau of Transportation Statistics:** Freight volumes, modal splits, transportation statistics
- **American Trucking Associations:** Trucking industry data (though advocacy-oriented)
- **Association of American Railroads:** Rail traffic data, industry statistics
- **Federal Maritime Commission:** Port throughput, ocean shipping data
- **Port authorities:** Individual port volume statistics

### Further Reading

- Marc Levinson, *The Box: How the Shipping Container Made the World Smaller and the World Economy Bigger* (2006)—The definitive history of containerization
- Clifford Winston, “U.S. Industry Adjustment to Economic Deregulation,” *Journal of Economic Perspectives* (1998)—Analysis of deregulation effects across industries
- Holmes and Singer, “The Logistics Revolution and Transportation System Efficiency” (2018)—Academic analysis of logistics transformation
- David Hummels, “Transportation Costs and International Trade in the Second Era of Globalization,” *Journal of Economic Perspectives* (2007)—How falling transport costs enabled globalization

## Exercises

### Review Questions

1. The chapter states that transportation is a “derived demand”—goods move because someone wants them somewhere else. Explain what this means and how it makes the transportation sector acutely cyclical. Use the 2021-2022 pandemic boom (when consumers shifted spending to goods and freight rates soared) and the subsequent 2023 softening (when inventory normalized and rates collapsed) to illustrate this relationship.
2. Trucking has over 900,000 registered motor carriers while freight rail operates as a geographic duopoly (Union Pacific and BNSF in the West; CSX and Norfolk Southern in the East). What structural factors—entry barriers, capital requirements, network economics—explain this dramatic difference in market concentration? How does the difference affect pricing power and profit margins in each mode?

3. The Staggers Rail Act of 1980 allowed railroads to set market-based rates, enter contracts with shippers, and abandon unprofitable lines. The chapter states this “saved an industry on the brink of collapse.” Explain the economic logic: how did these specific deregulatory changes improve the railroads’ financial position? What trade-off did deregulation create for shippers located on routes served by only one railroad?
4. Precision Scheduled Railroading (PSR) has delivered “stunning financial results”—operating ratios fell from the 80s to the low 60s—while the railroad workforce shrank by about 30% since 2011. Yet critics argue PSR “degraded service reliability and cut safety margins,” and the Surface Transportation Board held hearings on declining rail service. Explain the tension between financial optimization and service quality in a duopoly market where many shippers have access to only one railroad.
5. The Jones Act requires goods shipped between US ports to travel on American-built, American-owned, American-crewed ships. American-built ships cost three to four times as much as foreign-built equivalents, and the law costs Puerto Rico an estimated \$1.4 billion annually. What economic concept (protectionism, infant industry, regulatory capture) best explains this cost? Using the chapter’s discussion of the law’s defenders—domestic shipbuilders, maritime unions, and national security hawks—explain why the law persists despite its well-documented inefficiencies.
6. During the 2021-2022 supply chain crisis, the cost to ship a 40-foot container from Shanghai to Los Angeles rose from roughly \$1,500 to over \$15,000—a 10x increase. Trace the transmission mechanism described in the chapter: how did this shipping price increase cascade through the logistics chain (port congestion, trucking rates, warehouse capacity) and eventually show up in the Producer Price Index and consumer prices for goods like furniture, electronics, and food?
7. Amazon Logistics now handles about 27% of US parcel volume, surpassing both UPS (21%) and FedEx (15%). The chapter notes that Amazon has built its own air cargo fleet (90+ aircraft), hundreds of sortation centers, and a network of Delivery Service Partners. How has Amazon’s vertical integration into logistics changed the competitive dynamics for UPS and FedEx? What strategic responses have these incumbents adopted?

## Data Exercises

8. Using the Bureau of Transportation Statistics Freight Analysis Framework (<https://www.bts.gov/faf>), download the most recent data on freight flows by mode (truck, rail, water, air, pipeline) measured in both ton-miles and value. Calculate each mode’s share of ton-miles versus its share of value. Which mode shows the largest gap between these two measures? What does this gap reveal about the types of goods each mode carries (bulk commodities versus high-value, time-sensitive products)?
9. Using FRED, download the Producer Price Index for General Freight Trucking, Long-Distance (series ID: PCU484121484121). Plot this index from 2019 to the

present. Identify the pandemic freight boom and subsequent “freight recession” discussed in the chapter. How closely does the timing of rate changes correspond to the supply chain crisis narrative? What was the approximate peak-to-trough decline in trucking rates after the boom?

10. Visit the American Association of Port Authorities website (<https://www.aapaports.org/>) or individual port authority websites and compile container throughput (in TEUs) for the top 5 US ports (Los Angeles, Long Beach, New York/New Jersey, Savannah, Houston) for 2019, 2021, and the most recent year available. Has the shift away from the San Pedro Bay ports (LA/Long Beach) toward East Coast and Gulf ports—particularly Savannah—that the chapter describes as a response to the 2021-2022 congestion crisis continued?

## **Deeper Investigation**

11. The chapter identifies Chicago as “the crucial interchange point for transcontinental freight,” where all major Class I railroads either serve directly or connect. Research the history and current state of freight rail operations through Chicago, including the CREATE (Chicago Region Environmental and Transportation Efficiency) program launched in 2003. What are the estimated economic costs of rail congestion in Chicago (measured in delay hours, fuel waste, and supply chain inefficiency)? How would improving rail throughput in the Chicago region affect national freight efficiency? What political, financial, and engineering obstacles have slowed infrastructure investment, and what progress has the CREATE program made after two decades?

# Chapter 13. Construction

“We used to build things in this country.”

Construction is the great American productivity puzzle. While manufacturing productivity has doubled, retail has been transformed by logistics and technology, and agriculture has achieved miracles of output per worker, construction has gone backwards. A house takes longer to build today than it did in 1970. A highway costs more per mile in real terms. The sector that literally builds America has somehow forgotten how to get better at building.

This is not a statistical artifact. Goolsbee and Syverson (2023) systematically tested whether the productivity decline was measurement error and rejected the hypothesis. Construction really has become less efficient, even as every other major industry has improved. Understanding why—fragmentation, regulation, the inherent challenges of project-based production—is essential to understanding why housing is expensive, why infrastructure takes so long, and why the industrial policy ambitions of the CHIPS Act and Inflation Reduction Act face serious execution risk.

## Overview

### Size and Scope

- **GDP Contribution:** Approximately **\$1.3 trillion** (4.5% of GDP)
- **Gross Output:** roughly \$2.2 trillion annually (including intermediate inputs)
- **Employment:** roughly 8.3 million workers
- **Establishments:** roughly 800,000 firms, the vast majority with fewer than 10 employees
- **Value Put in Place:** \$2.1 trillion annually in new construction (2024)

Construction is both cyclical and foundational. It builds the physical infrastructure of the economy—houses, offices, factories, roads, bridges, power plants—but its activity swings wildly with interest rates, credit availability, and economic confidence. In recessions, construction employment can fall 20-30%; in booms, labor shortages become acute within months.

### Key Subsectors:

- **Residential:** Single-family homes, multifamily apartments, renovations (roughly 40% of total construction spending)
- **Commercial:** Offices, retail, hotels, healthcare facilities, data centers

- **Heavy Civil/Infrastructure:** Highways, bridges, airports, water systems, public transit
- **Industrial:** Manufacturing plants, refineries, power generation facilities

Each subsector operates differently. Residential is fragmented and local; heavy civil is dominated by a handful of giant engineering firms; industrial construction often involves specialized expertise (petrochemical, semiconductor fabs) concentrated in specific geographies.

## How the Industry Works

Construction is fundamentally different from manufacturing. You cannot build inventory. Each project is unique, produced at a specific site, subject to weather, local regulations, and the idiosyncrasies of the land. This project-based nature makes standardization difficult and scale economies elusive.

### The Project Lifecycle

**Design:** Architects and engineers create plans. This phase can take months for a house, years for a hospital or highway.

**Bidding:** Most commercial and public projects use competitive bidding. General contractors submit proposals based on plans; the lowest responsible bidder typically wins. This creates pressure to underestimate costs, leading to change orders and disputes later.

**Delivery Methods:** - **Design-Bid-Build (DBB):** Traditional model. Design is completed, then contractors bid. Clear separation of responsibility, but slow and adversarial. - **Design-Build (DB):** One entity handles both design and construction. Faster, but owner loses some control. - **Construction Manager at Risk (CMAR):** A hybrid. CM provides input during design and guarantees a maximum price.

**Construction:** General contractors (GCs) manage the site but typically self-perform only 10-30% of the work. Everything else flows to **specialty subcontractors:** electrical, plumbing, HVAC, concrete, steel, drywall, roofing. A major commercial project might have 50+ subcontractors.

**Payment Chains:** Money flows down a long chain: Owner pays GC, GC pays subs, subs pay their suppliers and workers. Payment delays are endemic—60, 90, even 120 days is common. Mechanic's lien laws give unpaid contractors claims against the property, but collecting is difficult. Cash flow kills more contractors than lack of work.

### Bonding and Insurance

Public and major commercial projects require **surety bonds:** - **Bid Bonds:** Guarantee the contractor will honor their bid - **Performance Bonds:** Guarantee the work will be completed - **Payment Bonds:** Guarantee subcontractors and suppliers will be paid

Bonding capacity is a major barrier to entry. A contractor can only take on projects up to their bonded limit, which depends on their financial strength and track record. This limits competition on large projects to established firms.

## Cyclical

Construction is among the most cyclical sectors in the economy:

- **Interest Rate Sensitivity:** Residential construction is directly tied to mortgage rates. When rates rise, housing starts collapse.
- **Credit Dependence:** Developers finance projects with construction loans. When credit tightens, projects don't start.
- **Lag Effects:** Projects take 1-3 years to complete. Activity today reflects decisions made years ago.

The 2008-2009 crash saw construction employment fall from 7.7 million to 5.4 million—a 30% decline. Recovery took a decade.

## Industry Structure

### Info:

#### The Construction Productivity Puzzle

Construction is the only major sector where productivity has declined since 1970, even as manufacturing productivity doubled. Goolsbee and Syverson (2023) documented this finding and rejected measurement error as an explanation.

#### The Productivity Puzzle

Goolsbee and Syverson systematically tested potential explanations for this decline:

- **Measurement Error:** Rejected. Using multiple data sources and methodologies, the decline persists.
- **Quality Improvements:** Buildings are better (more code requirements, energy efficiency), but not enough to explain the decline.
- **Input Shifts:** The industry has shifted toward more intermediate inputs relative to labor, yet efficiency has dropped.

#### Why has this happened?

D'Amico, Glaeser, et al. (2024) point to **regulation and fragmentation**:

- Land-use regulations limit project sizes, preventing economies of scale
- If homebuilding firms had manufacturing's size distribution, productivity could be **60% higher**
- Small, fragmented firms cannot invest in technology, training, or process improvement
- Regional misallocation: construction activity has not shifted to high-productivity regions, suggesting regulatory frictions prevent efficient sorting

Allen (1985) identified another factor: **de-skilling**. The shift from large-scale commercial projects (built by skilled union crews) to smaller residential work (built by less-skilled labor) reduced average productivity. The workforce became less capable even as buildings became more complex.

## The Construction Productivity Puzzle

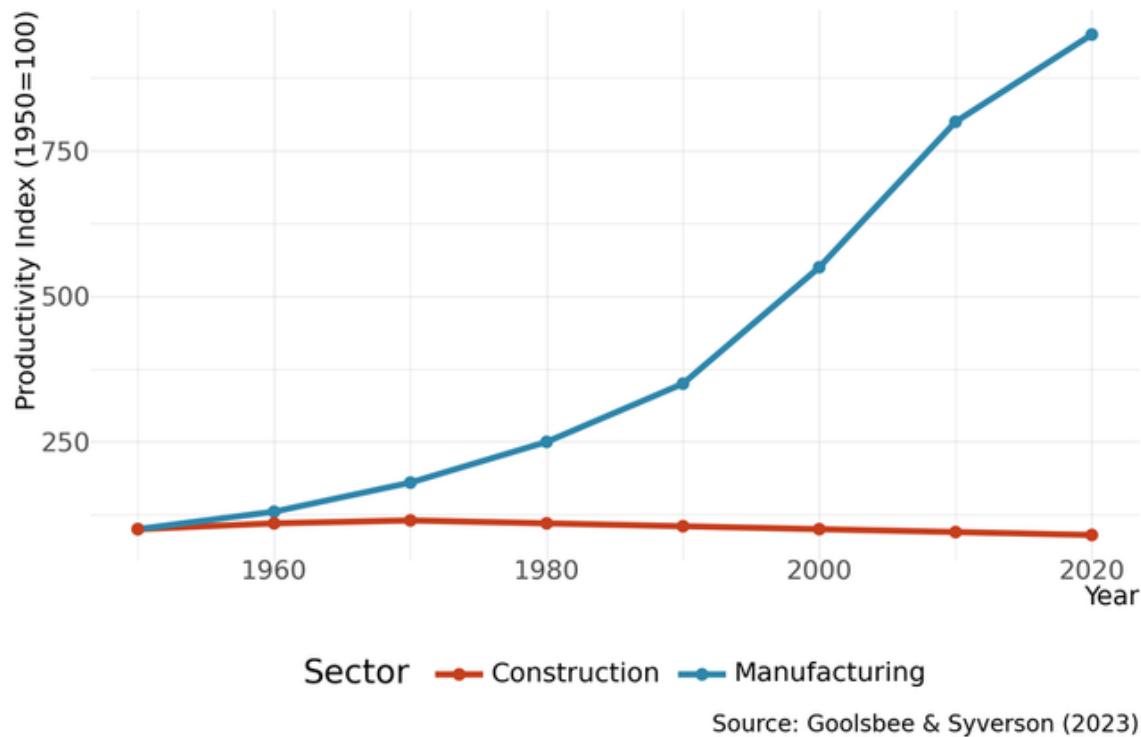


Figure 53: Figure 13.2: The construction productivity puzzle. Output per worker has declined since 1970, unlike every other major sector. Source: Goolsbee and Syverson (2023)

## Market Structure

**General Contracting:** Extraordinarily fragmented. Of the 800,000 construction firms in America, most are tiny. The median construction company has fewer than 5 employees. Entry barriers are low (a truck, some tools, a contractor's license), and failure rates are high.

**Homebuilding:** Consolidating. The top 10 builders now control approximately **45% of new home sales**, up from 27% two decades ago. Large public builders (D.R. Horton, Lennar, PulteGroup) achieved scale through land acquisition, standardization, and vertical integration. They operate more like manufacturers than traditional builders.

**Heavy Civil/Engineering:** More concentrated. Megaprojects (airports, transit systems, LNG terminals) require capabilities that few firms possess: bonding capacity in the billions, specialized engineering talent, multi-year project management experience. A handful of firms dominate this space.

## Major Players

### Engineering and Heavy Civil

Company	Revenue	Specialty
<b>Bechtel</b>	roughly \$18B	Energy, infrastructure, defense (private, family-owned)
<b>Fluor</b>	roughly \$15B	Energy, chemicals, mining (public)
<b>Kiewit</b>	roughly \$15B	Transportation infrastructure (employee-owned)
<b>Jacobs</b>	roughly \$16B	Buildings, infrastructure, advanced facilities (public)
<b>AECOM</b>	roughly \$14B	Design and construction management

Source: Engineering News-Record Top 400 Contractors, 2024

### Commercial Building

Company	Revenue	Market
<b>Turner Construction</b>	roughly \$16B	Commercial, healthcare, data centers (German-owned via Hochtief/ACS)
<b>Whiting-Turner</b>	roughly \$10B	Commercial, institutional

Company	Revenue	Market
<b>Skanska USA</b>	roughly \$8B	Commercial, infrastructure (Swedish parent)
<b>Clark Construction</b>	roughly \$6B	Government, commercial

Source: Engineering News-Record Top 400 Contractors, 2024

## Homebuilders

Company	Revenue	Homes/Year
<b>D.R. Horton</b>	roughly \$35B	roughly 90,000
<b>Lennar</b>	roughly \$34B	roughly 73,000
<b>PulteGroup</b>	roughly \$16B	roughly 28,000
<b>NVR</b>	roughly \$10B	roughly 24,000
<b>Toll Brothers</b>	roughly \$10B	roughly 10,000

Source: Company 10-K filings; Engineering News-Record Top 400 Contractors, 2024

Note that the largest American engineering contractors (Bechtel, Fluor, Kiewit) are essentially engineering firms that happen to build, while the largest commercial builders (Turner, Whiting-Turner) are project management operations that coordinate subcontractors. Neither model achieves the vertical integration that characterizes large homebuilders like D.R. Horton or global construction giants. This fragmentation reflects the industry's project-based nature: each job is custom, making standardization difficult.

**International Giants:** Global construction is increasingly dominated by European and Asian firms with scale American companies cannot match. **VINCI** (France, \$70B revenue), **Grupo ACS** (Spain, \$45B, owns Turner and Hochtief), and **Bouygues** (France, \$45B) operate worldwide. Chinese state-owned enterprises (China State Construction, China Railway) are the world's largest but focus on Asia and Africa. The American absence from the global top tier reflects the domestic industry's fragmentation—no U.S. firm has achieved the scale or international reach of these foreign giants.

## Geographic Distribution

### The Sunbelt Boom

Construction activity has shifted dramatically toward the South and West: - **Texas:** Dallas-Fort Worth and Houston are the nation's top markets for housing starts, industrial construction, and commercial development - **Florida:** Tampa, Orlando, Jacksonville lead population-driven residential construction - **Arizona:** Phoenix metro

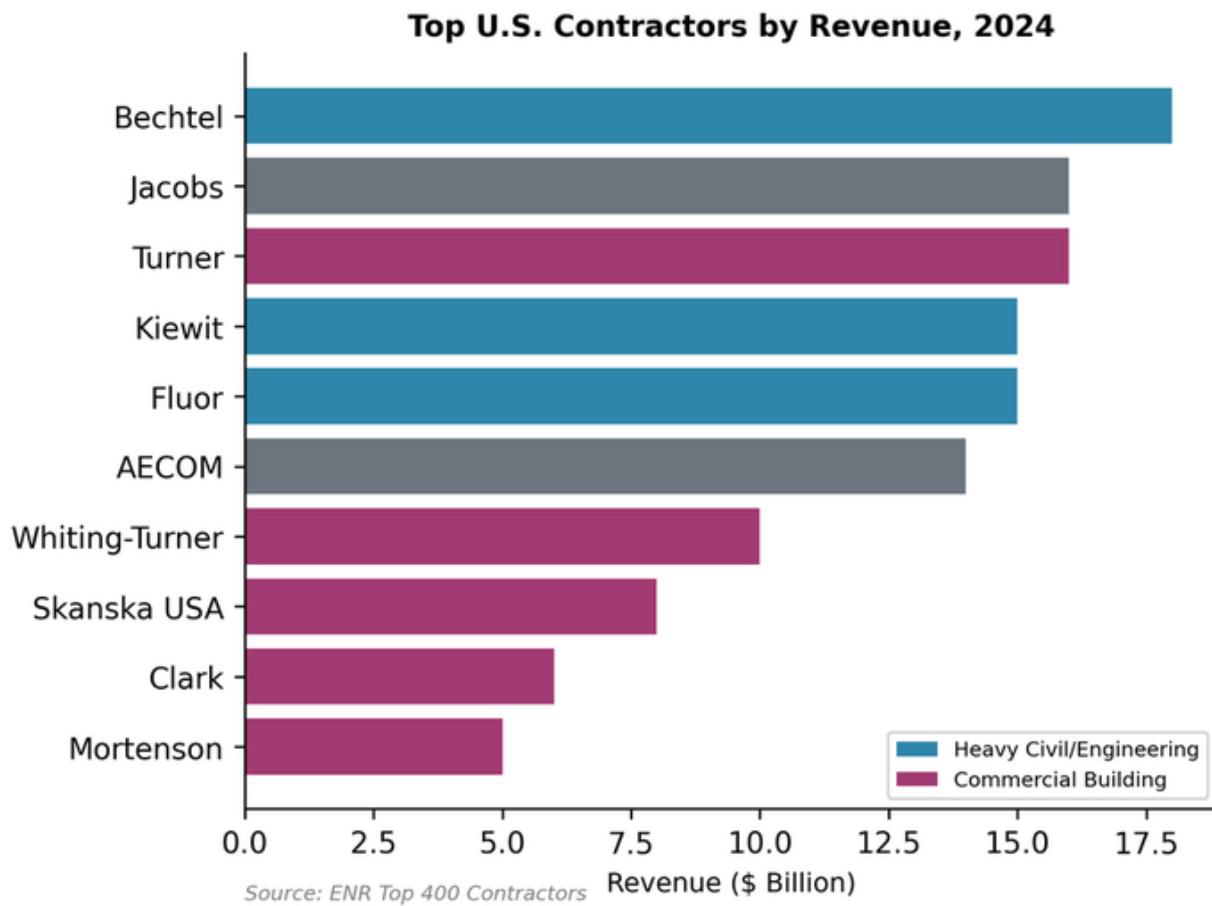


Figure 54: Figure 13.3: Top U.S. construction companies by revenue. Engineering giants (Bechtel, Fluor) differ from commercial builders (Turner, Whiting-Turner). Source: ENR (2024)

has seen explosive growth in both housing and industrial (semiconductor fabs) - **Tennessee:** Nashville has emerged as a corporate relocation destination

This geographic concentration reflects population migration, business-friendly regulatory environments, lower land costs, and available labor. It also creates severe local labor shortages when multiple large projects compete for workers.

## Coastal Constraints

In contrast, construction in coastal metros (San Francisco, Los Angeles, New York, Boston) faces severe constraints: - Permitting and environmental review can add years to project timelines - Land costs are prohibitive, requiring higher-density projects that are more complex to build - Union labor requirements raise costs (but also quality and safety) - NIMBYism delays or kills projects entirely

The result: housing construction in high-demand coastal cities is a fraction of what market prices would suggest is needed.

## Specialty Clusters

Certain geographies have developed specialized construction expertise: - **Houston:** Petrochemical and energy facility construction (refineries, LNG terminals) - **Las Vegas:** Gaming and hospitality construction - **Silicon Valley/Phoenix:** Semiconductor fab construction - **Nuclear Regions:** A handful of firms with nuclear construction expertise concentrate where plants exist or are planned

## The Workforce

### Employment Profile

Construction employs approximately **8.3 million workers**, roughly 5.5% of total US employment. The workforce is distinctive:

- **Demographics:** 97% male (one of the most gender-skewed major industries); median age rising steadily
- **Education:** Most workers have high school education or less; formal credentials matter less than experience and skill
- **Immigrant Labor:** Approximately **30%** of construction workers are foreign-born, rising to **50%+** in specific trades (drywall, roofing, concrete) in states like Texas and California

## Unionization

Union density varies dramatically by geography and subsector: - **National Rate:** 10.3% (2024) - **High-Union Markets:** New York City, Chicago, Boston, San Francisco—building trades unions (IBEW, Carpenters, Laborers, Ironworkers) dominate commercial construction - **Low-Union Markets:** Texas, Florida, Arizona—residential and much commercial construction is “open shop”

Union projects typically have higher wages, better safety records, and more formal training (apprenticeships). They also have higher costs, which is why developers often choose non-union contractors where possible.

## The Labor Crisis

The industry faces a structural labor shortage: - **Aging Workforce:** For every 4 workers retiring, only 1 enters the trades - **Image Problem:** Decades of “college for everyone” messaging stigmatized skilled trades - **Immigration Policy:** Restrictions have tightened labor supply precisely when demand is surging - **Competition:** Warehouse and logistics jobs (Amazon fulfillment centers) offer comparable pay with climate-controlled environments

The Associated General Contractors estimates the industry needs **500,000+ additional workers** to meet current demand. The gap is growing.

## Wages and Safety

**Wages** vary enormously by trade and geography: - **Laborers:** \$18-25/hour - **Carpenters:** \$22-35/hour - **Electricians:** \$28-45/hour - **Ironworkers:** \$30-50/hour - **Union Premium:** Union workers earn roughly 20-30% more than non-union in comparable roles

**Safety:** Construction is one of the most dangerous industries. Falls are the leading cause of death, followed by struck-by incidents, electrocution, and caught-between accidents (the “Fatal Four”). OSHA heavily regulates the industry, but enforcement is challenging given the number of worksites and the prevalence of small firms and subcontracting.

## Regulation and Policy

### Building Codes

The **International Building Code (IBC)** and related codes (plumbing, electrical, mechanical, fire) provide a baseline national standard, but adoption and enforcement are local. States adopt the IBC with modifications; local jurisdictions add their own requirements. The result is a patchwork: what's permissible in Houston may be prohibited in San Francisco.

Code updates (typically every 3 years) ratchet requirements upward—more energy efficiency, seismic resilience, fire safety, accessibility. Each requirement adds cost. Builders argue codes have become excessive; safety advocates argue they save lives and reduce long-term costs.

### Permitting

Permitting is a local function with enormous variation: - **Fast Markets:** Some Texas and Florida jurisdictions issue permits in days - **Slow Markets:** California projects can spend years in permitting and environmental review - **Discretionary Review:**

Beyond code compliance, many jurisdictions require neighborhood approval, design review, or other discretionary processes that add time and uncertainty

CEQA (California Environmental Quality Act) is the poster child for regulatory delay. Intended to protect the environment, it has become a tool for project opponents to delay or kill development through litigation.

## Labor Regulation

- **Davis-Bacon Act (1931):** Requires “prevailing wages” (typically union scale) on federal construction projects over \$2,000. Raises costs but supports union labor.
- **State Prevailing Wage Laws:** Many states have similar requirements for state-funded projects
- **Occupational Licensing:** Contractor licensing requirements vary by state, from minimal (Texas) to extensive (California)

## Zoning

Land-use regulation, covered in Chapter 5, is the dominant constraint on residential construction. Zoning determines what can be built where, and restrictive zoning in high-demand areas has created the housing affordability crisis.

## Trade Associations and Lobbying

### Major Associations

Association	Membership	Focus
<b>Associated General Contractors (AGC)</b>	27,000+ firms	General contractors; infrastructure, commercial
<b>National Association of Home Builders (NAHB)</b>	140,000+ members	Residential builders; housing policy
<b>Associated Builders and Contractors (ABC)</b>	23,000+ members	Open-shop/merit-shop contractors
<b>North America's Building Trades Unions (NABTU)</b>	3 million workers	Union labor; prevailing wage, apprenticeship

### Political Dynamics

The industry is politically divided: - **NAHB:** Focuses on housing affordability, land-use deregulation, immigration (labor supply), lumber tariffs - **AGC:** Infrastructure spending, workforce development, regulatory streamlining - **ABC:** Opposes prevailing wage

requirements and project labor agreements; promotes “merit shop” (non-union) construction - **Building Trades**: Defends prevailing wage, promotes apprenticeship programs, supports project labor agreements on public work

Infrastructure spending attracts bipartisan support—everyone likes ribbon-cuttings on bridges. Housing policy is more contentious, with builders seeking deregulation while labor and community groups resist.

## Recent Trends

### 1. The Manufacturing Supercycle

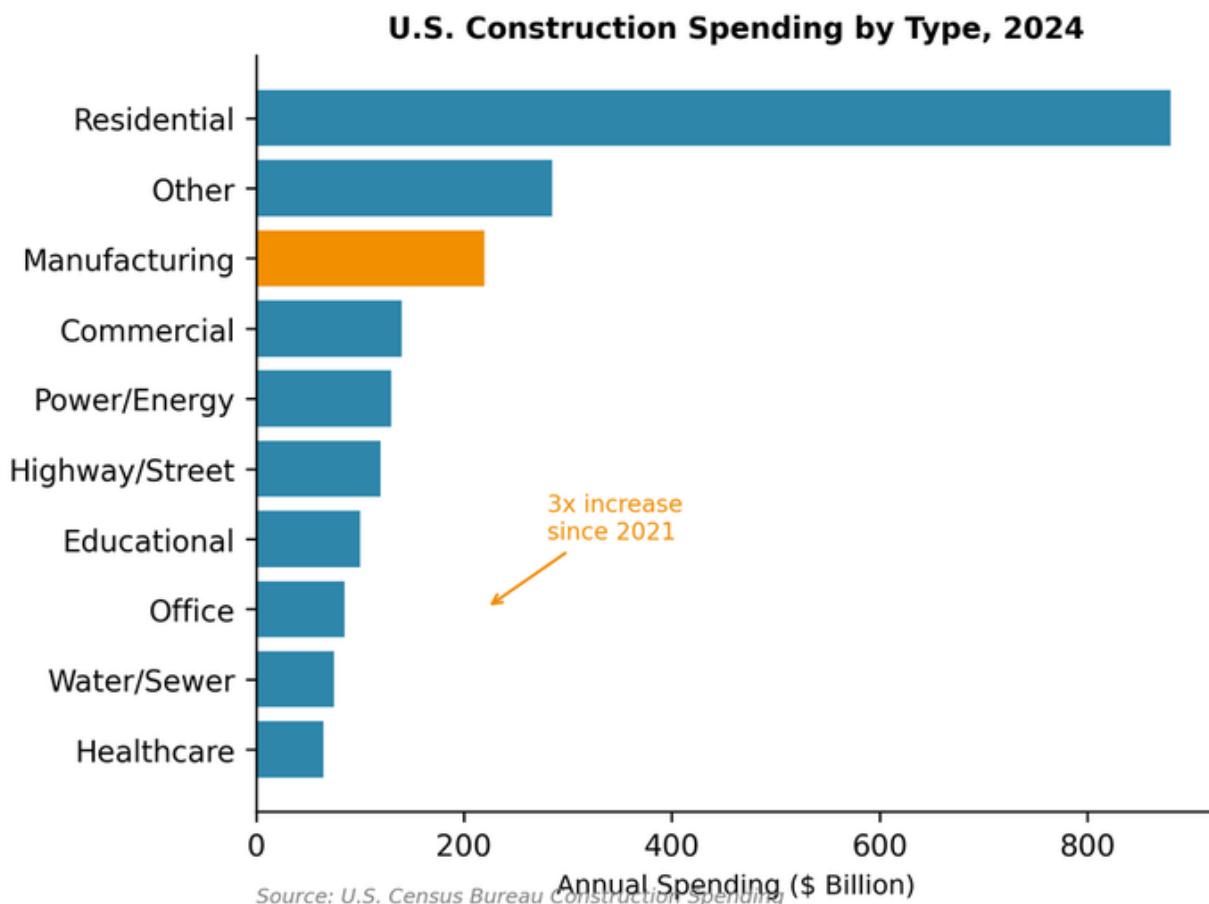


Figure 55: Figure 13.1: Construction spending by category. Manufacturing construction has tripled since 2021 due to CHIPS Act and IRA investments. Source: Census Bureau

Construction spending on manufacturing facilities has **tripled** since 2021, driven by industrial policy:

- **CHIPS Act**: \$52 billion in subsidies for domestic semiconductor production has triggered massive fab construction
  - Intel's Ohio fab: \$20 billion project, 7,000 construction workers at peak

- TSMC's Arizona fabs: \$40 billion commitment
- Samsung's Texas fab: \$17 billion
- Micron's New York fab: \$100 billion over 20 years
- **Inflation Reduction Act:** Clean energy subsidies driving battery plant and EV factory construction
  - Battery plants across Georgia, Tennessee, Kentucky, Michigan
  - Solar and wind manufacturing facilities

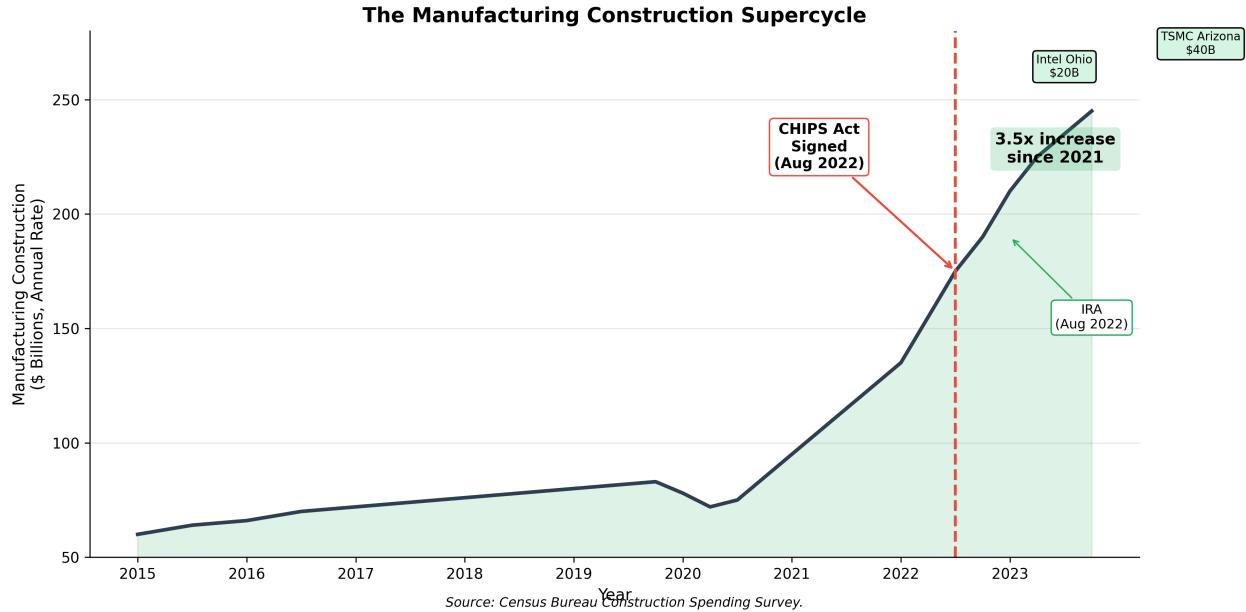


Figure 56: Figure 13.4: The manufacturing construction supercycle. CHIPS Act (August 2022) and IRA triggered a 3.5x increase in manufacturing construction spending, with major projects including Intel Ohio (\$20B) and TSMC Arizona (\$40B). Source: Census Bureau

This manufacturing construction boom is unprecedented in a generation. It is also straining labor markets—workers are being pulled from housing construction, exacerbating affordability problems.

## 2. Infrastructure Investment (IIJA)

The Infrastructure Investment and Jobs Act (2021) committed **\$1.2 trillion** over five years to:

- Highways and bridges
- Public transit
- Passenger and freight rail
- Airports
- Water infrastructure
- Broadband

Federal infrastructure dollars are now flowing at double-digit growth rates. Competition for heavy civil labor, equipment, and materials has intensified. Project costs are rising in part because everyone is building at once.

## 3. Cost Volatility

Construction costs have been exceptionally volatile:

- **Lumber:** Spiked 300%+ during COVID-19 pandemic (supply chain disruptions, DIY demand), then collapsed, now

stabilized - **Steel:** Tariffs and supply chain issues created price spikes - **Electrical Equipment:** Switchgear and transformers have 18-24 month lead times due to data center demand - **Concrete:** Steady price increases, regional shortages - **Labor:** Wage inflation of 5-8% annually in hot markets

The “time to build” has increased significantly. Lead times for materials that used to take weeks now take months or years. Projects that might have broken ground immediately now wait for equipment.

#### 4. Modular and Prefabrication

Off-site construction—building components in factories and assembling on-site—promises to address productivity problems: - McKinsey estimates modular construction can **reduce timelines by 50%** and **costs by 20%** - Factory-controlled environments improve quality and reduce weather delays - Prefab is common in other countries (Sweden, Japan) but rare in the US

**Barriers:** - Building codes written for site-built construction - **Financing:** Lenders don’t understand modular economics - **Transportation:** Modules must fit on trucks - **Labor:** Unions resist shifting work from jobsites to factories - **Katerra Failure (2021):** The most ambitious modular construction startup raised \$2 billion and collapsed, demonstrating how difficult disruption is in this industry

#### 5. Technology Adoption

Construction technology (“ConTech”) investment has surged, but adoption remains slow: - **BIM (Building Information Modeling):** 3D digital models are now standard on large projects - **Drones:** Used for site surveys and progress monitoring - **Robotics:** Experimental bricklaying, rebar-tying, and concrete-pouring robots exist but are not widely deployed - **Prefabrication:** Growing but still a small share of total construction - **Software:** Project management, estimating, and scheduling software is improving but fragmented

The fundamental challenge is that each project is unique, making automation harder than in manufacturing.

### Firm Profiles

#### Bechtel

**Quick Facts - Headquarters:** Reston, VA - **Ownership:** Private, family-controlled since 1898 - **Revenue:** roughly \$18 billion - **Employees:** roughly 55,000

Bechtel is America’s megaproject builder—the firm you call when the job is too big, too complex, or too strategically important for anyone else. The company built Hoover Dam, the San Francisco Bay Area’s BART system, the Channel Tunnel (with partners), Boston’s Big Dig, and countless refineries, power plants, and LNG terminals.

Family-controlled for five generations, Bechtel operates with a long-term orientation that public companies cannot match. It takes on projects others won't touch: nuclear cleanup at Hanford, post-war reconstruction in Iraq, infrastructure in developing countries where political risk is extreme.

The culture is conservative and engineering-driven. Bechtel doesn't seek publicity; it delivers projects. When something goes wrong on a major infrastructure project, Bechtel is often called in to fix it. The firm represents what American construction can do at its best—massive scale, technical excellence, project execution under difficult conditions.

## Turner Construction

**Quick Facts - Headquarters:** New York, NY - **Parent Company:** Hochtief AG (Germany) / ACS (Spain) - **Revenue:** roughly \$16 billion - **Employees:** roughly 10,000

Turner is the giant of American commercial building construction. The company built One World Trade Center, Madison Square Garden, Yankee Stadium, and countless hospitals, data centers, university buildings, and corporate headquarters.

Founded in 1902, Turner pioneered concrete construction techniques that made skyscrapers possible. The company went public in 1917, was acquired by German construction giant Hochtief in 1999, and is now ultimately owned by Spanish conglomerate ACS—illustrating how even iconic American builders have become subsidiaries of larger international firms.

Turner operates as a union contractor, dominant in the high-cost, high-complexity urban markets of New York, San Francisco, and other major cities. Its expertise is in managing the chaos of urban construction: tight sites, complex logistics, demanding schedules, union labor relations, and buildings that must meet exacting standards. Turner doesn't build tract houses; it builds the skyline.

## D.R. Horton

**Quick Facts - Headquarters:** Arlington, TX - **Founded:** 1978 - **Revenue:** roughly \$35+ billion - **Employees:** roughly 13,000 - **Homes Delivered:** roughly 90,000 annually

D.R. Horton is what construction could look like if the industry industrialized. While commercial contractors struggle with productivity, Horton has systematized home-building into something approaching manufacturing.

The model is relentless standardization. Horton offers limited customization—pick from a set of floor plans, a set of finishes, and a set of lots. This enables bulk purchasing (every house uses the same cabinets, the same appliances, the same fixtures), predictable scheduling, and efficient deployment of trade crews who repeat the same tasks across hundreds of homes.

Horton focuses on the entry-level buyer—first-time purchasers and move-up families seeking value over prestige. The company doesn't build McMansions; it builds

the affordable end of new construction. By controlling land pipelines (buying land years in advance), integrating mortgage services (DHI Mortgage), and achieving scale economies, Horton can deliver homes at price points smaller builders cannot match.

The contrast with commercial construction is stark. D.R. Horton achieves productivity gains through standardization and scale. Commercial and infrastructure construction, bound by custom designs and local regulations, cannot.

## Data Sources and Further Reading

### Key Data Sources

- **Census Bureau:** Construction Spending Survey (monthly); Value of Construction Put in Place
- **Bureau of Labor Statistics:** Employment data by construction subsector (NAICS 23); Occupational Employment and Wage Statistics
- **Engineering News-Record (ENR):** Top 400 Contractors ranking; Top 500 Design Firms
- **National Association of Home Builders (NAHB):** Housing starts, builder sentiment surveys
- **Federal Reserve:** Construction lending data; housing market indicators

### Further Reading

- **Goolsbee, Austan, and Chad Syverson.** “The Strange and Awful Path of Productivity in the U.S. Construction Sector.” NBER Working Paper No. 30845 (2023). [The definitive documentation of construction’s productivity decline.]
- **D’Amico, Leonardo, Edward Glaeser, Joseph Gyourko, William Kerr, and Giacomo Ponzetto.** “Why Has Construction Productivity Stagnated? The Role of Land-Use Regulation.” NBER Working Paper No. 33188 (2024). [Links regulatory fragmentation to productivity—if homebuilders had manufacturing’s firm size distribution, productivity would be 60% higher.]
- **Allen, Steven G.** “Why Construction Industry Productivity Is Declining.” NBER Working Paper No. 1555 (1985). [Foundational paper on de-skilling and the shift from commercial to residential work.]
- **Glaeser, Edward L., and Joseph Gyourko.** “The Economic Implications of Housing Supply.” Journal of Economic Perspectives 32, no. 1 (2018): 3-30. [How supply constraints in construction create housing affordability problems.]
- **McKinsey Global Institute.** “Modular Construction: From Projects to Products.” (2019). [The potential—and barriers—of off-site construction.]
- **Bernstein, Shai, Emanuele Connelli, Davide Malacrino, and Tim McQuade.** “Who Creates New Firms When Local Opportunities Arise?” Journal of Financial Economics (2022). [On construction entrepreneurship and local opportunity.]

## **Exercises**

### **Review Questions**

1. Construction is the only major sector where productivity has declined since 1970. The chapter cites Goolsbee and Syverson (2023) systematically testing and rejecting measurement error as an explanation. What three structural factors does the chapter identify as causes of this decline? Drawing on D'Amico, Glaeser, et al. (2024), explain which factor—regulation and fragmentation, de-skilling, or input shifts—the evidence suggests is most important, and why.
2. D'Amico, Glaeser, et al. (2024) estimate that if homebuilding firms had manufacturing's size distribution, productivity could be 60% higher. Explain the mechanism: how does the fragmentation of 800,000 firms (most with fewer than 10 employees) reduce productivity? What specific barriers—land-use regulation, local building codes, bonding requirements, the project-based nature of construction—prevent consolidation in construction the way it has occurred in manufacturing?
3. The chapter distinguishes three project delivery methods: Design-Bid-Build (DBB), Design-Build (DB), and Construction Manager at Risk (CMAR). For each, explain the allocation of risk between the project owner and the contractor, the advantages and disadvantages, and the type of project each method is best suited for. Why does the traditional DBB model tend to create adversarial relationships between owners and contractors?
4. Construction employment fell 30% (from 7.7 million to 5.4 million) during the 2008-2009 crash and took a decade to recover. Why is construction more cyclical than other sectors? Trace the specific mechanisms: how do rising interest rates reduce housing starts, how does credit tightening prevent new project starts, and how do the 1-3 year lag effects mean that activity today reflects decisions made years ago?
5. The chapter notes that approximately 30% of construction workers are foreign-born, rising to 50%+ in specific trades (drywall, roofing, concrete) in Texas and California, while the Associated General Contractors estimates the industry needs 500,000+ additional workers. How does immigration policy interact with the construction labor shortage? What would happen to construction costs and project timelines if immigration restrictions significantly reduced the available workforce?
6. The CHIPS Act triggered massive semiconductor fab construction—Intel's \$20 billion Ohio project, TSMC's \$40 billion Arizona commitment—while the IRA spurred battery plant and EV factory construction across the Southeast. The chapter notes this boom is “straining labor markets” and “pulling workers from housing construction.” Using the concept of opportunity cost, explain how industrial policy spending on manufacturing construction can exacerbate the housing affordability crisis.
7. Katerra raised \$2 billion to disrupt construction through modular and prefabricated building, then collapsed in 2021. The chapter identifies specific barriers

to modular construction in the United States: building codes written for site-built construction, lender unfamiliarity, transportation constraints, and union resistance. Why have countries like Sweden and Japan succeeded with modular construction while the US has not? What would need to change for off-site construction to achieve McKinsey's estimated 50% timeline reduction and 20% cost savings?

## Data Exercises

8. Using the Census Bureau's Construction Spending survey (<https://www.census.gov/construction>) download monthly construction spending data for the three major categories: residential, nonresidential (private), and public. Create a chart showing all three from 2018 to the present. Identify the manufacturing construction supercycle described in the chapter. Compare the timing of the manufacturing spending surge to the passage of the CHIPS Act and IRA (both August 2022). How quickly did legislative action translate into actual construction spending?
9. Using the BLS Occupational Employment and Wage Statistics (<https://www.bls.gov/oes/>), compare median wages for electricians (SOC 47-2111), carpenters (SOC 47-2031), and construction laborers (SOC 47-2061) across three states: New York, Texas, and California. Calculate the ratio of electrician wages to laborer wages in each state. How do the interstate and inter-occupation wage differences relate to the chapter's discussion of union density (high in New York, low in Texas) and the 20-30% union wage premium?
10. Using the FRED series for New Residential Construction (Housing Starts, series Houst) and the 30-Year Fixed Rate Mortgage Average (MORTGAGE30US), plot both from 2018 to the present on a dual-axis chart. How closely do housing starts respond to mortgage rate changes? Estimate the lag (in months) between a rate increase and a decline in starts. Does this support the chapter's claim that "residential construction is directly tied to mortgage rates"?

## Deeper Investigation

11. The chapter argues that land-use regulation is the dominant constraint on residential construction and a major driver of the construction productivity puzzle. Select two metropolitan areas—one with restrictive zoning (e.g., San Francisco or Boston) and one with permissive zoning (e.g., Houston or Dallas-Fort Worth)—and compare their housing construction rates (permits per capita), median home prices, average permitting timelines, and construction employment growth over the past two decades. Use the Wharton Residential Land Use Regulatory Index and local permitting data to quantify regulatory burden. Do your findings support the chapter's claim that "housing construction in high-demand coastal cities is a fraction of what market prices would suggest is needed"? What specific regulatory reforms would be most effective at increasing housing supply?

# Chapter 14. Energy

The United States consumes more energy than any country except China, burning through roughly 100 quadrillion BTUs annually—the equivalent of 20 million barrels of oil per day. This energy powers an \$800 billion sector that spans oil fields in the Permian Basin, natural gas pipelines crisscrossing the continent, nuclear plants operating since the 1970s, wind farms across the Great Plains, and solar installations spreading across rooftops and deserts. The American energy system is simultaneously ancient (some coal plants date to the 1950s) and revolutionary (solar costs have fallen 90% in a decade). Understanding energy means understanding both the legacy infrastructure that still dominates and the transformation now underway.

## Overview

**Size and Scope** - Total energy spending: roughly \$1.5 trillion annually - Electricity: roughly \$450 billion (retail sales) - Petroleum products: roughly \$600 billion - Natural gas (non-electric): roughly \$150 billion - Other: roughly \$300 billion - GDP contribution: roughly \$500 billion directly (utilities, extraction, refining); roughly \$800 billion including related sectors - Employment: roughly 1.2 million direct (utilities, extraction, refining); roughly 3 million including support services - Key subsectors: Electric utilities, oil and gas extraction, petroleum refining, pipelines, renewable generation, energy services

Energy's direct share of GDP (roughly 3-4%) understates its importance. Energy is an input to every other sector: manufacturing, transportation, agriculture, and buildings all depend on reliable, affordable energy. Energy price shocks ripple through the economy; energy geography shapes regional development; energy policy drives some of the largest investment flows in the economy.

The sector is also unusually capital-intensive. A single nuclear plant costs \$20-30 billion; a major offshore oil platform \$1-5 billion; even utility-scale solar projects run hundreds of millions. This capital intensity creates long asset lives, path dependence, and high barriers to entry.

## How the Industry Works

### Electricity: Generation, Transmission, and Distribution

Electricity is unique among commodities: it cannot be economically stored at scale (yet), so supply must match demand instantaneously. This physical constraint shapes everything about how the industry operates.

**Generation** (roughly 4,200 TWh annually):

Source	Share (2024)	Trend
Natural gas	43%	Growing (replaced coal)
Coal	16%	Declining rapidly
Nuclear	18%	Stable (aging fleet)
Wind	11%	Growing rapidly
Solar	6%	Growing very rapidly
Hydro	6%	Stable

Source: Energy Information Administration, Electric Power Monthly, 2024

### U.S. Utility-Scale Electricity Generation 2023

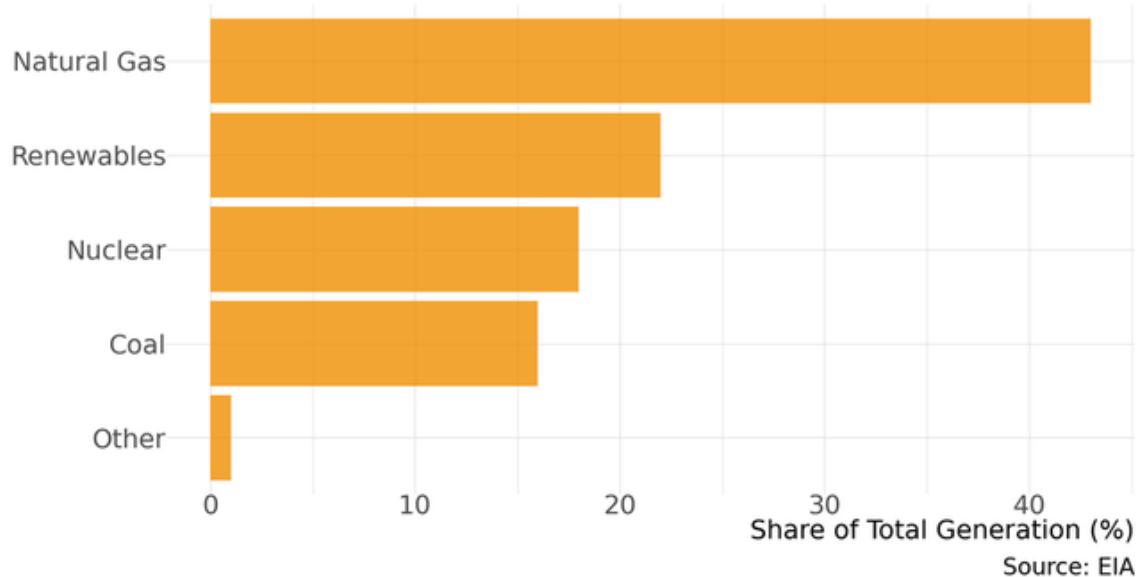


Figure 57: Figure 14.1: U.S. electricity generation by source. Natural gas has replaced coal as the dominant fuel, while wind and solar have grown rapidly. Source: EIA (2024)

The generation mix has transformed in 15 years. In 2008, coal provided 48% of US electricity; natural gas 21%. The shale revolution made gas cheap; environmental regulation made coal expensive. Coal's share has fallen by two-thirds.

**Note:**

### Three Separate Grids

The US operates three largely separate electrical grids with limited interconnection between them. ERCOT (Texas) deliberately isolated itself from the national grid to avoid federal regulation—but this means Texas cannot import power during emergencies, as the deadly February 2021 freeze demonstrated.

**Transmission** moves power from generators to load centers over high-voltage lines (100-765 kV). The US has three largely separate grids: - **Eastern Interconnection**: East of the Rockies (except Texas) - **Western Interconnection**: West of the Rockies - **ERCOT**: Texas only (deliberately isolated to avoid federal regulation)

Limited transmission between these interconnections constrains the ability to balance supply and demand across regions.

**U.S. Electric Grid: ISO/RTO Territories**

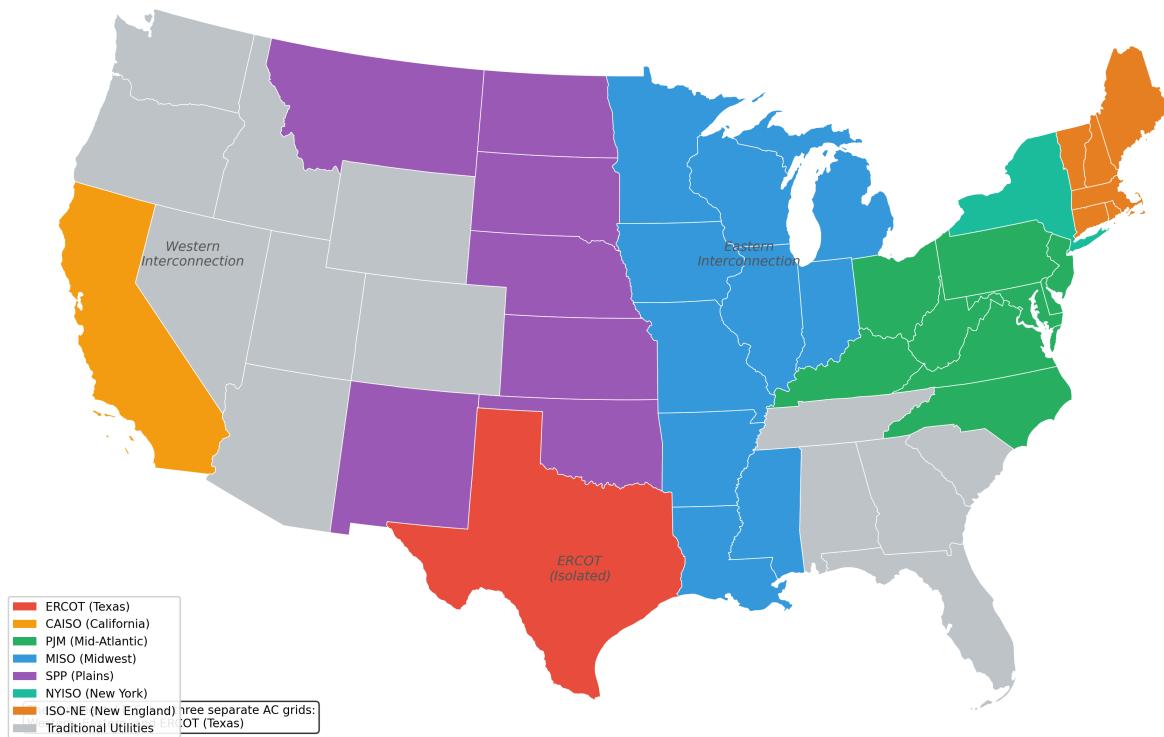


Figure 58: Figure 14.2: U.S. electric grid: ISO/RTO territories. Wholesale electricity markets are managed by Independent System Operators in restructured regions (colored), while traditional utilities operate in gray areas. Texas (ERCOT) is the only state with its own isolated grid. Source: FERC, EIA

**Distribution** delivers power from substations to end users over lower-voltage lines. Distribution utilities—often the same companies that own transmission—maintain local networks and handle customer billing.

**Retail Sales** (roughly \$450 billion):

Customer Class	Share of Sales	Share of Revenue
Residential	38%	44%
Commercial	36%	35%
Industrial	26%	21%

Residential customers pay the highest rates (roughly 15 cents/kWh national average); industrial customers the lowest (roughly 8 cents/kWh) due to volume and load characteristics.

## The Two Models: Regulated vs. Restructured

Electricity operates under two fundamentally different market structures:

**Regulated/Vertically Integrated** (roughly 30 states): - A single utility owns generation, transmission, and distribution - Utility earns a regulated rate of return on invested capital - State Public Utility Commission (PUC) approves rates and investments - No wholesale competition; utility must serve all load - Dominant in the South, West, and much of the Midwest

**Restructured/Deregulated** (roughly 20 states + DC): - Generation separated from transmission/distribution - Competitive wholesale markets operated by Independent System Operators (ISOs) - Retail choice: customers can buy from competing suppliers (in some states) - Transmission and distribution remain regulated monopolies - Dominant in the Northeast, Mid-Atlantic, Texas, and parts of the Midwest

The restructuring wave of the 1990s-2000s promised lower prices through competition. Results have been mixed: wholesale markets are more efficient, but retail prices in restructured states are generally higher than in regulated states (partly due to regional cost differences).

## Oil and Gas: From Wellhead to Pump

**Upstream (Exploration and Production):**

US oil production collapsed from 10 million barrels/day (1970) to 5 million (2008), then surged back to 13+ million (2024)—making America the world's largest producer. The **shale revolution** unlocked tight oil and gas through horizontal drilling and hydraulic fracturing.

Key producing regions: - **Permian Basin** (West Texas/New Mexico): Largest US oil field, roughly 6 million bbl/day - **Eagle Ford** (South Texas): roughly 1 million bbl/day - **Bakken** (North Dakota): roughly 1 million bbl/day - **Appalachian Basin** (PA, WV,

OH): Largest gas field (Marcellus/Utica shale) - **Haynesville** (LA/TX): Major gas production

### **Midstream (Transportation and Storage):**

Oil and gas move through an extensive pipeline network: - roughly 190,000 miles of oil pipelines - roughly 320,000 miles of natural gas transmission pipelines - roughly 2.2 million miles of natural gas distribution pipelines

Major pipeline companies: Energy Transfer, Kinder Morgan, Enterprise Products, Williams Companies. Pipelines are regulated as common carriers (must provide non-discriminatory access) but earn market-based returns.

### **Downstream (Refining and Marketing):**

US refining capacity: roughly 18 million barrels/day across roughly 130 refineries. Refining is concentrated on the Gulf Coast (Texas, Louisiana) due to proximity to oil production and port access.

Major refiners: Marathon Petroleum, Valero, Phillips 66, ExxonMobil, Chevron.

Refined products flow to retail through: - Company-owned stations (declining) - Branded franchises (Shell, ExxonMobil, BP stations owned by franchisees) - Unbranded independents

## **Renewables: The New Entrants**

**Wind Power** (roughly 150 GW installed capacity): - Concentrated in the Great Plains (Texas, Iowa, Oklahoma, Kansas) - Utility-scale wind is now cost-competitive with gas in good wind areas - Major developers: NextEra, Berkshire Hathaway Energy, Invenergy, AES

**Solar Power** (roughly 175 GW installed capacity): - Utility-scale: California, Texas, Florida lead - Distributed (rooftop): California dominates (roughly 40% of US rooftop solar) - Costs have fallen 90% since 2010 - Major developers: NextEra, AES, Clearway, Array Technologies

**Battery Storage** (roughly 30 GW installed, growing rapidly): - Paired with solar to provide dispatchable power - Grid-scale batteries reaching 4+ hours duration - California, Texas, Arizona leading deployment

The Inflation Reduction Act (2022) provides 10-year tax credits for wind, solar, and storage, accelerating deployment. Annual utility-scale solar installations are expected to reach 50+ GW by 2030.

## **Industry Structure**

### **Electric Utilities**

The electric utility industry is fragmented but consolidating:

**Investor-Owned Utilities (IOUs)**: roughly 170 companies, serving roughly 70% of customers - Publicly traded, profit-seeking - Largest by market cap: NextEra (\$140B), Southern Company (\$80B), Duke Energy (\$75B) - Subject to state PUC regulation

**Public Power**: roughly 2,000 entities, serving roughly 15% of customers - Owned by municipalities, states, or federal government - Tennessee Valley Authority (TVA): Largest public utility - Los Angeles DWP, Sacramento Municipal Utility District, others - Nonprofit; rates set by governing boards

**Cooperatives**: roughly 900 co-ops, serving roughly 15% of customers - Member-owned, primarily rural - Formed in 1930s-40s to electrify rural America - National Rural Electric Cooperative Association represents the sector

### Largest US Electric Utilities (by retail sales):

Rank	Utility	Customers	States	Type
1	Duke Energy	8.2M	NC, SC, FL, IN, OH, KY	IOU
2	Southern Company	9.0M	GA, AL, MS	IOU
3	Dominion Energy	7.0M	VA, NC, SC	IOU
4	Florida Power & Light (NextEra)	5.8M	FL	IOU
5	Pacific Gas & Electric	5.5M	CA	IOU
6	Xcel Energy	3.8M	MN, CO, TX, WI, etc.	IOU
7	TVA	10M (wholesale)	TN region	Federal

Source: Energy Information Administration, Form 861, 2023

### Independent System Operators (ISOs/RTOs)

In restructured markets, ISOs/RTOs operate wholesale markets and manage the grid:

ISO/RTO	Region	Load (TWh)	States
PJM	Mid-Atlantic	800	PA, NJ, MD, VA, OH, etc.
MISO	Midwest	680	IL, IN, MI, MN, etc.
ERCOT	Texas	450	TX only
ISO-NE	New England	120	MA, CT, NH, VT, ME, RI
NYISO	New York	150	NY
CAISO	California	230	CA
SPP	Great Plains	250	KS, OK, NE, etc.

ISOs run day-ahead and real-time energy markets using **locational marginal pricing (LMP)**: prices vary by location based on generation costs and transmission constraints. They also run capacity markets (to ensure adequate generation) and ancillary service markets (for grid stability).

### Oil and Gas Companies

**Integrated Majors** (upstream, midstream, and downstream):

Company	Market Cap	US Production	Focus
ExxonMobil	\$450B	3.8M boe/day	Global integrated
Chevron	\$280B	3.0M boe/day	Global integrated

### **Large Independents** (primarily upstream):

Company	Market Cap	US Production	Focus
ConocoPhillips	\$130B	1.9M boe/day	E&P only
EOG Resources	\$70B	1.0M boe/day	Shale (Permian, Eagle Ford)
Pioneer Natural Resources	Acquired by Exxon	-	Was largest Permian pure-play
Occidental Petroleum	\$50B	1.2M boe/day	Permian, carbon capture
Devon Energy	\$30B	660K boe/day	Multi-basin shale

Source: Energy Information Administration, Petroleum Supply Monthly, 2024

The Permian Basin has driven consolidation: ExxonMobil acquired Pioneer (\$60B, 2024); Chevron acquired PDC Energy and attempted Hess; Occidental acquired Anadarko (2019).

### **Oilfield Services** (equipment, drilling, completion):

Company	Revenue	Business
SLB (Schlumberger)	\$35B	Drilling, reservoir
Halliburton	\$23B	Completion, production
Baker Hughes	\$27B	Equipment, digital

## **Renewable Developers**

### **Leading US Renewable Developers:**

Company	Capacity	Business Model
NextEra Energy Resources	32 GW	Utility subsidiary, wind/solar
Berkshire Hathaway Energy	15 GW	Utility + merchant
AES Clean Energy	12 GW	Independent developer
Invenergy	10 GW	Private, wind/solar/storage
Clearway Energy	8 GW	Public yieldco

NextEra is the dominant player, having built more wind and solar than any other company. Its utility subsidiary (Florida Power & Light) provides stable cash flows to fund renewable development.

## Geographic Distribution

### Energy Production Geography

America's energy geography creates a fundamental divide between **producing states** and **consuming states**:

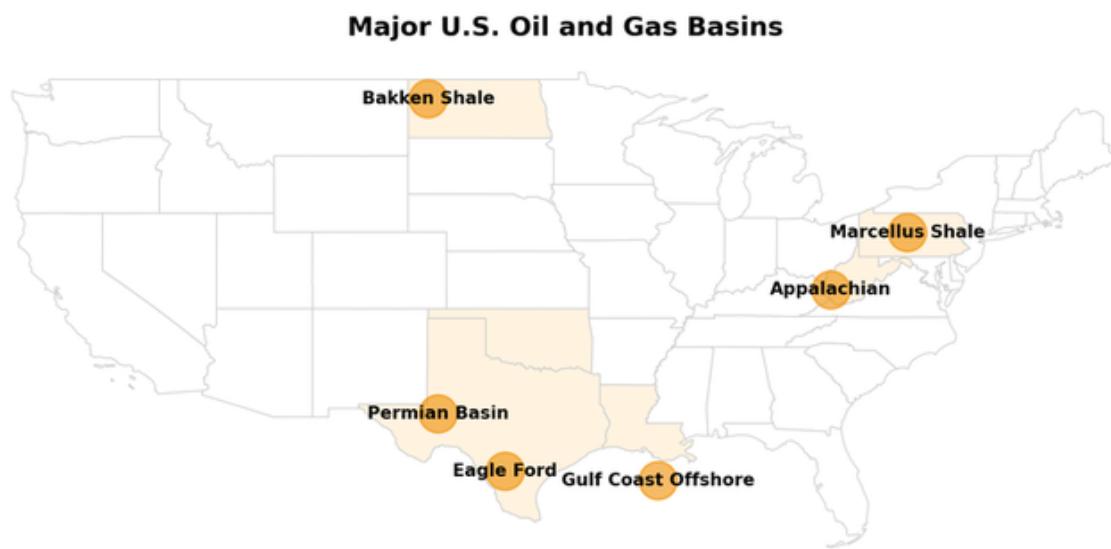


Figure 59: Figure 14.2: Major energy production regions. The Permian Basin (oil) and Appalachian Basin (natural gas) dominate U.S. production. Source: EIA

**Top Oil Producing States** (million bbl/day): 1. Texas: 5.5 2. New Mexico: 1.8 3. North Dakota: 1.1 4. Colorado: 0.4 5. Alaska: 0.4

**Top Natural Gas Producing States** (trillion cubic feet/year): 1. Texas: 11.0 2. Pennsylvania: 7.5 3. Louisiana: 4.0 4. West Virginia: 2.5 5. Oklahoma: 2.3

**Top Coal Producing States** (million short tons): 1. Wyoming: 230 (Powder River Basin) 2. West Virginia: 70 3. Pennsylvania: 40

**Wind Generation Leaders:** 1. Texas: 40 GW 2. Iowa: 12 GW 3. Oklahoma: 12 GW 4. Kansas: 8 GW

**Solar Generation Leaders:** 1. California: 40 GW 2. Texas: 20 GW 3. Florida: 10 GW 4. North Carolina: 8 GW

### Energy Consumption Geography

Energy consumption follows population and industrial activity:

**Highest Per Capita Energy Use:** - Louisiana, Wyoming, Alaska, North Dakota: Industrial activity (refining, mining) - Texas: Large state with heavy industry and hot climate

**Lowest Per Capita Energy Use:** - California, New York, New England: Mild climates, service economies, efficiency policies

## The Grid Geography

The US grid reflects historical development rather than optimal design:

- **Eastern Interconnection:** 70% of US load, relatively well-interconnected
- **Western Interconnection:** Less interconnected internally; California imports from neighbors
- **ERCOT:** Deliberately isolated; Texas's 2021 blackout showed the risks

Transmission constraints limit the ability to move cheap renewable power (from windy Plains or sunny Southwest) to population centers (coasts, Midwest cities). Building new transmission faces permitting challenges, landowner opposition, and cost allocation disputes.

## The Workforce

### Employment by Segment

Segment	Employment	Avg Wage	Trend
Oil and gas extraction	150,000	\$100,000	Cyclical
Mining support (drilling, services)	300,000	\$65,000	Cyclical
Electric utilities	400,000	\$90,000	Stable
Natural gas distribution	100,000	\$80,000	Stable
Petroleum refining	60,000	\$95,000	Declining
Pipeline transportation	50,000	\$85,000	Stable
Solar installation	250,000	\$50,000	Growing rapidly
Wind technicians	15,000	\$60,000	Growing

**Total direct energy employment:** roughly 1.3 million **Including indirect/induced:** roughly 3 million

### Workforce Characteristics

**Oil and gas:** Highly cyclical; hiring surges when oil prices rise, mass layoffs when they fall. The 2014-2016 and 2020 downturns each eliminated 100,000+ jobs. Workers must be mobile (go where the drilling is) and accept shift schedules.

**Utilities:** Stable but aging workforce. Many utility workers are 50+; retirements are creating succession challenges. Strong union presence (IBEW, UWUA).

**Solar:** Fastest-growing energy occupation, but jobs tend to be lower-wage than traditional energy. Installation is labor-intensive but doesn't require specialized credentials (unlike utility or oil/gas work).

**Geographic concentration:** Energy jobs concentrate in producing regions (Texas, Gulf Coast, Appalachia, Rockies). The energy transition implies job losses in some regions (coal communities) and gains in others (solar manufacturing, offshore wind ports).

## Regulation and Policy

### Federal Regulators

**Federal Energy Regulatory Commission (FERC):** - Regulates interstate electricity transmission and wholesale markets - Regulates interstate natural gas pipelines - Approves major infrastructure projects (LNG terminals, pipelines) - Sets transmission rates and market rules - Does NOT regulate retail electricity (state jurisdiction)

**Department of Energy (DOE):** - National laboratories and research - Strategic Petroleum Reserve - Energy efficiency standards (appliances, vehicles) - Nuclear waste management - Administers IRA clean energy programs

**Environmental Protection Agency (EPA):** - Air quality standards affecting power plants - Greenhouse gas regulations (Clean Power Plan / Inflation Reduction Act) - Vehicle emissions standards - Refinery and pipeline regulations

**Nuclear Regulatory Commission (NRC):** - Licenses and regulates nuclear power plants - Oversees nuclear waste storage

### State Regulators

**Public Utility Commissions (PUCs):** - Set retail electricity and gas rates - Approve utility investments and power purchases - Enforce reliability standards - Implement renewable portfolio standards

State PUCs have enormous power over utility decisions. A PUC that denies cost recovery for a plant effectively kills the project. PUCs vary widely in approach: some prioritize low rates; others environmental goals; others utility financial health.

**State Environmental Agencies:** - Implement federal environmental law - May set stricter standards than federal (California) - Permit power plants and refineries

### Key Policy Frameworks

**Renewable Portfolio Standards:** 30+ states require utilities to obtain a percentage of power from renewables. California: 100% clean by 2045. Texas: No RPS but strong market for renewables anyway.

**Inflation Reduction Act (2022):** Largest US climate legislation ever: - 10-year tax credits for wind, solar, storage, nuclear, hydrogen - EV tax credits and charging

infrastructure - Manufacturing credits (solar panels, batteries, etc.) - Estimated \$370 billion in climate spending over 10 years

**Infrastructure Investment and Jobs Act (2021):** - Grid modernization funding - EV charging network buildout - Hydrogen hubs - Carbon capture demonstrations

## Trade Associations and Lobbying

### Major Trade Associations

Association	Members	Focus
Edison Electric Institute (EEI)	Investor-owned utilities	Utility industry interests
American Petroleum Institute (API)	Oil and gas companies	Oil/gas production, refining
American Gas Association	Natural gas utilities	Gas distribution
American Clean Power Association	Renewables developers	Wind, solar, storage
Solar Energy Industries Association	Solar companies	Solar policy
Nuclear Energy Institute	Nuclear operators	Nuclear power
National Rural Electric Cooperative Association	Electric co-ops	Rural electric interests

### Lobbying Activity

Energy is among the most heavily lobbied sectors: - Oil and gas: roughly \$125 million annually in federal lobbying - Electric utilities: roughly \$100 million - Renewable energy: roughly \$30 million (growing)

Key lobbying issues: Tax treatment, permitting, environmental regulation, grid rules, trade policy (tariffs on solar panels, LNG exports).

The industry contributes heavily to campaigns, particularly in energy-producing states. Texas, Louisiana, Oklahoma, and Wyoming politics are shaped by oil and gas interests.

## Beyond Electricity: Water, Gas, and Broadband Utilities

The electricity system dominates energy policy debates, but Americans depend on several other networked utility systems that share the same fundamental economics: natural monopoly structure, heavy capital requirements, regulated pricing, and aging infrastructure. These systems are less visible precisely because they work—until they fail.

## **Water and Wastewater Systems**

The United States has roughly 50,000 community water systems, but the sector's structure could hardly be more different from electricity. Most water systems are small and municipally owned: over 80% serve fewer than 3,300 people, and private ownership accounts for only about 15% of systems. This extreme fragmentation—tens of thousands of independent operators, many run by local governments with limited technical capacity—creates persistent challenges for maintenance, compliance, and capital investment.

The infrastructure gap is staggering. The American Society of Civil Engineers estimates a \$600+ billion shortfall in water infrastructure investment over the next two decades. Pipes installed in the early twentieth century are reaching end of life simultaneously across thousands of systems. The crisis in Flint, Michigan, which exposed widespread lead contamination in 2014, was not an anomaly—the EPA estimates that 9.2 million lead service lines remain in use nationwide. The Bipartisan Infrastructure Law (2021) allocated \$15 billion specifically for lead pipe replacement, but that covers only a fraction of the estimated \$45-60 billion total cost.

PFAS contamination has emerged as the next major water crisis. These “forever chemicals,” found in firefighting foam, nonstick coatings, and industrial processes, contaminate drinking water supplies serving an estimated 100+ million Americans. The EPA finalized enforceable PFAS limits in 2024, but compliance will cost water systems billions—costs that ultimately flow to ratepayers in a sector where many customers already struggle with affordability.

## **Natural Gas Distribution**

While electricity debates focus on generation and transmission, natural gas has its own “last mile” problem. Roughly 77 million residential, commercial, and industrial customers receive gas through local distribution companies (LDCs)—the regulated utilities that operate the low-pressure pipeline networks running under streets and into buildings. These systems represent enormous sunk capital, and their future is increasingly contested.

The electrification movement poses an existential question for gas distribution. Several cities—including New York, San Francisco, and Seattle—have restricted or banned new natural gas hookups in buildings, arguing that electrification (heat pumps, induction stoves) is necessary to meet climate goals. The gas industry has responded by promoting hydrogen blending and “renewable natural gas” from landfills and dairy operations as pathways to decarbonize existing infrastructure. Critics argue these alternatives are expensive and unproven at scale.

Meanwhile, methane leaks from aging distribution infrastructure represent both a climate problem and a safety hazard. The EPA estimates that gas distribution systems leak roughly 0.6 million metric tons of methane annually. Since methane is roughly 80 times more potent than CO<sub>2</sub> as a greenhouse gas over a 20-year horizon, these leaks substantially undercut natural gas’s climate advantage over coal for electricity generation.

## **Broadband as Essential Utility**

Broadband internet increasingly functions as essential infrastructure, yet it remains the least regulated major networked service. The FCC's broadband deployment data shows that roughly 24 million Americans—disproportionately in rural areas and on Tribal lands—lack access to broadband meeting the current 100/20 Mbps standard. The digital divide is not purely a rural problem: low-income urban neighborhoods also face gaps in affordability and adoption.

The Broadband Equity, Access, and Deployment (BEAD) program, funded at \$42.5 billion through the Bipartisan Infrastructure Law, represents the largest single investment in broadband infrastructure in American history. Each state received an allocation to fund last-mile deployment to unserved and underserved locations. Whether this investment closes the gap depends on execution—and on resolving the tension between municipal broadband advocates and incumbent providers.

Over 750 communities have built some form of municipal broadband network, often in response to inadequate private-sector service. The incumbent industry has fought back aggressively: roughly 18 states have laws restricting or prohibiting municipal broadband, passed largely through industry lobbying. The policy question—whether broadband should be regulated as a common-carrier utility, similar to electricity or water—remains unresolved, though the pandemic-era experience of remote work and school reinforced the argument that internet access is no longer optional.

## **Common Themes Across Utility Systems**

### **□ Info:**

#### **Natural Monopoly Theory**

Water, gas, electricity, and broadband networks all exhibit natural monopoly characteristics: high fixed costs (pipes, wires, towers), low marginal costs of serving additional customers, and network duplication that is wasteful or physically impractical. This is why most utility services are provided by a single supplier in each territory, subject to price regulation rather than competition. The core regulatory bargain is simple: the utility gets an exclusive service territory (and protection from competition), and in exchange accepts an obligation to serve all customers at rates approved by a public commission. Rate cases—formal proceedings where regulators set prices—are the mechanism through which this bargain is enforced.

Several structural patterns recur across all utility sectors. Cross-subsidization is pervasive: urban customers, who are cheaper to serve due to density, effectively subsidize rural customers who require more infrastructure per connection. This cross-subsidy is a deliberate policy choice—universal service at uniform rates—but it creates tensions as costs rise and some customers seek alternatives (rooftop solar, private wells, satellite internet). Aging infrastructure is a shared crisis: the American Society of Civil Engineers gives the nation's infrastructure a C- overall, with water (C-), energy (C-), and broadband (C) all reflecting decades of deferred maintenance.

And the political economy of rate-setting—where regulators must balance utility profitability, consumer affordability, and infrastructure investment—produces the same difficult tradeoffs whether the commodity flowing through the network is water, electrons, gas, or data.

## **Oil Price Volatility and Regional Economies**

Energy prices fluctuate more dramatically than prices in most sectors, and these fluctuations transmit directly to producing regions. No episode illustrates this better than the 2014-2016 oil price collapse—a shock that devastated energy-dependent communities while benefiting consumers everywhere else.

### **The 2014-2016 Oil Shock**



Figure 60: Figure 14.3: Brent crude oil collapsed from \$115/barrel in June 2014 to \$28/barrel in January 2016—a 76% decline in 19 months. Source: FRED

Brent crude oil traded above \$100/barrel from early 2011 through mid-2014, supporting unprecedented investment in American shale production. The Permian Basin, Bakken, and Eagle Ford boomed. Oil-field services companies expanded aggressively. Workers flooded into West Texas, North Dakota, and South Texas, accepting harsh conditions for wages that could exceed \$100,000 annually.

Then prices collapsed. OPEC, led by Saudi Arabia, decided to defend market share rather than prices, flooding an already oversupplied market. Brent fell from \$115 in June 2014 to \$28 in January 2016—a 76% decline.

### **First-Round Effects: The Energy Sector**

The immediate impact devastated oil-dependent industries:

- **Rig counts collapsed:** Active US oil rigs fell from 1,600 (October 2014) to 316 (May 2016)—an 80% decline
- **Employment cratered:** The oil and gas extraction sector shed over 150,000 jobs; oilfield services lost even more
- **Capital investment froze:** Exploration and development spending fell by more than half
- **Bankruptcies surged:** Over 100 North American oil and gas producers filed for bankruptcy in 2015-2016

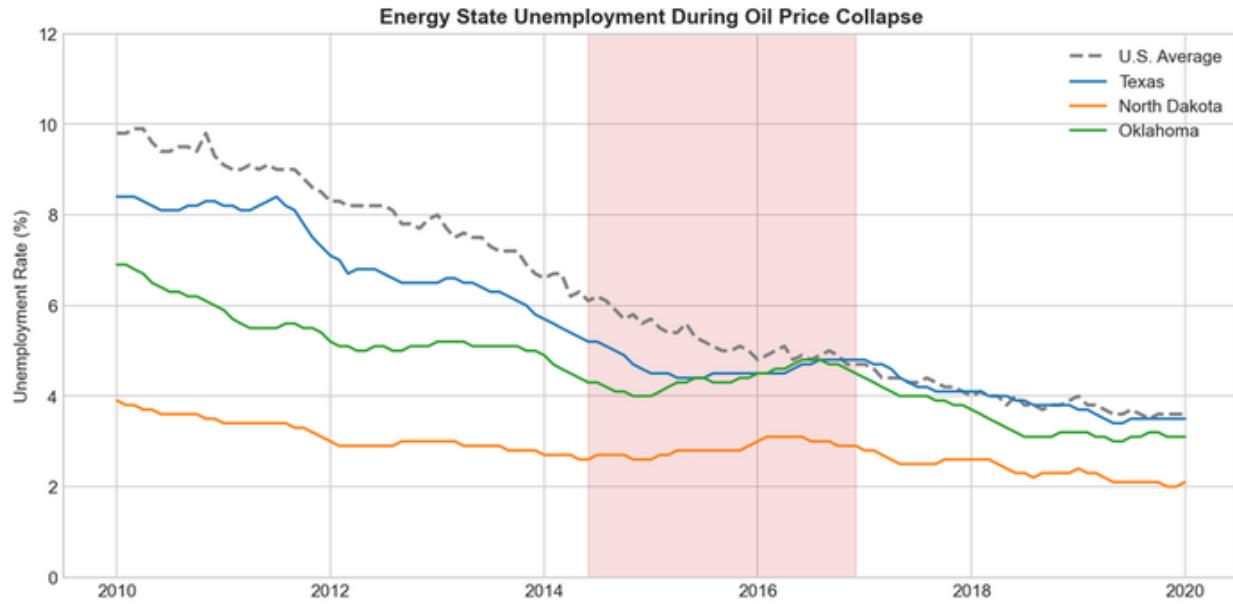


Figure 61: Figure 14.4: Unemployment in oil-producing states spiked during the 2014-2016 oil shock. Texas unemployment rose modestly given its diversified economy; North Dakota unemployment tripled. Source: BLS

## Geographic Concentration

The pain concentrated in producing regions:

- **Permian Basin (West Texas/New Mexico):** Midland unemployment jumped from 2.4% to 4.9%. Hotel occupancy collapsed. Real estate prices fell 20-30% in some markets.
- **Bakken (North Dakota):** Williston, which had grown from 12,000 to 35,000 residents during the boom, saw workers depart as quickly as they had arrived. Unemployment tripled.
- **Eagle Ford (South Texas):** Employment in the San Antonio-New Braunfels metro area slowed dramatically; smaller towns dependent on oil suffered worse.
- **Gulf Coast:** Houston's diversified economy provided some buffer, but the city still lost tens of thousands of energy jobs and office vacancy rates spiked.

## Second-Round Effects: The I-O Linkages

The shock rippled outward through input-output linkages:

- **Steel pipe manufacturers** in Arkansas and Texas saw orders collapse

- **Trucking companies** serving the oil fields cut capacity and jobs
- **Hotels and restaurants** near drilling sites closed
- **Oilfield housing** (man-camps) emptied
- **Regional banks** with energy loan exposure faced mounting non-performing loans

State budgets suffered as well. Texas, which relies heavily on oil and gas severance taxes, faced revenue shortfalls. Oklahoma's budget crisis forced school districts to four-day weeks. North Dakota's sovereign wealth fund stopped growing.

### **Third-Round Effects: Consumer Benefits**

For the broader economy, the oil shock was not entirely negative. Gasoline prices fell from nearly \$4/gallon to below \$2, delivering an effective tax cut to American households. Industries using petroleum as an input—chemicals, plastics, airlines—saw reduced costs. The net effect on national GDP was roughly neutral: losses in energy-producing regions offset gains elsewhere.

### **Adjustment and Recovery**

The industry adjusted through three mechanisms:

1. **Productivity improvements:** Surviving producers learned to produce more with less. Breakeven costs in the Permian fell from \$70+/barrel to below \$40/barrel through better technology and practices.
2. **Consolidation:** Weaker producers were acquired or liquidated. The number of independent producers shrank; survivors emerged stronger.
3. **Capital discipline:** Investors, burned by the boom-bust cycle, demanded returns over growth. The industry shifted from “drill baby drill” to sustainable cash flow generation.

By 2018, oil prices had recovered to \$70+/barrel and production had resumed growth—but with far fewer workers. The industry had learned it could produce more oil with less capital and fewer people. This structural shift means that even when oil prices rise, employment in energy regions may not return to boom-era levels.

### **Lessons for Shock Transmission**

The oil price shock illustrates several principles of how disturbances propagate through the economy:

- **Geographic concentration amplifies pain:** Because oil production is geographically concentrated, the shock devastated specific communities rather than spreading thinly across the country.
- **I-O linkages extend the impact:** The shock affected not just drilling companies but the entire ecosystem of suppliers, services, and local businesses.
- **Adjustment takes time:** Workers who left Williston or Midland didn't immediately find equivalent employment elsewhere. The “adjustment costs” economists discuss can last years.

- **Structural change may follow:** The industry that emerged from 2016 was fundamentally different from the one that entered 2014—more efficient, more consolidated, and less labor-intensive.

These dynamics recur in energy-dependent regions during every price cycle. The current boom may create another bust; the question is not whether but when.

## **Environmental Economics and the Energy Transition**

The energy sector's economic geography cannot be separated from its environmental consequences. Climate change has moved from a scientific debate to an economic force—reshaping insurance markets, stranding capital, redirecting investment, and creating new industries. Understanding these dynamics requires treating environmental costs and policies as structural economic variables, not externalities to be footnoted.

For most of the 20th century, energy economics and environmental economics operated as separate fields. Energy economists studied markets, prices, and resource extraction; environmental economists studied pollution externalities, regulation, and valuation of non-market goods. The climate crisis has collapsed this distinction. Every major energy investment decision now incorporates—or must incorporate—assumptions about carbon constraints, regulatory trajectories, and physical climate risk. The result is a structural transformation that extends well beyond the energy sector into finance, real estate, agriculture, and public budgeting.

### **Climate Risk as Economic Force**

Climate-related economic losses have escalated sharply. NOAA counted 28 separate billion-dollar weather disasters in the US in 2023 alone, with total costs exceeding \$90 billion. These are not abstract projections—they are balance sheet events that show up in insurance premiums, municipal bond ratings, mortgage risk models, and corporate capital allocation decisions.

**Physical risks** manifest through several channels:

- **Extreme weather costs:** Hurricane, wildfire, and flood damages now routinely exceed \$100 billion annually. Insurers have withdrawn from entire markets: State Farm and Allstate stopped writing new homeowner policies in California; multiple carriers have exited Florida and Louisiana. When private insurance retreats, state-backed insurers of last resort absorb risk—effectively socializing climate costs. Florida's Citizens Property Insurance Corporation, originally designed as a backstop, has become the state's largest property insurer.
- **Agricultural disruption:** Drought in the West and Midwest, heat stress on crops, and shifting growing seasons impose direct costs on the \$200+ billion agricultural sector. The federal crop insurance program paid out \$19 billion in 2022. Longer-term, changing precipitation patterns threaten the viability of irrigated agriculture across the Colorado River Basin and the Ogallala Aquifer region.

- **Infrastructure degradation:** Extreme heat buckles roads and rail lines; rising sea levels threaten coastal infrastructure worth trillions; permafrost thaw undermines Arctic pipelines and foundations. The Army Corps of Engineers estimates that adapting US flood control infrastructure alone could cost \$100+ billion over the next two decades.

The economic significance of these physical risks is increasingly priced into financial markets. The Federal Reserve has begun incorporating climate scenarios into bank stress tests. Municipal bond markets now assign risk premiums to coastal communities with high exposure. Real estate valuations in flood-prone and fire-prone areas have begun to diverge from comparable inland properties—a repricing that could accelerate as insurance costs rise further.

**Transition risks** arise from the shift away from fossil fuels. The central concern is **stranded assets**—capital investments in fossil fuel infrastructure that may lose value as the energy system decarbonizes.

#### **Info:**

#### **Stranded Assets**

Stranded assets are investments that lose value prematurely due to regulatory, market, or technological shifts. Estimates of fossil fuel assets at risk of stranding range from \$1 trillion to \$4 trillion globally, including oil reserves that may never be extracted, pipelines that may lose throughput, and refineries that may become uneconomic. Coal has already demonstrated this dynamic: the market capitalization of US coal companies fell over 90% between 2011 and 2020, destroying billions in shareholder value and pension assets. The question is whether—and how quickly—a similar repricing extends to oil and gas assets.

For producing regions like the Permian Basin or Appalachian coal country, stranded assets represent not just corporate losses but threats to regional tax bases, employment, and public services built around extraction revenue.

### **Carbon Pricing: The Policy the US Hasn't Adopted**

Economists across the political spectrum broadly agree that pricing carbon emissions is the most efficient way to reduce them. The logic is straightforward: if emitters pay for the damage their emissions cause, they will find the cheapest ways to reduce those emissions, and the market will allocate abatement effort more efficiently than any regulator could. In practice, the US has largely avoided explicit carbon pricing at the federal level—a choice that distinguishes it from virtually every other advanced economy.

Two mechanisms exist for pricing carbon:

**Cap-and-trade programs** set an emissions cap and let firms trade allowances:

- **Regional Greenhouse Gas Initiative (RGGI):** Covers power plants in 12 Northeast and Mid-Atlantic states. Allowance prices have traded at \$10-

15/ton—low enough to avoid political backlash but too low to drive major fuel switching.

- **California Cap-and-Trade:** Broader in scope, covering roughly 80% of state emissions. Allowance prices have reached \$30-40/ton. Linked with Quebec's system, it is the most ambitious North American program.

**Carbon taxes** have been proposed repeatedly at the federal level—by both conservative economists (the Climate Leadership Council) and progressive legislators—but none has been enacted. Political opposition from fossil fuel interests and consumer price sensitivity have blocked every proposal.

The contrast with peer economies is stark:

Jurisdiction	Mechanism	Price/ton CO2 (2024)	Coverage
EU ETS	Cap-and-trade	\$50-100	Power, industry, aviation
Canada	Carbon tax + cap-and-trade	\$50+ (rising to \$135 by 2030)	Economy-wide
California	Cap-and-trade	\$30-40	~80% of state emissions
RGGI (Northeast)	Cap-and-trade	\$10-15	Power sector only
US federal	None (tax credits via IRA)	N/A	N/A

The **EU Emissions Trading System** prices carbon high enough to drive real changes in power generation and industrial processes. **Canada** has implemented a national carbon tax with a scheduled escalation to \$135/ton by 2030—a price designed to make fossil fuels progressively uncompetitive. The US has instead opted for the **Inflation Reduction Act's** approach: tax credits and subsidies rather than explicit pricing. This is economically less efficient—subsidies cost the Treasury revenue while a carbon price raises it—but proved politically achievable where pricing could not. The IRA's production tax credit for wind (roughly \$26/MWh) and investment tax credit for solar (30%) function as implicit subsidies for low-carbon generation rather than penalties on high-carbon generation.

#### □ Note:

#### **The Hidden Carbon Price**

The absence of a formal carbon price does not mean carbon is unpriced in the US. Renewable portfolio standards, vehicle emissions rules, methane regulations, and IRA tax credits all impose implicit costs on carbon-intensive activities. Researchers estimate the effective implicit carbon price created by this patchwork ranges from \$5 to \$50/ton depending on sector and state—but it applies unevenly, creating economic distortions that a uniform price would avoid.

## **Environmental Regulation as Economic Force**

Environmental regulation has been a significant economic force since the 1970s, though its costs and benefits are often debated in ideological rather than empirical terms. The reality is more nuanced than either side acknowledges: environmental rules impose real compliance costs on energy producers while generating quantifiable public health and economic benefits that typically exceed those costs.

**The Clean Air Act** is the most studied case. EPA estimates that the Act's benefits from 1990 to 2020—reduced mortality, fewer hospitalizations, improved agricultural yields—totaled roughly \$2 trillion per year by 2020, against compliance costs of roughly \$65 billion per year. The roughly 30:1 benefit-cost ratio reflects the enormous health costs of air pollution, particularly fine particulate matter (PM2.5) and ground-level ozone. Critics argue these estimates overstate benefits by using high valuations for statistical lives saved, but even conservative recalculations show benefits exceeding costs by large margins. The Clean Air Act also demonstrates how regulation can drive innovation: the sulfur dioxide cap-and-trade program established in 1990 achieved its emissions targets at roughly one-quarter of projected costs, as utilities found cheaper abatement methods than regulators had anticipated.

**NEPA permitting** has become a critical infrastructure bottleneck. The National Environmental Policy Act (1970) requires environmental impact statements for major federal actions. Average completion time for an EIS now exceeds 4.5 years. This affects energy projects of all types: pipelines, transmission lines, wind farms, and solar installations all face NEPA review. The irony is acute: NEPA delays now impede both fossil fuel projects (pipelines, LNG terminals) and the clean energy infrastructure (transmission lines, offshore wind) needed to reduce emissions. Permitting reform has bipartisan support in principle but stalls over specifics—Democrats worry about weakening environmental protections; Republicans focus on fossil fuel project approvals. The Fiscal Responsibility Act of 2023 included modest NEPA reforms, but the fundamental bottleneck remains.

**EPA's evolving climate role** was constrained by the Supreme Court's 2022 decision in *West Virginia v. EPA*, which limited the agency's authority to impose sector-wide emissions caps on power plants. The ruling applied the "major questions doctrine," requiring clear Congressional authorization for regulations of vast economic significance. This effectively shifted climate policy power from EPA rulemaking to Congressional legislation—making the IRA's tax credit approach not just politically convenient but legally necessary. The decision left EPA with authority over individual source standards and technology-based rules, but removed the agency's most powerful lever for system-wide emissions reduction.

## **The Green Transition as Structural Economic Shift**

The Inflation Reduction Act's roughly \$370 billion in climate and energy spending is producing a geographically concentrated investment wave. This is not a gradual diffusion—it is a place-based industrial policy reshaping specific regions. The scale of capital reallocation is historically unusual: private sector clean energy investment in the US exceeded \$300 billion in 2023, more than double the 2019 level.

The transition also has a supply chain dimension. The IRA includes domestic content requirements and manufacturing credits designed to build American clean energy supply chains. Solar panel, battery cell, and critical mineral processing facilities are being built or expanded domestically—reversing a decade-long trend of offshoring clean energy manufacturing to China. Whether these facilities remain competitive without subsidies is an open question.

**The “Battery Belt”:** Battery, EV, and solar manufacturing investments have clustered heavily in the Southeast and lower Midwest—Georgia, Tennessee, Kentucky, South Carolina, and Michigan. Since the IRA’s passage, over \$150 billion in announced clean energy manufacturing investments have targeted these states, drawn by right-to-work laws, lower costs, available land, existing automotive supply chains, and IRA bonus credits for energy communities. Georgia alone has attracted \$20+ billion in battery and EV investments from Hyundai, Rivian, and SK Innovation. This geographic pattern is politically significant: much of the IRA’s investment is flowing into Republican-represented districts, creating a constituency for clean energy subsidies even among legislators who voted against the law.

**Job creation vs. job displacement:** The clean energy economy already employs roughly 3.3 million workers across several categories:

- Energy efficiency (building retrofits, insulation, HVAC): roughly 2.1 million
- Renewable energy generation (solar, wind, hydro): roughly 500,000
- Clean vehicles (EV manufacturing, charging infrastructure): roughly 300,000
- Grid modernization and storage: roughly 400,000

By comparison, traditional fossil fuel extraction, generation, and refining employ roughly 1.1 million. But these numbers obscure a geographic mismatch: clean energy jobs are growing in the Sun Belt and industrial Midwest, while fossil fuel job losses concentrate in Appalachia, Wyoming’s Powder River Basin, and parts of the Gulf Coast. A solar installer in Georgia does not help a displaced coal miner in West Virginia. Moreover, clean energy jobs on average pay less than the unionized fossil fuel positions they notionally replace—median solar installation wages run \$25/hour versus \$35-45/hour for experienced oil field or utility workers.

The “**just transition**” concept—ensuring that fossil fuel workers and communities are not left behind—has become a federal policy goal. The IRA includes bonus tax credits for projects in “energy communities” (areas with closed coal mines, retired coal plants, or high fossil fuel employment). The Appalachian Regional Commission and similar bodies administer transition funding. But the scale of federal investment in transition assistance remains modest relative to the economic disruption in affected communities. Historical precedent is not encouraging: Appalachian coal communities that began losing jobs in the 1980s still have not recovered economically, despite decades of federal and state aid programs.

## **Environmental Justice**

Environmental burdens are not distributed equally. Decades of industrial siting decisions, highway construction, and zoning practices have concentrated pollution exposure in low-income communities and communities of color. This pattern is not

incidental—it reflects the political economy of facility siting, where communities with less political power bear disproportionate environmental costs.

The data is well-documented: communities near refineries, chemical plants, power plants, and waste facilities are disproportionately Black, Hispanic, and low-income. A 2021 EPA analysis found that Black Americans are 36% more likely to live in areas with high levels of particulate matter pollution, and Hispanic Americans are 39% more likely to live in counties that fail to meet air quality standards. In Louisiana's industrial corridor between Baton Rouge and New Orleans—commonly known as "Cancer Alley"—cancer rates in some census tracts are 50 times the national average, and the population is predominantly Black and low-income.

EPA's environmental justice initiatives—formalized through Executive Order 12898 (1994) and expanded under the Biden administration's Justice40 initiative (directing 40% of certain federal investment benefits to disadvantaged communities)—intersect directly with industrial permitting. New petrochemical facilities in Louisiana's Cancer Alley, LNG export terminals along the Gulf Coast, and pipeline projects through Indigenous lands all face heightened scrutiny under environmental justice frameworks. This creates real tensions: these projects bring jobs and tax revenue to economically distressed areas while imposing health and environmental costs on residents.

The energy transition itself raises environmental justice concerns. Lithium mining, battery manufacturing, and large-scale solar and wind installations create new siting conflicts. Tribal nations have raised concerns about mineral extraction on or near reservation lands. Rural communities in the Midwest and West have pushed back against large-scale wind and solar projects that alter landscapes and concentrate benefits with distant developers.

Ensuring that the clean energy economy does not replicate the environmental inequities of the fossil fuel era is a stated federal policy goal—but implementation depends on permitting decisions made at the project level, often under intense pressure from competing economic and political interests.

## Recent Trends

### 1. The Shale Revolution Matures

US oil production peaked at 13 million bbl/day (2019), fell during COVID, and has recovered to near-record levels. But the industry is changing:

- **Capital discipline:** After burning through investor capital in the 2010s, shale producers now prioritize returns over growth
- **Consolidation:** Majors are acquiring independents (Exxon-Pioneer, Chevron-PDC)
- **Productivity plateau:** Well productivity gains are slowing; Tier 1 acreage is being depleted
- **Permian dominance:** The Permian Basin accounts for nearly half of US oil production

## **2. Coal's Collapse**

Coal generation has fallen by two-thirds since 2008: - 2008: 48% of US generation - 2024: 16% of US generation

Coal plants are retiring faster than regulators expected. The remaining fleet is aging (average plant is 45+ years old), and economics favor gas and renewables. Some regions (Appalachia, Powder River Basin) face severe economic disruption.

## **3. The Renewable Buildout**

Wind and solar now provide 17% of US electricity (up from 3% in 2010). The IRA has accelerated deployment: - 2023: 32 GW of utility-scale solar added - 2024: 40+ GW expected - Battery storage growing 50%+ annually

Challenges remain: Grid interconnection queues are 5+ years long; permitting delays kill projects; supply chains face constraints.

## **4. Grid Reliability Concerns**

Rapid change is straining grid reliability: - **Texas (February 2021)**: Winter storm caused 4+ days of blackouts; 200+ deaths - **California (rolling blackouts)**: Tight margins during heat waves - **Interconnection backlogs**: New generation can't connect fast enough

Dispatchable generation (gas, nuclear) is retiring faster than storage and demand response can compensate. Grid operators warn of increasing reliability risks.

## **5. The Nuclear Question**

The existing nuclear fleet (93 GW, 54 plants) provides 18% of US generation—all carbon-free. But: - No new conventional plants since 2016 (Vogtle 3&4 in Georgia finally completed, massively over budget) - Several plants have closed or announced closure (economics, not safety) - Small modular reactors (SMRs) are years away from commercial deployment

Nuclear's future depends on whether it's valued for reliability and carbon-free generation. Some states (Illinois, New York, California) have subsidized plants to prevent closure.

## **6. Electrification and Load Growth**

After decades of flat electricity demand, load growth is resuming: - **EVs**: Each 1% EV penetration adds roughly 0.3% to electricity demand - **Data centers**: AI/cloud computing driving massive data center construction - **Electrification**: Heat pumps, industrial electrification - **Hydrogen/manufacturing**: IRA incentives driving new industrial load

Utilities that planned for flat demand now face potential shortages. Load growth could reach 2-3% annually—rates not seen since the 1990s.

## Firm Profiles

### NextEra Energy

**Quick Facts** - Headquarters: Juno Beach, FL - Market Cap: roughly \$140 billion - Employees: roughly 16,000 - CEO: John Ketchum

NextEra Energy is the world's largest generator of wind and solar power—and also Florida's largest electric utility. This combination of regulated utility (Florida Power & Light) and competitive renewables developer (NextEra Energy Resources) has made NextEra the most valuable utility in America.

**Florida Power & Light (FPL)**: Serves 5.8 million customer accounts (12 million people) across Florida. FPL is known for operational efficiency, low rates by Florida standards, and aggressive solar deployment (Florida's largest solar fleet).

**NextEra Energy Resources (NEER)**: The competitive subsidiary, operating 32 GW of wind, solar, and storage across North America. NEER pioneered utility-scale wind development in the 2000s and has maintained market leadership through scale, low cost of capital, and sophisticated power marketing.

The company's strategy: use FPL's regulated cash flows to fund NEER's growth, while maintaining investment-grade credit. NextEra has outperformed the utility sector for two decades.

Challenges: Rising interest rates (which affect all capital-intensive developers); Florida's hurricane exposure; regulatory risk in states skeptical of renewables.

### ExxonMobil

**Quick Facts** - Headquarters: Spring, TX (Houston area) - Market Cap: roughly \$450 billion - Employees: roughly 62,000 - CEO: Darren Woods

ExxonMobil is the largest US oil company and one of the largest in the world, tracing its history to Standard Oil (broken up in 1911). The company operates across the petroleum value chain:

**Upstream**: Major positions in the Permian Basin (acquired Pioneer Natural Resources for \$60B in 2024), Guyana (massive offshore discoveries), and global LNG. Production: roughly 3.8 million boe/day.

**Downstream**: Largest US refiner (4.6 million bbl/day capacity globally), major chemicals producer (polyethylene, polypropylene).

**Low Carbon Solutions**: Investing in carbon capture, hydrogen, and biofuels—though critics argue the pace is too slow. ExxonMobil has been more skeptical of the energy transition than European peers (Shell, BP, TotalEnergies).

ExxonMobil's strategy under CEO Darren Woods emphasizes maximizing returns from oil and gas rather than pivoting to renewables. The Pioneer acquisition doubled Permian production, betting on continued oil demand.

The company has faced climate litigation, shareholder activism, and reputational challenges. But ExxonMobil remains enormously profitable when oil prices are high, generating \$50+ billion in net income in 2022.

## Duke Energy

**Quick Facts** - Headquarters: Charlotte, NC - Market Cap: roughly \$75 billion - Employees: roughly 27,000 - CEO: Lynn Good

Duke Energy exemplifies the large regulated utility: predictable, capital-intensive, politically connected, and facing the challenges of energy transition.

Duke serves 8.2 million electric customers across six states (North Carolina, South Carolina, Florida, Indiana, Ohio, Kentucky), plus 1.6 million gas customers. The company operates as regulated monopolies in all service territories—no competitive markets.

**Generation portfolio:** Historically coal-heavy, Duke has been transitioning to gas and renewables. The company operates nuclear plants in the Carolinas and is exploring SMRs. Coal retirement timelines are contentious: North Carolina regulators push faster; Duke seeks gradual transition.

**Regulatory relationships:** Duke's business depends on PUC approval of investments and rates. The company maintains close relationships with state regulators and legislatures—critics say too close. Duke has faced criticism for coal ash cleanup costs, rate increases, and political influence.

**Clean energy transition:** Duke has committed to net-zero emissions by 2050, with interim targets. But execution faces challenges: grid reliability concerns, coal plant retirement schedules, and the need for massive transmission investment.

Duke illustrates the tensions facing traditional utilities: pressure to decarbonize, need to maintain reliability, desire to grow rate base, and exposure to regulatory and political risk.

## Data Sources and Further Reading

### Key Data Sources

- **Energy Information Administration (EIA):** Comprehensive energy data—production, consumption, prices, international comparisons. The essential source.
- **FERC:** Wholesale market data, infrastructure filings, regulatory proceedings
- **ISO/RTO Market Data:** Real-time and historical electricity prices, generation mix
- **S&P Global / Platts:** Energy market intelligence (subscription)
- **Lazard's LCOE:** Annual levelized cost of energy analysis (free report)
- **BloombergNEF:** Clean energy market analysis (subscription)

## **Further Reading**

**Accessible** - Yergin, Daniel (2011). *The Quest: Energy, Security, and the Remaking of the Modern World*. Comprehensive energy history and geopolitics. - Gold, Russell (2014). *The Boom: How Fracking Ignited the American Energy Revolution*. The shale story.

**Intermediate** - Jenkins, Jesse. ENE 522 course materials (Princeton). Excellent electricity sector primer. - Borenstein, Severin, and James Bushnell (2015). "The US Electricity Industry after 20 Years of Restructuring." *Annual Review of Economics*. - Joskow, Paul (2008). "Lessons Learned from Electricity Market Liberalization." *The Energy Journal*.

**Policy and Transition** - Jenkins, Jesse, et al. (2018). "Getting to Zero Carbon Emissions in the Electric Power Sector." Joule. - IEA World Energy Outlook (annual). Global energy scenarios and analysis. - Princeton Net-Zero America study. Detailed US decarbonization pathways.

**Government Reports** - EIA Annual Energy Outlook. Official US energy projections. - FERC State of the Markets. Annual wholesale market assessment. - DOE Quadrennial Energy Review. Comprehensive policy analysis.

## **Exercises**

### **Review Questions**

1. The chapter describes two fundamentally different market structures for electricity: regulated/vertically integrated utilities (roughly 30 states) and restructured/deregulated markets with competitive wholesale trading (roughly 20 states). Compare these models in terms of how electricity prices are set, who bears investment risk, and what role Independent System Operators (ISOs) play. The chapter notes that retail prices in restructured states are generally higher than in regulated states. Does this mean restructuring failed, or could other factors explain the difference?
2. ERCOT (Texas) deliberately isolated its grid from the Eastern and Western Interconnections to avoid federal regulation by FERC. The February 2021 winter storm caused 4+ days of blackouts and 200+ deaths. Using the chapter's discussion, explain the specific trade-off Texas made between regulatory independence and grid reliability. How could interconnection with the Eastern or Western grids have mitigated the crisis, and what political factors prevent Texas from joining a larger interconnection?
3. Coal's share of US electricity generation fell from 48% in 2008 to 16% in 2024. The chapter attributes this to the shale revolution making natural gas cheap and environmental regulation making coal expensive. Explain the economic mechanism by which cheap natural gas displaced coal in the electricity generation merit order. Why is this displacement difficult to reverse even if gas prices rise?
4. The 2014-2016 oil price collapse saw Brent crude fall from \$115/barrel to \$28/barrel. Active US oil rigs fell 80%; over 100 producers filed for bankruptcy;

the Permian Basin town of Midland saw unemployment jump from 2.4% to 4.9%. Yet by 2018, production had recovered to near-record levels with far fewer workers. Explain the three adjustment mechanisms the chapter identifies—productivity improvements (breakeven costs falling from \$70+ to below \$40/barrel), consolidation, and capital discipline—and how they made the post-2016 industry structurally different.

5. NextEra Energy combines a regulated utility (Florida Power & Light, serving 5.8 million customers) with a competitive renewables developer (NextEra Energy Resources, 32 GW of wind, solar, and storage). Explain the strategic logic of this corporate structure: how does the regulated utility's predictable cash flow support the renewables business, and why has this combination made NextEra the most valuable utility in America at roughly \$140 billion in market capitalization?
6. The Inflation Reduction Act (2022) provides 10-year tax credits for wind, solar, storage, nuclear, and hydrogen—the chapter calls this the “largest US climate legislation ever,” with an estimated \$370 billion in climate spending. Explain how long-duration, predictable tax credits affect investment decisions differently than short-term credits that Congress must repeatedly renew. Why does the 10-year horizon matter particularly for capital-intensive projects like offshore wind or battery manufacturing?

## Data Exercises

7. Using the Energy Information Administration’s Electricity Data Browser (<https://www.eia.gov/electricity/data/browser/>), download monthly net electricity generation data by fuel source (natural gas, coal, nuclear, wind, solar, hydroelectric) for the most recent 5 years. Create a stacked area chart showing the generation mix over time. Has the displacement of coal by natural gas and renewables continued at the pace the chapter describes? Identify any months where wind and solar combined exceeded coal generation.
8. Using FRED, download the Brent crude oil price series (DCOILBRENTEU) and the BLS employment data for oil and gas extraction (series CES1021100001). Plot both on the same graph from 2010 to the present using dual y-axes. Does employment track oil prices with a lag, and if so, approximately how many months? How does the relationship between price recovery (post-2016) and employment recovery support the chapter’s claim that the industry learned to “produce more oil with less capital and fewer people”?
9. Using the EIA’s State Energy Data System (<https://www.eia.gov/state/seds/>), compare per-capita energy consumption across five states: Texas, California, Louisiana, New York, and Wyoming. Then, using EIA electricity price data, compare average retail electricity prices in these same states. Do high-consumption states pay lower prices per unit? What combination of factors—industrial mix, climate, energy policy, and production geography—explains the patterns you observe?

## **Deeper Investigation**

10. The chapter identifies grid interconnection queues (5+ years long) and transmission permitting as critical bottlenecks for the renewable energy buildout. Using PJM Interconnection's publicly available queue data (<https://www.pjm.com/planning/services-requests/interconnection-queues>), determine how many gigawatts of generation capacity are currently waiting to connect to PJM (the largest US wholesale electricity market). What is the approximate average wait time, and what share of projects in queue are withdrawn before completion? Compare the total capacity in queue to PJM's current installed generation. What reforms to interconnection study processes, cost allocation, and transmission permitting have been proposed by FERC, PJM, and state regulators, and what political obstacles do they face?

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Chapter 14 | Energy The American Economy: A Structural Geography Draft v1 — January 2026

# Chapter 15. Education

Americans spend over \$1.5 trillion annually on education, making it one of the largest sectors of the economy. Yet the American education “system” is barely a system at all: 13,000 independent school districts, 50 state bureaucracies, 4,000 colleges with wildly different missions, a growing commercial sector of test-prep companies and for-profit schools, and an emerging ed-tech industry promising to disrupt it all. Understanding American education means understanding both the public system that educates most students and the \$400+ billion commercial ecosystem built around it.

## Overview

**Size and Scope** - Total spending: roughly \$1.6 trillion annually - K-12 public: roughly \$800 billion - Higher education: roughly \$700 billion - Private K-12: roughly \$70 billion - Federal direct: roughly \$100 billion (grants, loans, Title I) - Employment: roughly 13 million workers (teachers, professors, administrators, support staff) - Establishments: roughly 130,000 K-12 schools, roughly 4,000 degree-granting colleges - Key subsectors: K-12 public, K-12 private, higher education, for-profit education, testing and assessment, textbooks and curriculum, education technology

Education's share of GDP is roughly 7%, comparable to healthcare in the 1980s before that sector's explosive growth. Education is the single largest expenditure category for state and local governments, exceeding Medicaid and infrastructure combined.

The sector is unusual because most spending flows through government, but the industry surrounding education—publishers, test makers, technology providers, and for-profit schools—is thoroughly commercial. The College Board, technically a non-profit, generates \$1.5 billion in annual revenue. Pearson, the world's largest education company, is a London-listed corporation. Understanding education in America means understanding both the public mission and the private interests.

## How the Industry Works

### The Public Side: Revenue Flows

K-12 public education is funded from three sources (national averages): - **Local**: 45% (primarily property taxes) - **State**: 47% (sales and income taxes, distributed via formulas) - **Federal**: 8% (targeted programs: Title I for low-income schools, IDEA for special education, school nutrition programs)

## **U.S. Higher Education Enrollment by Sector,**

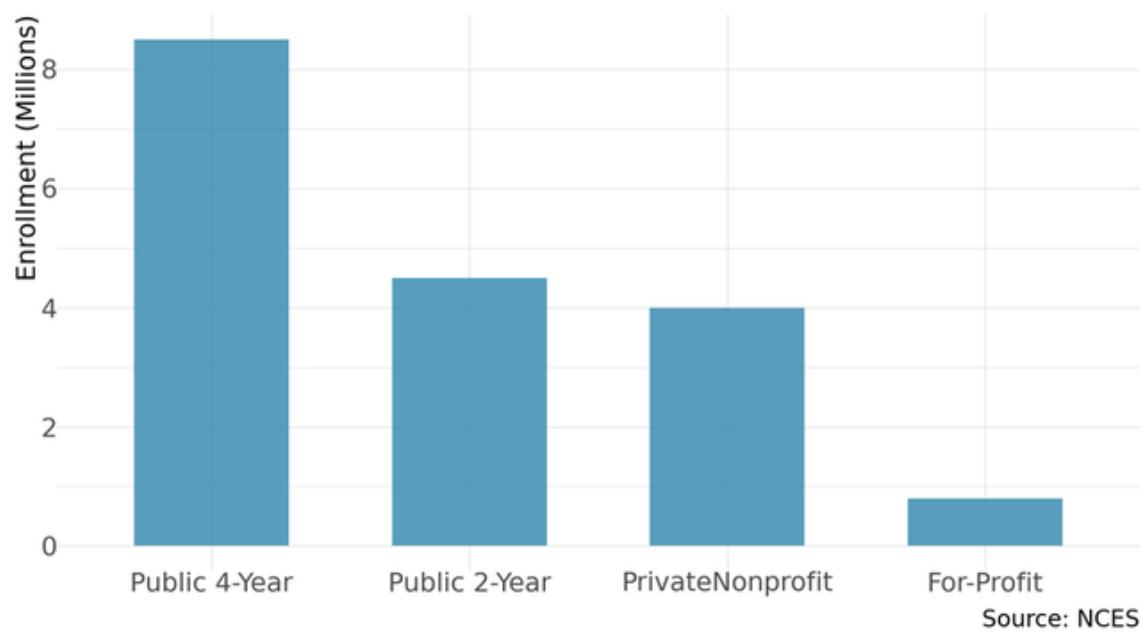


Figure 62: Figure 15.1: U.S. educational enrollment by sector. K-12 public schools enroll the vast majority of students, with higher education and private K-12 as secondary segments. Source: NCES

This funding structure creates enormous inequality. Districts in wealthy suburbs collect abundant property taxes; districts in poor rural or urban areas cannot. State formulas partially equalize, but gaps persist: New York spends \$29,000 per pupil; Utah spends \$9,000. Even after cost-of-living adjustment, the ratio exceeds 2:1.

Higher education has a different funding model: - **Public universities:** State appropriations (declining from 75% in 1980 to roughly 40% today), tuition (rising), federal research grants, auxiliaries (housing, athletics, hospitals) - **Private nonprofits:** Tuition, endowment returns, gifts, federal research grants - **For-profit colleges:** Almost entirely tuition, roughly 90% from federal student aid

## **The Commercial Side: Where the Money Goes**

The education sector generates enormous commercial activity beyond direct instruction:

**Textbooks and Curriculum** (roughly \$15 billion market) - K-12 textbooks: States adopt textbooks on 6-8 year cycles; Texas and California dominate adoption decisions - Higher ed textbooks: Professors choose; students pay \$1,200+ per year; used book and rental markets growing - Digital curriculum: Increasingly bundled with assessment and learning management systems

**Testing and Assessment** (roughly \$5 billion market) - Standardized tests: State accountability tests (Pearson, ETS, AIR) - College admissions: SAT (College Board), ACT - Professional licensing: Bar exam, CPA, medical boards, teacher certification - Credential assessments: GED, CLEP, AP exams

**Education Technology** (roughly \$40 billion market, fast-growing) - Learning management systems (Canvas, Blackboard) - Online course platforms (Coursera, edX, 2U) - Tutoring and homework help (Chegg, Varsity Tutors) - Assessment software and proctoring - Administrative systems (PowerSchool, Ellucian)

**For-Profit Education** (roughly \$25 billion revenue) - Online universities (University of Phoenix, Southern New Hampshire, Grand Canyon) - Career training (coding bootcamps, trade schools) - Test preparation (Kaplan, Princeton Review) - K-12 virtual schools (Stride Inc., formerly K12)

## **Business Models**

**Traditional public education** operates on a cost-plus model: schools receive funding based on enrollment (average daily attendance) and spend it on salaries (80%+ of budgets), facilities, and operations. There is limited competitive pressure; most students attend their assigned school.

**For-profit education** operates on a tuition-extraction model, often dependent on federal financial aid. The infamous “90/10 rule” requires for-profit colleges to derive at least 10% of revenue from non-federal sources—a rule designed to ensure schools provide value beyond capturing government funds. Many for-profits cluster at 89% federal revenue.

**Textbook publishers** operate on an adoption-cycle model: heavy upfront investment in content creation, then years of revenue from adoptions. The shift to digital threatens this model by enabling piracy and unbundling.

**Testing companies** operate on a monopoly or oligopoly model. College Board has no competitor for AP exams. State assessment contracts go to a handful of companies with the capacity to develop, administer, and score tests for millions of students.

## Industry Structure

### Market Concentration

Education is fragmented on the public side, concentrated on the commercial side:

**K-12 Public Education:** Extremely fragmented - 13,000+ school districts - Average district serves roughly 3,800 students - Largest: NYC (1 million students), LA Unified (600,000) - Many rural districts serve <500 students

**Higher Education:** Moderately fragmented - 4,000 degree-granting institutions - But consolidation increasing: University systems (UC, SUNY, Texas) operate multiple campuses - Online programs dominated by a handful of mega-enrollers

**Commercial Education:** Concentrated

Segment	Top Players	Market Structure
K-12 Textbooks	Pearson, McGraw-Hill, Cengage, Houghton Mifflin	Oligopoly (4 firms: roughly 80% market)
Higher Ed Textbooks	Same Big 4	Oligopoly
College Admissions Testing	College Board (SAT), ACT Inc.	Duopoly
State Assessment	Pearson, ETS, AIR, Cambium	Oligopoly
For-Profit Higher Ed	University of Phoenix, Southern NH, Grand Canyon	Concentrated but declining
Online Program Management	2U, Coursera, Noodle	Consolidating
K-12 Virtual	Stride Inc.	Near-monopoly in full-time virtual K-12

Source: National Center for Education Statistics, Digest of Education Statistics, 2023

### Major Players

#### Public Systems (by enrollment)

Rank	System	Enrollment	Type
1	California Community Colleges	1.8 million	Public 2-year
2	CUNY	275,000	Public 4-year
3	SUNY	400,000	Public 4-year
4	Texas A&M System	175,000	Public 4-year
5	University of California	285,000	Public 4-year

Source: National Center for Education Statistics, Digest of Education Statistics, 2023

### Commercial Education Companies (by revenue)

Rank	Company	Revenue	Business
1	Pearson	\$4.7B	Publishing, testing, online learning
2	McGraw-Hill	\$1.8B	Publishing, digital platforms
3	Chegg	\$800M	Homework help, textbook rental
4	Stride Inc.	\$1.9B	K-12 virtual schools
5	2U	\$950M	Online program management
6	Grand Canyon Education	\$900M	OPM for Grand Canyon University
7	Coursera	\$600M	Online courses, degrees

Source: National Center for Education Statistics, Digest of Education Statistics, 2023

### Competitive Dynamics

In public education, competition occurs primarily through residential sorting (families choose schools by choosing neighborhoods) and through school choice programs (charters, vouchers, open enrollment). Roughly 10% of public school students attend charter schools; charter market share exceeds 50% in some urban districts (New Orleans, Detroit, DC).

In commercial education, competition is fierce for government contracts (state assessments, curriculum adoptions) and for student enrollment (for-profit colleges, online programs). Regulatory risk is high: for-profit colleges face periodic crackdowns on predatory practices; ed-tech companies face privacy scrutiny.

In higher education, elite institutions compete for prestige (rankings, research funding, star faculty). Community colleges and regional universities compete for local enrollment. Online programs compete nationally for working adults.

### Geographic Distribution

#### Regional Patterns

#### K-12 Spending Variation

Per-pupil spending varies dramatically by state:

Highest Spending	Per Pupil	Lowest Spending	Per Pupil
New York	\$29,000	Utah	\$9,000
New Jersey	\$23,000	Idaho	\$9,500
Vermont	\$22,000	Arizona	\$10,000
Connecticut	\$21,000	Oklahoma	\$10,500
Massachusetts	\$19,000	Mississippi	\$10,500

Source: National Center for Education Statistics, Digest of Education Statistics, 2023

These gaps reflect: property wealth, political preferences, cost of living, and school finance litigation history. Court decisions in many states (beginning with *Serrano v. Priest* in California, 1971) forced equalization, but substantial interstate inequality remains.

### Charter School Concentration

Charter schools cluster in urban areas and in states with permissive charter laws:

State	Charter Enrollment Share	Notes
Arizona	18%	Most permissive charter law
Colorado	14%	Strong authorization system
California	11%	Large absolute numbers
Florida	11%	Recent rapid growth
Michigan	10%	Detroit roughly 55% charter

Source: National Center for Education Statistics, Digest of Education Statistics, 2023

Rural states (Montana, West Virginia, Nebraska) have minimal charter presence. Charter schools are rare in the Northeast except in cities.

### Higher Education Geography

Higher education is more geographically concentrated than K-12:

- **Research universities:** Cluster in metros with strong knowledge economies (Boston, Bay Area, Research Triangle, Ann Arbor, Austin)
- **College towns:** University dominates local economy (State College PA, Champaign-Urbana, Madison, Boulder, Athens GA)
- **Community colleges:** Distributed roughly proportional to population
- **For-profit schools:** Concentrated in Sunbelt metros with large working-adult populations (Phoenix, Dallas, Atlanta, Miami)

The geography of higher education shapes regional economies. Universities anchor innovation ecosystems; student spending supports college-town retail; alumni networks facilitate hiring. The absence of a major research university can limit a region's economic development options.

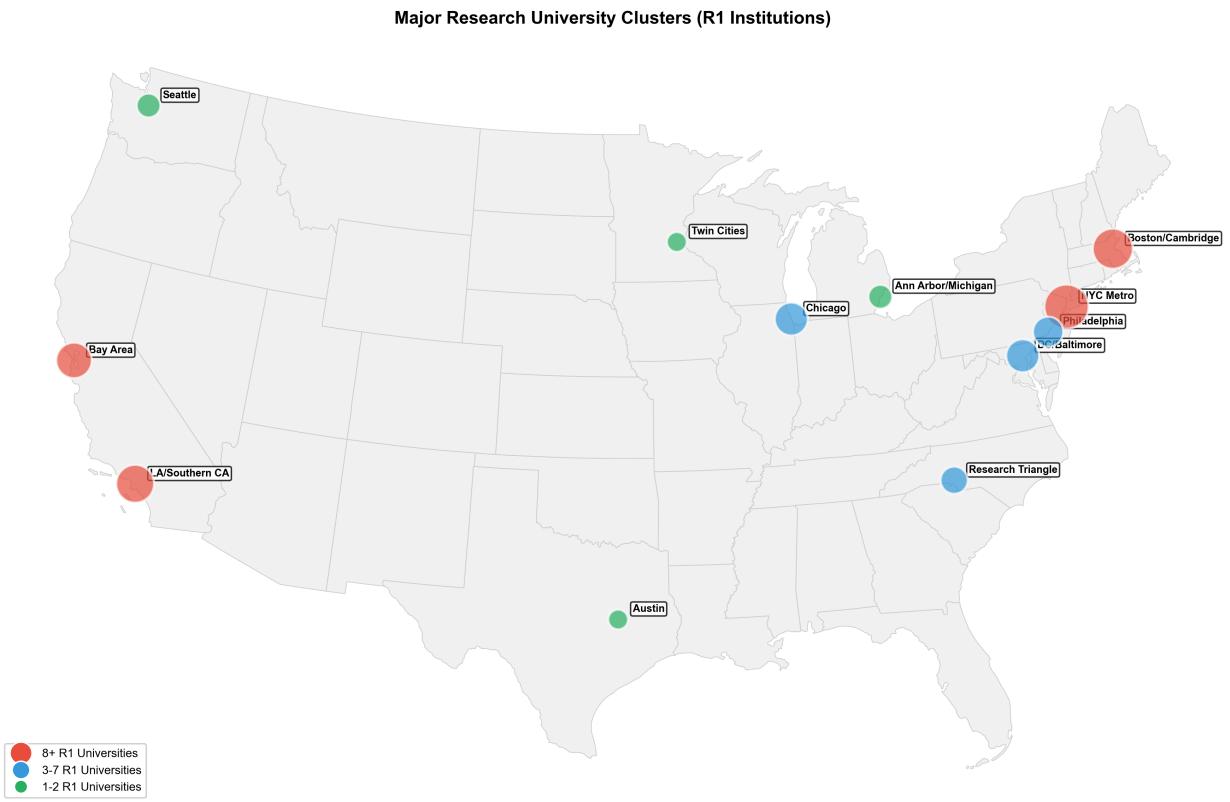


Figure 63: Figure 15.2: Major research university clusters (R1 institutions). Knowledge economy hubs concentrate around elite research universities, with Boston/Cambridge, the Bay Area, and NYC hosting the largest clusters. Source: Carnegie Classification (2024)

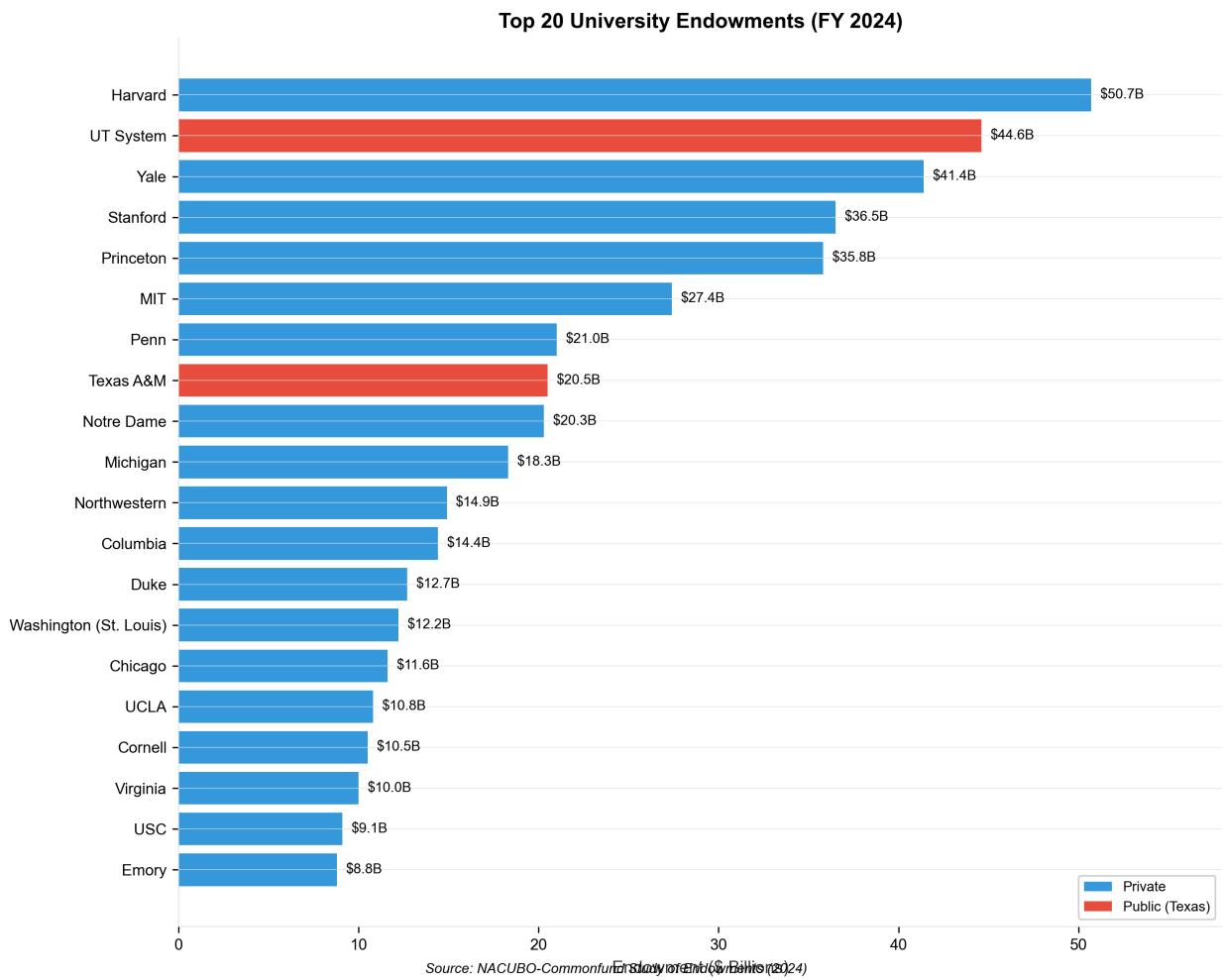


Figure 64: Figure 15.3: Top 20 university endowments (FY 2024). Harvard leads with over \$50 billion, followed by the University of Texas System. Endowments fund financial aid, research, and operations at wealthy institutions. Source: NACUBO-Commonfund Study of Endowments

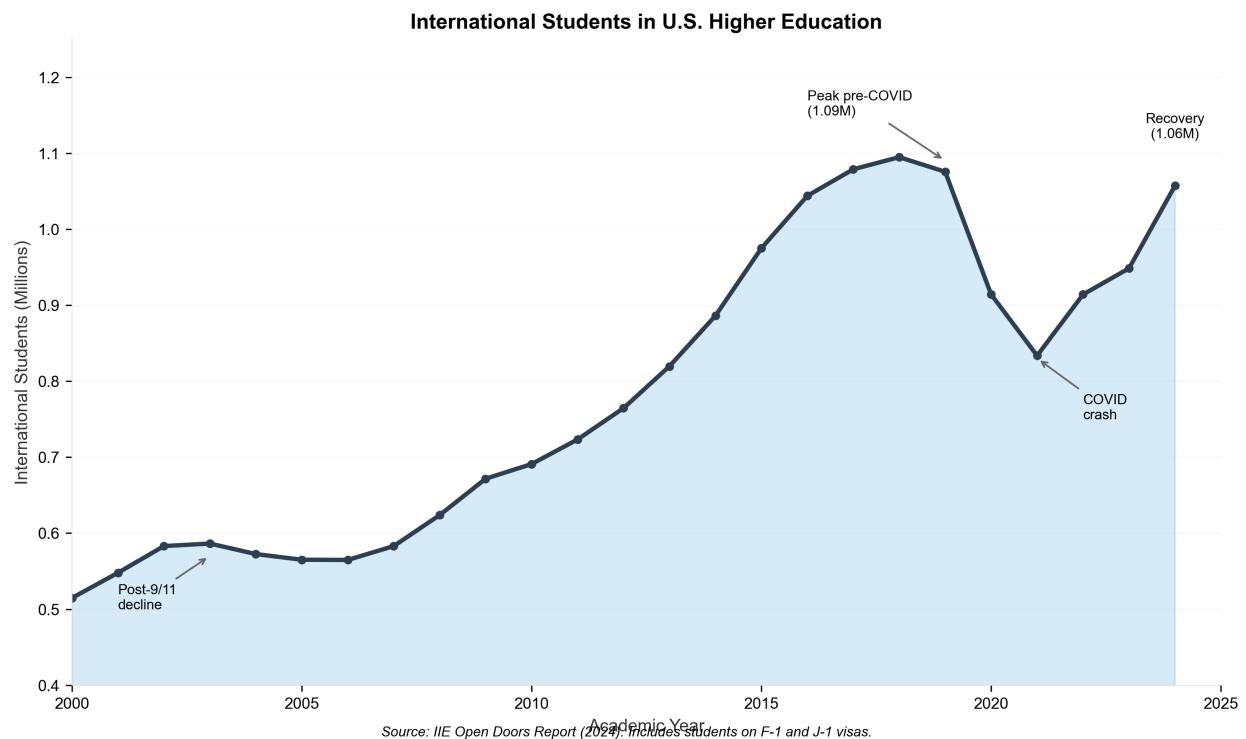


Figure 65: Figure 15.4: International students in U.S. higher education. Enrollment peaked at 1.09 million before COVID, crashed during the pandemic, and has since recovered. International students contribute \$40+ billion annually to the U.S. economy. Source: IIE Open Doors Report

# The Workforce

## Employment Overview

Education employs roughly 13 million workers—about 8% of total employment:

Segment	Employment	Avg Wage
K-12 Teachers	3.7 million	\$65,000
K-12 Support Staff	2.5 million	\$35,000
K-12 Administrators	500,000	\$100,000
Higher Ed Faculty	1.5 million	\$80,000 (varies enormously)
Higher Ed Staff	2.5 million	\$50,000
Private Education	1.5 million	\$45,000
Education Services	800,000	\$60,000

Source: National Center for Education Statistics, Digest of Education Statistics, 2023

## The Teacher Labor Market

Teaching is the largest single occupation in the United States. The teacher labor market has several distinctive features:

**Wage compression:** Teacher salaries vary less than in other professions. A stellar teacher earns perhaps 20% more than a mediocre colleague; in the private sector, the ratio might be 2:1 or 3:1. This reflects union contracts, public sector pay scales, and difficulty measuring teacher productivity.

**Experience premium:** Teachers receive substantial raises for experience (especially in the first 10 years) and for additional credentials (master's degrees). Whether these credentials improve teaching is disputed—the evidence is weak—but the pay incentives persist.

**Geographic immobility:** Teachers accumulate pension benefits in state-specific systems, creating substantial costs to interstate mobility. A teacher who moves after 15 years may forfeit hundreds of thousands in retirement benefits.

**Shortages:** Teacher shortages are persistent in certain areas: - Subjects: Math, science, special education, bilingual - Locations: Rural areas, high-poverty urban schools - Overall: Fewer students entering teaching programs since 2010

Research on teacher quality finds enormous variation in effectiveness. Replacing a bottom-5% teacher with an average teacher raises students' lifetime earnings by roughly \$250,000 per classroom (Chetty, Friedman, and Rockoff 2014). Yet identifying effective teachers before hiring remains difficult; credentials and test scores are weak predictors.

## Higher Education Faculty

The higher education labor market has bifurcated:

**Tenure-track faculty** (roughly 30% of instructional staff): Secure positions, high salaries, research time, shared governance. Median salary roughly \$100,000; top researchers earn \$200,000+.

**Contingent faculty** (roughly 70% of instructional staff): - Adjunct instructors: Paid per course (\$3,000-5,000 per class), no benefits, no job security - Full-time non-tenure-track: Better paid but still precarious - Graduate students: Provide instruction while training

This casualization of academic labor has accelerated since the 1990s. Universities save money and maintain flexibility; faculty bear the risk. Adjuncts at multiple institutions may earn \$25,000-40,000 for full-time teaching loads.

## **Administrative Growth**

Education administration has expanded faster than instruction:

- K-12: Administrators grew 88% from 1992-2019; teachers grew 60%; enrollment grew 19%
- Higher Ed: Administrative positions grew 60% from 1993-2009; faculty grew 10%

This “administrative bloat” reflects regulatory compliance (special education, Title IX, accreditation), student services expansion, and revenue-generating activities (fundraising, athletics, research administration). Critics argue it raises costs without improving instruction.

## **Regulation and Policy**

### **K-12 Governance**

Education governance in America is radically decentralized:

**Federal:** Department of Education provides roughly 8% of K-12 funding with conditions attached. Major laws: - Elementary and Secondary Education Act (1965, reauthorized as Every Student Succeeds Act 2015): Title I funding for low-income schools - Individuals with Disabilities Education Act (1975): Requires free appropriate public education for disabled students - No Child Left Behind (2002, replaced by ESSA): Mandated testing and accountability

**State:** Constitutional responsibility for education. State boards of education set standards, approve curricula, license teachers, authorize charters, distribute state aid.

**Local:** roughly 13,000 school districts governed by elected or appointed boards. Districts hire superintendents, negotiate contracts, build schools, and make most operational decisions.

### **Higher Education Regulation**

Higher education operates in a different regulatory environment:

**Accreditation:** Regional accreditors (e.g., Higher Learning Commission, SACSCOC) serve as gatekeepers for federal aid eligibility. Accreditation is peer-review based and controversial—critics argue it protects incumbents and impedes innovation.

**Federal Aid Conditions:** Institutions accepting federal financial aid must comply with: - Title IX (gender equity) - Clery Act (campus safety reporting) - Gainful employment rules (for vocational programs) - 90/10 rule (for-profit revenue limits)

**State Authorization:** Each state licenses institutions to operate within its borders. Online education has complicated this—Arizona-based universities must be authorized in 50 states.

## Policy Debates

Current debates include:

- **School choice:** Whether to expand charters, vouchers, and education savings accounts
- **College affordability:** Free college proposals, student debt forgiveness, income-driven repayment
- **Accountability:** How to measure school and teacher performance
- **Curriculum:** Debates over “critical race theory,” sex education, and school library content
- **For-profit regulation:** Whether and how to regulate predatory for-profit colleges

## Trade Associations and Lobbying

Education is heavily lobbied from all directions:

### Major Trade Associations

Association	Members	Focus
National Education Association (NEA)	3 million teachers	Teacher interests, public education funding
American Federation of Teachers (AFT)	1.7 million	Teachers, support staff, higher ed
American Association of State Colleges and Universities	400 institutions	State university interests
Association of American Universities	69 research universities	Research funding, graduate education
National School Boards Association	roughly 14,000 districts	Local governance, federal policy
National Alliance for Public Charter Schools	Charter sector	Charter expansion, funding equity

Association	Members	Focus
American Council on Education	1,700 institutions	Higher education policy
Association of Community College Trustees	6,500 trustees	Community college interests

Source: National Center for Education Statistics, Digest of Education Statistics, 2023

## Lobbying Activity

Education lobbying is substantial:

**Teacher unions** (NEA, AFT): Among the largest political spenders. Primarily Democratic-aligned. Focus: compensation, class size, opposing vouchers and merit pay.

**For-profit colleges**: Heavy lobbying against regulatory restrictions. Career Education Colleges and Universities (CECU) represents the sector.

**Testing companies and publishers**: Lobby for testing mandates and procurement opportunities.

**Higher education**: Universities lobby for research funding, student aid, and regulatory flexibility. Elite universities defend tax-exempt endowments.

Political economy dynamics: Teacher unions oppose many reforms (charters, vouchers, evaluation) that threaten member jobs or working conditions. School choice advocates (supported by conservative foundations and some tech billionaires) push for competition. Higher education lobbies for subsidies while resisting accountability.

## Returns to Education

Despite its complexity, the American education system delivers substantial economic returns—at least on average.

### The College Premium

College graduates earn dramatically more than high school graduates:

- **College wage premium**: roughly 80% (college grads earn 80% more than high school grads)
- **Lifetime earnings gap**: \$1-1.5 million higher for bachelor's degree holders
- **Premium has grown**: From roughly 40% in 1980 to roughly 80% today

This growth reflects technological change favoring cognitive skills and stagnant demand for routine labor.

## Causal Estimates

How much of this gap reflects the causal effect of education (skills gained) versus selection (higherAbility people attend college)?

Careful studies using instrumental variables and natural experiments find: - **7-10% wage increase per year of schooling**—substantial but somewhat below naive estimates - **Effects are real, not just signaling:** Compulsory schooling laws, school construction, draft avoidance all show genuine productivity effects

The Mincer equation remains the workhorse model:

$$\ln W_i = \alpha + \beta S_i + \gamma_1 X_i + \gamma_2 X_i^2 + \varepsilon_i$$

where  $W$  is wages,  $S$  is schooling,  $X$  is experience. Typical estimates:  $\beta \approx 0.08 - 0.12$ .

## Returns Vary

Returns to education differ by: - **Level:** Highest returns in developing countries for primary school; in the US, highest for college - **Field:** STEM majors earn 50-100% more than humanities at mid-career - **Institution:** Selective college attendance raises earnings modestly (5-15%), with larger effects for disadvantaged students - **Completion:** Dropouts earn little more than high school graduates while accumulating debt

## Recent Trends

### 1. The For-Profit Collapse and Online Pivot

For-profit higher education boomed in the 2000s, enrolling 2+ million students by 2010. Then came collapse: Obama-era regulations, lawsuits, and bad publicity crushed enrollment. University of Phoenix fell from 460,000 students (2010) to under 100,000 (2023). ITT Tech and Corinthian Colleges closed entirely.

But online education didn't die—it migrated to nonprofits. Southern New Hampshire University (nonprofit) grew from 3,000 to 200,000 students. Traditional universities partnered with "OPMs" (Online Program Managers) to launch online degrees. The line between nonprofit and for-profit blurred.

### 2. The Testing Wars

Standardized testing faces unprecedented challenges: - **Test-optional admissions:** Post-COVID, many colleges dropped SAT/ACT requirements; some made the change permanent - **State testing backlash:** "Opt-out" movements; criticism of teaching to the test - **Alternative credentials:** Skills-based hiring, microcredentials, badges challenging degree monopoly

Yet testing remains entrenched: state accountability laws mandate it; the College Board and ACT adapt and persist.

**Note:**

**The Enrollment Cliff (2025+)**

Birth rates fell sharply during the 2008-09 recession. Those smaller cohorts are now reaching college age, creating a demographic “enrollment cliff” with 15% fewer high school graduates projected through 2037.

### **3. The Enrollment Cliff**

Demographics are about to reshape higher education:

- Birth rates fell during and after 2008-09 recession
- The “enrollment cliff” arrives roughly 2025: 15% fewer high school graduates
- Impact will concentrate on small private colleges and regional publics
- Elite institutions and community colleges relatively insulated

Predictions: 500-1,000 college closures or mergers in the next 15 years.

### **4. AI and the Future of Instruction**

ChatGPT’s arrival (2022) created immediate disruption: - **Cheating**: Traditional homework and essays easily automated - **Tutoring**: AI tutors (Khan Academy’s Khanmigo) promise personalized instruction at scale - **Assessment**: Shift toward in-class, supervised evaluation - **Teaching**: Potential to automate routine instruction; human teachers focus on facilitation

The magnitude of AI disruption remains uncertain. If AI tutoring replicates human tutoring effects (0.4 SD), it could transform education equity. Or it could become another oversold ed-tech fad.

### **5. Geographic Polarization**

Education has become politically polarized along geographic lines: - **Rural/suburban red states**: School choice expansion, curriculum restrictions, homeschool growth - **Urban/blue states**: Defend traditional public schools, expand early childhood, resist charters - **Sorting**: Families choose communities partly based on school politics

This polarization complicates national policy and may increase interstate variation.

## **Firm Profiles**

### **College Board**

**Quick Facts** - Headquarters: New York, NY - Founded: 1900 - Revenue: roughly \$1.5 billion - Employees: roughly 6,000 - Status: Nonprofit

The College Board is the most powerful organization in American education that most Americans have never thought about. It administers the SAT (2+ million test-takers annually), the PSAT (3.5 million), and Advanced Placement exams (5 million). It owns the CSS Profile used for financial aid at selective colleges.

The organization's nonprofit status belies its market power. There is no alternative to AP exams—a student who wants college credit for AP Biology must take the College Board's test. The SAT faces only one competitor (ACT); together they long held a duopoly on college admissions testing.

The College Board has faced criticism for: high test fees (\$60 per AP exam, \$60 for SAT), selling student data to colleges, and scoring delays. The test-optional movement threatens its SAT business, though AP remains strong.

CEO David Coleman (since 2012) previously led development of the Common Core standards, making him one of the most influential figures in American education—all from a position outside government.

## Pearson

**Quick Facts** - Headquarters: London, UK (major US operations) - Founded: 1844 (education focus since 1998) - Revenue: \$4.7 billion - Employees: roughly 20,000 - Stock: LSE: PSON

Pearson is the world's largest education company, touching almost every segment of American education: - **Testing**: Contracts for state assessments in numerous states; GED testing; NCLEX (nursing); professional certifications - **Higher Ed**: Major textbook publisher; owns Pearson+, digital platform with 4 million subscribers - **Online Learning**: Pearson Online Learning Services; virtual schools - **English Learning**: Largest provider of English language instruction globally

Pearson exemplifies the commercial penetration of public education. A single company may provide a state's curriculum, assessments, teacher training, and remediation materials—controlling the entire “value chain” of accountability.

The company has struggled financially as digital disruption hits textbooks. Revenue has declined from \$8 billion (2014) to under \$5 billion. Pearson has pivoted toward “direct-to-consumer” subscription models and workforce credentials.

Critics accuse Pearson of prioritizing profit over quality, citing testing errors and aggressive sales tactics. Supporters note that scale enables sophisticated assessment development smaller players cannot match.

## University of California System

**Quick Facts** - Headquarters: Oakland, CA - Founded: 1868 - Budget: roughly \$45 billion (system-wide, including medical centers) - Students: roughly 285,000 (10 campuses) - Faculty: roughly 24,000 - Status: Public

The University of California is the crown jewel of American public higher education—and a case study in the tensions facing elite public universities.

The system includes five top-50 research universities (Berkeley, UCLA, San Diego, Davis, Santa Barbara) and three national laboratories (Lawrence Berkeley, Lawrence Livermore, Los Alamos). UC faculty have won 71 Nobel Prizes.

UC pioneered the “California Master Plan” (1960), which stratified higher education: UC for the top 12.5% of high school graduates, Cal State for the top third, community colleges open to all. This system provided both excellence and access—though it has frayed as state funding declined.

The UC model is under strain: - **State funding collapsed**: From 78% of core funding (1990) to roughly 40% (2023) - **Tuition rose**: From essentially free (1960s) to \$14,000 in-state, \$44,000 out-of-state - **Out-of-state enrollment**: UC campuses admit more non-resident students (who pay full freight), angering California families - **Housing crisis**: California’s housing costs make UC campuses unaffordable for many students

UC remains a remarkable institution—world-class research combined with genuine socioeconomic diversity (40%+ of undergrads are Pell-eligible). But its future depends on political will to fund public higher education.

## Data Sources and Further Reading

### Key Data Sources

- **National Center for Education Statistics (NCES)**: Comprehensive data on schools, colleges, enrollment, spending, outcomes. Digest of Education Statistics is the essential reference.
- **BLS Occupational Employment and Wage Statistics**: Employment and wages by occupation and industry
- **IPEDS (Integrated Postsecondary Education Data System)**: Detailed data on every college receiving federal aid
- **Census Bureau**: School enrollment, educational attainment
- **College Scorecard**: Federal tool with college-specific earnings and cost data
- **NAEP (Nation’s Report Card)**: National and state test score trends over time
- **State education agency websites**: State-specific enrollment, funding, and performance data

### Further Reading

**Accessible** - Dynarski, Susan, and Judith Scott-Clayton (2013). “Financial Aid Policy: Lessons from Research.” Future of Children. Clear summary of financial aid evidence. - Carey, Kevin (2015). The End of College. Argument that technology will disrupt higher education.

**Intermediate** - Hanushek, Eric A., and Ludger Woessmann (2015). The Knowledge Capital of Nations. Education quality and economic growth. - Deming, David, Claudia Goldin, and Lawrence Katz (2012). “The For-Profit Postsecondary School Sector.” Journal of Economic Perspectives. Anatomy of the for-profit boom. - Chetty, Raj, John Friedman, and Jonah Rockoff (2014). “Measuring the Impacts of Teachers.” American Economic Review. Landmark study on teacher quality.

**Industry and Business** - Brill, Steven (2011). Class Warfare. Inside account of education reform politics. - Marcus, Jon. Coverage in The Hechinger Report. Best ongoing education journalism. - Chronicle of Higher Education. Essential trade publication for higher ed.

## Exercises

### Review Questions

1. K-12 public education is funded roughly 45% from local property taxes, 47% from state sources, and 8% from federal sources. The chapter notes that New York spends \$29,000 per pupil while Utah spends \$9,000—a ratio exceeding 2:1 even after cost-of-living adjustment. Explain how the reliance on local property taxes creates this inequality. Why have state equalization formulas and court decisions (beginning with *Serrano v. Priest* in 1971) not fully closed the interstate spending gap?
2. The chapter describes a bifurcated higher education labor market: roughly 30% tenure-track faculty earning median salaries around \$100,000 and roughly 70% contingent faculty paid \$3,000-5,000 per course with no benefits or job security. Explain the economic incentives that led universities to shift toward contingent labor since the 1990s. What are the consequences for teaching quality, faculty welfare, and the attractiveness of academic careers to talented graduates?
3. The for-profit higher education sector boomed in the 2000s, enrolling 2+ million students by 2010, then collapsed under Obama-era regulations, lawsuits, and bad publicity. The chapter notes that many for-profit colleges clustered at 89% federal revenue—just below the 90/10 rule threshold. What does this clustering reveal about the sector’s underlying business model and its dependence on federal financial aid rather than labor market value of its credentials?
4. The College Board is technically a nonprofit but generates \$1.5 billion in annual revenue, has no competitor for AP exams (5 million test-takers), and charges \$60 per SAT and \$60 per AP exam. Using economic concepts (monopoly power, barriers to entry, regulatory capture), explain how a nonprofit organization can exercise market power comparable to a for-profit monopolist. Does the College Board’s position serve students’ interests, or does it exploit a captive market?
5. Chetty, Friedman, and Rockoff (2014) found that replacing a bottom-5% teacher with an average teacher raises students’ lifetime earnings by roughly \$250,000 per classroom. Yet teacher salaries show extreme wage compression: a stellar teacher earns perhaps 20% more than a mediocre colleague, compared to 2:1 or 3:1 ratios in the private sector. What economic and institutional factors—union contracts, public sector pay scales, difficulty measuring teacher effectiveness—explain why the labor market does not reward teacher quality more strongly?
6. The chapter describes a demographic “enrollment cliff” arriving around 2025, with 15% fewer high school graduates projected through 2037 as smaller cohorts born during the 2008-09 recession reach college age. The chapter predicts 500-1,000 college closures or mergers over 15 years. Which types of institutions will

be most affected, and why are elite universities (with strong demand and large endowments) and community colleges (with local service missions and open access) relatively insulated?

7. Administrative positions in K-12 grew 88% from 1992-2019, while teachers grew 60% and enrollment grew only 19%. In higher education, administrative positions grew 60% from 1993-2009 while faculty grew 10%. The chapter attributes this to regulatory compliance (special education, Title IX, accreditation), student services expansion, and revenue-generating activities. Evaluate whether this “administrative bloat” represents wasteful cost growth or a necessary response to increasingly complex student needs and accountability requirements.

## **Data Exercises**

8. Using the NCES Digest of Education Statistics (<https://nces.ed.gov/programs/digest/>), download per-pupil expenditure data by state for the most recent year available. Create a ranked bar chart or choropleth map showing spending variation. Then, using NAEP (Nation’s Report Card) 8th-grade mathematics scores from the same source, test whether higher per-pupil spending correlates with higher state-level test scores. What confounding factors—cost of living, student demographics, state education policies—might explain your findings? Does money “matter” for educational outcomes?
9. Using the College Scorecard (<https://collegescorecard.ed.gov/>) downloadable data files, compare median earnings 10 years after enrollment for graduates of for-profit institutions versus public community colleges within the same state. Select three states with significant for-profit enrollment (e.g., Arizona, Florida, California). Control for field of study where possible. Do the data support the chapter’s skepticism about for-profit college outcomes, or do some for-profit programs deliver competitive returns?
10. Using IPEDS data (<https://nces.ed.gov/ipeds/>), track the ratio of full-time faculty to full-time-equivalent enrollment at public four-year universities from 2002 to the most recent year available. Has the shift toward contingent faculty described in the chapter continued? Compare this ratio for R1 research universities (Carnegie classification) versus regional comprehensive universities. Which type of institution has relied more heavily on adjunct and non-tenure-track instructors?

## **Deeper Investigation**

11. The chapter presents the Mincer equation and estimates a 7-10% wage increase per year of schooling. Using microdata from the Current Population Survey (available through IPUMS-CPS at <https://cps.ipums.org/cps/>), estimate your own Mincer equation ( $\ln W_i = \alpha + \beta S_i + \gamma_1 X_i + \gamma_2 X_i^2 + \varepsilon_i$ ) for the most recent year of data. Then extend the analysis: estimate separate returns to education by gender, race/ethnicity, and Census region. Do the returns to a bachelor’s degree vary significantly across these categories? What does this heterogeneity tell you about the universality of the “college premium” described in the chap-

ter? Discuss potential sources of bias in your estimates and how instrumental variable approaches might improve identification.

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Chapter 15 | Education The American Economy: A Structural Geography Draft v1.1  
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# Chapter 16. Agriculture and Food Production

Drive across Iowa in July and you will see corn in every direction—millions of acres of it, planted in rows so precise they look machined, tended by GPS-guided tractors that steer themselves to sub-inch accuracy. You will not see many people. A single farm operator, working 2,000 acres alone with \$1 million in equipment, can produce enough corn to feed 2,500 people for a year. American agriculture feeds roughly 330 million Americans and exports enough to feed hundreds of millions more. It does this with fewer than 2.6 million farm workers—less than 2% of the labor force. No other sector in the economy has achieved such an extraordinary ratio of output to labor. And no other sector so thoroughly contradicts its own popular image: the romantic small family farm persists in the national imagination, but the reality is an industrial system dominated by large operations, multinational corporations, and commodity markets that set prices in Chicago and move grain across oceans.

The paradox of American agriculture is abundance and invisibility. The sector contributes barely 1% of GDP directly, yet it anchors a food system worth over \$1.3 trillion—spanning processing plants, trucking fleets, grocery chains, and restaurant kitchens. It shapes the landscape of entire states, dominates the politics of rural America, and consumes more land than any other human activity on the continent. Agriculture is the foundation on which the rest of the economy was built. Understanding how it works today—who grows what, where, and under what economic pressures—reveals a system that is simultaneously one of America’s greatest achievements and one of its most concentrated industries.

## Overview

### □ Info:

#### **The Farm Economy vs. the Food Economy**

Agriculture’s direct GDP contribution (~1%, roughly \$200 billion) vastly understates its economic footprint. The broader food and agriculture system—including food processing, packaging, transportation, wholesale and retail distribution, and food service—accounts for roughly 5% of GDP and over \$1.3 trillion in economic activity. About 21 million Americans work somewhere in this chain, even though fewer than 2.6 million work on farms.

## Size and Scope

- **Farm-level GDP contribution (2023):** roughly \$200 billion (crops ~\$140B, livestock ~\$60B in net value added)
- **Broader food system output:** roughly \$1.3 trillion
- **Farm cash receipts (2023):** roughly \$510 billion (crops ~\$275B, livestock ~\$235B)
- **Farm employment:** roughly 2.6 million (farm operators and hired workers)
- **Broader food system employment:** roughly 21 million
- **Number of farms:** roughly 2 million (USDA definition: any place that produced or sold \$1,000+ of agricultural products)
- **Total farmland:** roughly 895 million acres (about 39% of U.S. land area)
- **Agricultural exports (2023):** roughly \$170 billion

Farm cash receipts—the gross revenue farmers receive for crops and livestock—totaled roughly \$510 billion in 2023. But net farm income, what remains after paying for inputs like seed, fertilizer, fuel, labor, and equipment, was roughly \$155 billion. The difference reflects the capital- and input-intensive nature of modern farming: for every dollar of crop revenue, farmers spend 70-80 cents on inputs.

## Key Subsectors

Subsector	Cash Receipts (2023)	Share	Key States
Cattle and calves	\$93 billion	18%	TX, KS, NE
Corn	\$87 billion	17%	IA, IL, NE
Soybeans	\$53 billion	10%	IL, IA, MN
Dairy	\$47 billion	9%	CA, WI, ID
Broilers (chicken)	\$40 billion	8%	GA, AR, AL
Hogs	\$28 billion	5%	IA, MN, NC
Wheat	\$14 billion	3%	KS, ND, MT
Fruits and nuts	\$35 billion	7%	CA, FL, WA
Vegetables	\$22 billion	4%	CA, AZ, FL
Cotton	\$8 billion	2%	TX, GA, MS
Other	\$83 billion	17%	Various

Source: USDA Economic Research Service, Farm Income and Wealth Statistics, 2023

[Figure: Figure 16.1: U.S. farm cash receipts by commodity. Cattle, corn, and soybeans dominate, but the sector is remarkably diverse. Source: USDA ERS (2023)]

[Figure: Figure 16.2: Total farm cash receipts, 2000-2023. Receipts surged after 2020 due to commodity price spikes, then partially retreated. Source: USDA ERS]

# How the Industry Works

## Revenue Streams: Where Does the Money Come From?

Farm revenue flows through several channels, each with its own pricing logic.

### Commodity crops (corn, soybeans, wheat, cotton)

Most row crops are commodities—interchangeable units priced on futures exchanges. The Chicago Board of Trade sets benchmark prices for corn, soybeans, and wheat; farmers are price-takers. A corn farmer in Iowa has virtually no ability to charge a premium for her corn over her neighbor's. Revenue depends on two things: yield per acre (driven by weather, seed genetics, and farming practices) and the commodity price (driven by global supply and demand).

Farmers manage price risk through futures contracts and crop insurance. The federal crop insurance program, subsidized by the government, covers roughly 90% of major crop acreage. In a bad year, crop insurance payments can exceed \$20 billion.

### Livestock

Cattle, hogs, and poultry follow different models. Cattle ranchers typically sell calves to feedlots, which fatten them on corn for 4-6 months before selling to packers. Hog operations are increasingly vertically integrated, with large companies like Smithfield owning animals from birth to slaughter. Poultry is the most integrated: companies like Tyson and Perdue own the birds and the processing plants; contract growers simply provide the labor and the chicken houses.

### Specialty crops (fruits, vegetables, nuts)

Higher-value crops command premium prices but require more labor, more specialized knowledge, and more capital per acre. California's Central Valley produces the vast majority of U.S. almonds, pistachios, strawberries, and lettuce. These crops depend heavily on irrigation and seasonal labor.

### Government payments

Federal payments to farmers totaled roughly \$15-20 billion annually in recent years (excluding the anomalous COVID-era payments of \$45+ billion in 2020). These include commodity price support programs, conservation payments, and disaster assistance. Government payments represent roughly 3-4% of gross farm income in a normal year but can be much higher for specific crops and regions.

## Cost Structure: Where Does the Money Go?

Farm production expenses totaled roughly \$430 billion in 2023. The major cost categories:

Cost Category	Amount	Share
Feed	\$75 billion	17%
Farm services (custom work, labor)	\$55 billion	13%
Fertilizer and chemicals	\$50 billion	12%

Cost Category	Amount	Share
Interest and rent	\$45 billion	10%
Seed	\$30 billion	7%
Fuel and oil	\$22 billion	5%
Livestock purchases	\$40 billion	9%
Equipment and repairs	\$35 billion	8%
Other	\$78 billion	19%

Source: USDA ERS, Farm Income and Wealth Statistics, 2023

Land is the largest capital asset. U.S. farmland was worth roughly \$3.5 trillion in 2023, with per-acre values ranging from under \$1,000 in parts of the arid West to over \$15,000 in prime Iowa cropland. Cash rents for Iowa farmland average \$250-300 per acre; a 2,000-acre corn-soybean operation might pay \$500,000 or more in annual rent alone.

#### Note:

#### **The Input Cost Squeeze**

Farmers face a persistent structural problem: the prices they pay for inputs (fertilizer, seed, equipment, land) tend to rise steadily, while the prices they receive for commodities fluctuate unpredictably. In the long run, commodity prices have been roughly flat in real terms, meaning farmers must constantly increase productivity just to stay even. This “cost-price squeeze” is the fundamental economic force driving farm consolidation.

### **The Farm Bill**

The Farm Bill, renewed approximately every five years, is the single most important piece of agricultural legislation. The most recent version (2018) authorized roughly \$430 billion in spending over five years, but the vast majority—roughly 75-80%—goes to nutrition programs (primarily SNAP, formerly food stamps), not to farm subsidies. The agricultural title covers commodity programs, crop insurance, conservation, trade promotion, and rural development.

The Farm Bill’s commodity programs provide a safety net through two main mechanisms: Price Loss Coverage (PLC), which pays farmers when commodity prices fall below reference levels, and Agriculture Risk Coverage (ARC), which pays when revenue falls below historical averages. Farmers choose between the two for each crop on each farm.

### **Vertical Integration in Meat Processing**

The meat industry has become strikingly vertical. In poultry, the integrator model is nearly universal: a company like Tyson owns the hatcheries, feed mills, and processing plants. Contract growers—Independent farmers who raise the birds—invest \$500,000-\$1 million in chicken houses but own neither the birds nor the feed. They are paid per pound of weight gain, with bonuses and penalties based on performance

relative to other growers. The grower bears the capital risk; the integrator controls the margins.

Hog production has followed a similar path. Smithfield Foods (owned by China's WH Group since 2013) controls operations from genetics to grocery shelf. In beef, vertical integration is less complete—cow-calf ranching remains mostly independent—but the packing segment is extraordinarily concentrated.

## Industry Structure

### Farm Size Distribution

The USDA counts roughly 2 million farms, but this number is misleading. The vast majority of farms are small, and most agricultural output comes from a small number of large operations.

Farm Size (Annual Sales)	Number of Farms	Share of Farms	Share of Output
Less than \$10,000	1,100,000	55%	1%
\$10,000 - \$249,999	550,000	27%	8%
\$250,000 - \$499,999	120,000	6%	7%
\$500,000 - \$999,999	100,000	5%	11%
\$1 million+	130,000	7%	73%

Source: USDA Census of Agriculture, 2022

[Figure: Figure 16.3: The 7% of U.S. farms with annual sales above \$1 million produce 73% of all agricultural output. Most farms are small, part-time operations. Source: USDA Census of Agriculture (2022)]

The 1.1 million farms with sales under \$10,000 are mostly rural residences with some agricultural activity—hobby farms, horse properties, small timber tracts. Their operators typically earn most of their income from off-farm jobs. The 130,000 farms with sales above \$1 million are the commercial core: these are sophisticated businesses managing thousands of acres or thousands of head of livestock.

### Major Agribusiness Firms

Agriculture is flanked by highly concentrated industries on both sides—the firms that sell inputs to farmers and the firms that buy and process what farmers grow.

### Grain Trading and Processing

Company	Revenue	Headquarters	Key Business
Cargill	\$160 billion	Wayzata, MN	Grain trading, meat, food ingredients

Company	Revenue	Headquarters	Key Business
Archer Daniels Midland (ADM)	\$94 billion	Chicago, IL	Grain processing, oilseeds, ethanol
Bunge	\$56 billion	St. Louis, MO	Grain trading, oilseed processing
Louis Dreyfus	\$50 billion	Rotterdam (US ops)	Grain, oilseeds, sugar

Source: Company filings and estimates, FY 2023

These four firms—known as the “ABCD” traders (ADM, Bunge, Cargill, Louis Dreyfus)—dominate global grain flows. They buy from millions of farmers, store grain in elevators spanning the Midwest, and sell to buyers worldwide.

## Meat Processing

Company	Revenue	Headquarters	Key Business
JBS USA	\$53 billion (US)	Greeley, CO (Brazilian parent)	Beef, pork, poultry
Tyson Foods	\$53 billion	Springdale, AR	Chicken, beef, pork
Cargill Protein	~\$20 billion	Wichita, KS	Beef, poultry
Smithfield Foods	~\$15 billion	Smithfield, VA	Pork (owned by WH Group)
Hormel Foods	\$12 billion	Austin, MN	Branded meats

Source: Company filings, FY 2023

### □ Note:

#### The Meatpacking Bottleneck

Four companies—Tyson, JBS, Cargill, and National Beef—control over 80% of U.S. beef slaughter. Similar concentration exists in pork (roughly 70% by top four) and poultry (roughly 54% by top four). This concentration gives packers outsized bargaining power over both the ranchers who sell them cattle and the consumers who buy the finished product. During the 2020-2021 period, meatpacker margins surged while cattle ranchers saw little benefit from rising retail prices.

## Farm Inputs

Company	Revenue	Headquarters	Key Business
Deere & Company	\$55 billion	Moline, IL	Farm equipment, precision ag
AGCO Corporation	\$14 billion	Duluth, GA	Farm equipment (Massey Ferguson, Fendt)

Company	Revenue	Headquarters	Key Business
Corteva Agriscience	\$17 billion	Indianapolis, IN	Seeds, crop protection
Bayer Crop Science	\$25 billion (global)	St. Louis, MO (US ops)	Seeds (Monsanto), herbicides
Nutrien	\$29 billion	Saskatoon (major US ops)	Fertilizer, retail
CF Industries	\$6 billion	Deerfield, IL	Nitrogen fertilizer

Source: Company filings, FY 2023

The seed and chemical market was transformed by a wave of megamergers: Dow and DuPont merged, then spun off Corteva; Bayer acquired Monsanto for \$63 billion (2018); ChemChina acquired Syngenta. Three companies now control over 60% of the global commercial seed market.

## Geographic Distribution

American agriculture is organized by geography as rigidly as any sector in the economy. Climate, soil, water, and topography dictate what grows where, creating distinct agricultural regions that have persisted for over a century.

[Figure: Figure 16.4: Major U.S. agricultural regions. Each region specializes in commodities suited to its climate, soil, and water resources. Source: USDA ERS]

### **The Corn Belt (Iowa, Illinois, Indiana, Ohio, southern Minnesota, eastern Nebraska)**

The heart of American agriculture. Deep, black prairie soils and reliable summer rainfall make this the most productive cropland on Earth. Iowa alone produces more corn than most countries. The Corn Belt produces roughly 60% of U.S. corn and 55% of U.S. soybeans, typically in annual rotation (corn one year, soybeans the next). Farmland here is the most expensive in the country—\$10,000-\$15,000 per acre—and is intensively managed.

### **The Great Plains (Kansas, the Dakotas, Montana, Oklahoma, western Nebraska, western Texas)**

Drier than the Corn Belt, the Great Plains specialize in wheat (Kansas is the top wheat state), grain sorghum, and cattle. The western Plains are dominated by ranching—vast ranches running cattle on grassland too dry to farm. Eastern portions, particularly where the Ogallala Aquifer allows irrigation, grow corn and cotton. The Ogallala, which underlies portions of eight states, is being depleted faster than it recharges, threatening the long-term viability of irrigated agriculture in the region.

## **California's Central Valley**

The most productive agricultural region in the country by dollar value. The Central Valley—a 450-mile trough between the Sierra Nevada and the Coast Ranges—produces over 250 crops, including nearly all U.S.-grown almonds, pistachios, walnuts, processing tomatoes, and table grapes. The valley relies almost entirely on irrigation, drawing from a complex system of federal and state water projects. Chronic water scarcity and recurring drought are existential threats: in drought years, hundreds of thousands of acres are fallowed.

## **The Southeast (Georgia, Arkansas, Alabama, Mississippi, North Carolina)**

The South leads in poultry production—Georgia is the number-one broiler state. Arkansas and Alabama rank second and third. The region also produces cotton, peanuts, tobacco (declining), and timber. North Carolina is the second-largest hog state (after Iowa), with large-scale confined hog operations concentrated in the eastern part of the state.

## **The Delta (Mississippi Delta, Arkansas, Louisiana)**

The alluvial floodplain of the Mississippi River produces rice, cotton, soybeans, and catfish (Mississippi leads U.S. catfish production). The Delta's flat topography and heavy clay soils are well-suited to rice paddies, making Arkansas the top rice-producing state.

## **Texas**

Texas leads the nation in cattle, cotton, and total farm cash receipts. The state's agricultural geography is diverse: cattle ranching across much of the state, cotton in the Panhandle and South Plains (irrigated from the Ogallala), citrus in the Rio Grande Valley, and rice along the Gulf Coast.

## **The Workforce**

### **Farm Operators**

Of the roughly 3.4 million farm operators counted by the USDA (many farms have multiple operators), the average age is 58—and rising. Fewer young people enter farming, partly because the capital requirements are enormous: a viable commercial row-crop operation in the Corn Belt requires \$2-5 million in land and equipment.

Most small-farm operators work off-farm jobs. Among farms with sales under \$250,000, roughly 75% of household income comes from non-farm sources. Farming, for the majority of America's farm operators, is a supplementary activity, not a primary occupation.

## Hired Farm Workers

Roughly 1.1 million workers are hired for farm labor, including roughly 250,000 workers on H-2A temporary agricultural visas (a number that has roughly tripled since 2015). The H-2A program allows employers to bring foreign workers for seasonal agricultural jobs when they cannot find sufficient domestic labor.

Hired farm workers are disproportionately Hispanic (roughly 75%) and foreign-born (roughly 60%). Many work seasonally, following harvest cycles from south to north. Wages for field workers average \$15-18 per hour, though piece-rate workers picking high-value crops can earn more. Farm labor is physically demanding, often performed in extreme heat, and carries higher injury rates than most occupations.

### Info:

#### The H-2A Visa Program

The H-2A temporary agricultural worker program has become the primary legal channel for seasonal farm labor. Employers must demonstrate that domestic workers are unavailable and must provide housing, transportation, and wages at or above the “adverse effect wage rate” (ranging from roughly \$14 to \$19/hour depending on the state). H-2A usage surged from roughly 80,000 certified positions in 2015 to over 370,000 in 2023, reflecting both tightening labor markets and increased enforcement against unauthorized workers.

## Meatpacking Workers

Meatpacking plants employ roughly 500,000 workers in some of the most physically demanding and dangerous jobs in the economy. The industry relies heavily on immigrant labor—plants in towns like Lexington, Nebraska; Marshalltown, Iowa; and Gainesville, Georgia have transformed the demographics of rural communities. Meatpacking wages average \$16-20 per hour, and the work involves standing for long shifts performing repetitive cutting motions in cold, wet environments. Injury rates, while improved from the 1990s, remain well above the manufacturing average.

## Key Occupations

Occupation	Employment	Median Wage
Farmers, ranchers, farm managers	970,000	Varies widely
Farmworkers and laborers (crops)	570,000	\$33,000
Farmworkers (livestock)	260,000	\$32,000
Agricultural equipment operators	50,000	\$36,000
Meat, poultry, fish cutters	500,000	\$35,000
Food batchmakers, processing	200,000	\$37,000
Agricultural inspectors	20,000	\$46,000

Source: Bureau of Labor Statistics, Occupational Employment and Wage Statistics, 2023

# Regulation and Policy

## Key Regulatory Agencies

### USDA (United States Department of Agriculture)

The primary agency governing agriculture. The USDA has over 100,000 employees and a budget exceeding \$200 billion (mostly nutrition programs). Key sub-agencies include:

- **Farm Service Agency (FSA):** Administers commodity programs, crop insurance, and farm loans
- **Natural Resources Conservation Service (NRCS):** Conservation programs and technical assistance
- **Agricultural Marketing Service (AMS):** Marketing orders, grading, organic certification
- **Animal and Plant Health Inspection Service (APHIS):** Animal disease, plant pests, agricultural imports
- **Food Safety and Inspection Service (FSIS):** Meat and poultry inspection

### EPA (Environmental Protection Agency)

Regulates pesticide registration and use, agricultural water discharges, and air emissions from livestock operations. The EPA's regulation of atrazine, glyphosate, and other widely used herbicides directly affects farming practices and costs.

### FDA (Food and Drug Administration)

Regulates food safety for all products except meat and poultry (which fall under USDA/FSIS). The Food Safety Modernization Act (2011) shifted FDA's approach from responding to contamination to preventing it.

## The Farm Bill: Structure and Spending

The Farm Bill is less a single policy than a massive legislative package bundling disparate programs. Its major titles:

Title	Spending (5-year est.)	Share
Nutrition (SNAP)	\$340 billion	76%
Crop insurance	\$47 billion	11%
Commodity programs	\$20 billion	5%
Conservation	\$28 billion	6%
Trade	\$4 billion	1%
Other (rural dev, research, etc.)	\$5 billion	1%

Source: Congressional Budget Office, 2018 Farm Bill baseline

### ☐ Key Point:

#### Why Nutrition Dominates the Farm Bill

The political alliance between farm-state legislators (who want commodity and crop insurance programs) and urban legislators (who want nutrition assistance) has sustained the Farm Bill for decades. Neither group has enough votes alone to pass its priorities. By bundling SNAP with farm

subsidies, the coalition assembles a majority. This is why the Farm Bill—nominally about agriculture—is primarily a nutrition spending bill.

## Agricultural Subsidies and Their Distribution

Federal agricultural subsidies—including commodity payments, crop insurance premium subsidies, and conservation payments—flow disproportionately to large operations. The top 10% of farm subsidy recipients receive roughly 70% of all payments. Subsidies concentrate in the Corn Belt and Great Plains, where commodity crops dominate. Fruit and vegetable growers—the producers of what nutritionists want Americans to eat more of—receive relatively little federal support.

## Trade Associations and Lobbying

### Major Trade Associations

Association	Members	Focus
American Farm Bureau Federation	5.5 million member families	Broad agricultural policy
National Cattlemen's Beef Association	175,000 cattlemen	Beef industry interests
National Corn Growers Association	300,000 corn farmers	Corn policy, ethanol
American Soybean Association	500,000 soybean farmers	Soybean trade, biodiesel
National Pork Producers Council	60,000 pork producers	Pork industry regulation
National Milk Producers Federation	Dairy cooperatives	Dairy pricing, trade
International Dairy Foods Association	Dairy processors	Dairy regulation

Source: Association websites and public filings, 2024

## Political Influence

The farm lobby wields political power disproportionate to agriculture's share of the economy. Several factors explain this:

**Geographic advantage.** Farm states are overrepresented in the Senate. Wyoming (population 580,000) and California (population 39 million) each get two senators, giving rural interests outsized legislative influence. The Senate Agriculture Committee is dominated by members from farm states.

**Commodity checkoff programs.** Mandatory assessments on commodity sales (e.g., \$1 per head of cattle sold) fund promotion and research boards like the National

Dairy Promotion Board and the Beef Checkoff. These programs generate hundreds of millions in annual revenue for commodity promotion.

**Ethanol mandate.** The Renewable Fuel Standard requires blending roughly 15 billion gallons of corn ethanol into the gasoline supply annually, consuming roughly 35-40% of the U.S. corn crop. This mandate is fiercely defended by corn-state legislators, as it provides a guaranteed demand floor for corn.

Agricultural lobbying spending totals roughly \$160 million annually at the federal level, with the American Farm Bureau, crop-specific groups, and individual agribusiness firms among the top spenders.

## Recent Trends

### 1. Precision Agriculture and Farm Technology

Modern farming is increasingly a technology business. GPS-guided auto-steer tractors are standard on commercial farms. Variable-rate technology adjusts seed and fertilizer application acre by acre based on soil data and yield maps. Drones monitor crop health. Sensors track soil moisture in real time.

John Deere has positioned itself as an agricultural technology company as much as an equipment manufacturer. Its precision agriculture platform collects data from millions of acres, creating a digital ecosystem that competitors struggle to match. The data raises questions about who owns farm data and whether equipment manufacturers' control over software gives them excessive power over farmers—a conflict that has fueled the “right to repair” movement.

### 2. Consolidation of Farmland

The number of farms has declined from 6.8 million in 1935 to roughly 2 million today, while average farm size has more than tripled. This consolidation continues: mid-size farms (sales of \$250,000 to \$999,999) are being squeezed out, with acreage flowing to the largest operations. Institutional investors, including pension funds, REITs, and family offices, have entered farmland markets, driving up prices and changing the ownership structure of rural America. Bill Gates has become the largest private farmland owner in the country, with roughly 270,000 acres.

### 3. Climate Change and Agricultural Adaptation

Climate change is already reshaping American agriculture. Growing seasons have lengthened in northern states, allowing corn production to push into areas previously too cold. But heat stress, drought, and extreme weather events impose mounting costs: prevented planting claims, crop insurance payouts, and livestock losses have all trended upward. The Ogallala Aquifer's depletion compounds the problem in the Great Plains. Farmers are adapting through drought-tolerant seed varieties, cover crops, no-till farming, and shifting crop mixes, but the pace of climate change may outrun adaptation in some regions.

## **4. Alternative Proteins and Lab-Grown Meat**

Plant-based meat companies (Beyond Meat, Impossible Foods) and cultivated meat startups have attracted billions in investment, though consumer adoption has plateaued after initial enthusiasm. Plant-based meat represents less than 1.5% of retail meat sales by volume. Cultivated (lab-grown) meat received its first USDA approvals in 2023 but remains far from commercial scale. The traditional meat industry has responded with both defensive lobbying (state-level labeling laws restricting use of the word “meat” for plant-based products) and its own product development.

## **5. Rising Input Costs and Farm Financial Stress**

Fertilizer prices spiked sharply in 2022 following the Russia-Ukraine war (Russia and Belarus are major fertilizer exporters), and while they have retreated, they remain elevated relative to pre-2020 levels. Equipment costs, land rents, and interest rates have also risen. Meanwhile, commodity prices fell from their 2022 peaks. The result is a cost-price squeeze that has reduced net farm income from its 2022 record and placed financial pressure on operations that expanded during the boom years.

## **Firm Profiles**

### **Cargill**

**Quick Facts** - Headquarters: Wayzata, Minnesota - Founded: 1865 - Revenue: \$160 billion (FY 2023) - Employees: roughly 160,000 - Ownership: Private (Cargill and MacMillan families)

Cargill is the largest private company in the United States by revenue—and one of the most powerful firms most Americans have never heard of. Founded by William Cargill in 1865 as a single grain warehouse in Conover, Iowa, the company has grown into a global colossus that trades, processes, and transports agricultural commodities across 70 countries.

Cargill’s business spans the agricultural supply chain: it buys grain from farmers at country elevators across the Midwest, transports it by barge, rail, and ship, processes it into animal feed, corn sweeteners, ethanol, and cooking oils, and sells the finished products to food manufacturers and livestock operations worldwide. The company is also a major meat processor (the third-largest U.S. beef packer) and a significant player in financial trading of agricultural commodities.

Cargill’s private ownership is central to its strategy. Freed from quarterly earnings pressure, the company can take long-term positions, absorb cyclical losses, and invest counter-cyclically. The Cargill and MacMillan families, descendants of the founder, own roughly 88% of the company. This structure has sustained the business through 160 years of commodity booms and busts. But it also limits transparency: Cargill discloses far less than publicly traded peers, and its environmental and labor practices face growing scrutiny from activists and policymakers.

## **John Deere (Deere & Company)**

**Quick Facts** - Headquarters: Moline, Illinois - Founded: 1837 - Revenue: \$55 billion (FY 2023) - Employees: roughly 83,000 - Market Cap: roughly \$105 billion

John Deere is synonymous with American farming. The company's green-and-yellow tractors are as iconic as the landscape they work, and Deere commands roughly 60% of the U.S. large agricultural equipment market—a dominance that approaches monopoly in some categories.

Deere's competitive advantage rests on three pillars. First, a dealer network of roughly 2,000 locations that provides financing, parts, and service—a relationship infrastructure no competitor can easily replicate. Second, product quality and brand loyalty built over nearly two centuries. Third, and increasingly important, a precision agriculture technology platform that collects and analyzes data from Deere equipment operating on millions of acres.

The technology strategy is both Deere's greatest growth opportunity and its most contentious feature. The company's digital ecosystem—sensors, software, GPS guidance, and data analytics—promises to make farming more efficient. But farmers complain that software locks on Deere equipment prevent independent repair, force reliance on expensive dealer service, and raise questions about data ownership. The "right to repair" movement, which has won legislative victories in several states, targets Deere more than any other company. In 2023, Deere signed a memorandum of understanding with the American Farm Bureau Federation committing to expand access to repair tools and software, though critics argue the concessions are insufficient.

## **Tyson Foods**

**Quick Facts** - Headquarters: Springdale, Arkansas - Founded: 1935 - Revenue: \$53 billion (FY 2023) - Employees: roughly 142,000 - Market Cap: roughly \$18 billion

Tyson Foods is the largest U.S. meat and poultry company, processing roughly one in five pounds of all chicken, beef, and pork produced in the country. The company traces its origins to John W. Tyson, who began hauling chickens from Arkansas to markets in the Midwest during the Depression.

Tyson's scale is staggering: the company slaughters roughly 35 million chickens, 125,000 cattle, and 415,000 hogs per week. Its operations span the supply chain from animal feed mills and hatcheries to processing plants and branded consumer products (Tyson, Jimmy Dean, Hillshire Farm, Ball Park).

The poultry segment, Tyson's original business, operates on the integrator model: Tyson owns the birds, supplies the feed, and processes the meat, while roughly 3,700 contract growers provide the labor and facilities. This model keeps capital requirements off Tyson's balance sheet while maintaining control over quality and volume.

Tyson has faced recurring controversies: antitrust investigations into price-fixing (the company paid over \$220 million to settle chicken price-fixing claims in 2021), work-

place safety issues (particularly during the COVID-19 pandemic, when meatpacking plants became major infection sites), environmental complaints about water pollution from poultry operations, and labor practices at its processing plants. The company has invested in automation to reduce labor dependence and improve working conditions, but the nature of meat processing makes full automation elusive.

## Key Takeaways

1. **American agriculture is extraordinarily productive but economically small.** Fewer than 2% of workers farm, and agriculture's direct GDP share is roughly 1%—but the broader food system employing 21 million people and generating over \$1.3 trillion depends on what those farms produce.
2. **Most farms are small; most production comes from large farms.** The 7% of farms with annual sales above \$1 million produce 73% of output. The “average farm” is a statistical fiction that obscures a deeply bifurcated industry.
3. **Agriculture is flanked by concentrated industries.** Farmers operate in a competitive commodity market, but the firms that sell them inputs (seeds, chemicals, equipment) and the firms that buy their output (grain traders, meat packers) are highly concentrated, giving those intermediaries disproportionate market power.
4. **Geography dictates what grows where.** The Corn Belt, Great Plains, Central Valley, and Southeast each specialize based on climate, soil, and water—a pattern that has persisted for generations and will be disrupted by climate change.
5. **The Farm Bill is mostly a nutrition bill.** Three-quarters of Farm Bill spending goes to SNAP and other nutrition programs, not farm subsidies. The political coalition that sustains this arrangement—urban legislators backing nutrition, rural legislators backing farm programs—has held for decades.
6. **Technology is transforming farming faster than the public realizes.** Precision agriculture, GPS-guided equipment, data analytics, and genetic technology have made farming a high-tech industry—and have raised new questions about data ownership, equipment repair, and the relationship between farmers and technology companies.
7. **The agricultural workforce depends heavily on immigrant labor.** From field crops to meatpacking, immigrant workers—both authorized and unauthorized—perform much of the physical labor in American food production. The H-2A visa program has grown dramatically but remains contentious.

## Data Sources and Further Reading

### Key Data Sources

- **USDA Economic Research Service (ERS):** Farm income, food spending, trade data, and rural economics. The authoritative source for agricultural economics.

- **USDA National Agricultural Statistics Service (NASS):** Crop production, acreage, livestock inventories, prices, and the Census of Agriculture (conducted every five years).
- **Bureau of Labor Statistics:** Agricultural employment and wages data through the Occupational Employment and Wage Statistics and Quarterly Census of Employment and Wages.
- **USDA Foreign Agricultural Service:** Agricultural trade data, export forecasts, and international market analysis.
- **Congressional Budget Office:** Farm Bill cost estimates and baseline projections.

## **Further Reading**

- Wendell Berry, *The Unsettling of America: Culture and Agriculture* (1977) — The classic critique of industrial agriculture and its effects on rural communities
- Michael Pollan, *The Omnivore's Dilemma* (2006) — Traces the American food chain from Iowa cornfields to the dinner table
- Christopher Leonard, *The Meat Racket* (2014) — Investigative account of the poultry integrator model and its effects on contract farmers
- Ted Genoways, *The Chain: Farm, Factory, and the Fate of Our Food* (2014) — Inside the meatpacking industry and the human costs of consolidation
- Nathan Rosenberg, *Inside the California Food Revolution* (2017) — The economic and agricultural transformation of the Central Valley

## **Exercises**

### **Review Questions**

1. The chapter states that 7% of farms with annual sales above \$1 million produce 73% of all agricultural output, while 55% of farms with sales under \$10,000 produce just 1% of output. The USDA counts roughly 2 million farms, but most are “rural residences with some agricultural activity.” What does this extreme bifurcation reveal about the gap between the USDA’s statistical definition of a “farm” (any place producing or selling \$1,000+ of agricultural products) and the commercial reality of American agriculture?
2. The “ABCD” grain traders (ADM, Bunge, Cargill, Louis Dreyfus) dominate global grain flows, while four meat packers (Tyson, JBS, Cargill, National Beef) control over 80% of US beef slaughter. Farmers, meanwhile, are price-takers selling interchangeable commodities on the Chicago Board of Trade. Using the chapter’s framework of market structure, explain how this arrangement affects the distribution of value in the food supply chain. During 2020-2021, meatpacker margins surged while cattle ranchers saw little benefit from rising retail prices—what structural feature made this possible?
3. The Farm Bill allocates roughly 76% of spending to nutrition programs (primarily SNAP), 11% to crop insurance, and only 5% to commodity programs. The chapter explains the bundling of farm subsidies with nutrition assistance as a po-

litical coalition between farm-state and urban legislators. Why can't each group pass its priorities separately? What would likely happen to farm subsidies if the coalition broke apart and farm-state legislators had to assemble a majority for commodity programs alone?

4. The chapter describes a "cost-price squeeze" in which input prices (fertilizer, seed, equipment, land) tend to rise steadily while commodity prices fluctuate and are roughly flat in real terms over the long run. Explain how this persistent squeeze drives farm consolidation—specifically, why mid-size farms (\$250,000-\$999,999 in annual sales) are being squeezed out while both very small farms (supplemented by off-farm income) and very large operations (achieving scale economies) survive.
5. In the poultry integrator model, companies like Tyson own the birds, supply the feed, and process the meat, while contract growers invest \$500,000-\$1 million in chicken houses and provide the labor. Growers are paid per pound of weight gain, with bonuses and penalties based on relative performance. The chapter states that "the grower bears the capital risk; the integrator controls the margins." Evaluate whether this arrangement represents a fair division of risk and reward, or whether the grower's sunk costs in specialized facilities create a hold-up problem that the integrator exploits.
6. The Ogallala Aquifer underlies portions of eight Great Plains states and is being depleted faster than it recharges. Using the chapter's discussion of regional agricultural geography, identify the specific crops and livestock operations that depend on Ogallala irrigation (irrigated corn, cotton in the Texas Panhandle, cattle feedlots). What would be the economic consequences for the Great Plains if significant portions of the aquifer become uneconomical to pump within the next 20-30 years?
7. John Deere commands roughly 60% of the US large agricultural equipment market and has built a digital ecosystem of sensors, software, GPS guidance, and data analytics. The "right to repair" movement targets Deere's software locks that prevent independent repair. Using economic concepts—monopoly power, network effects, switching costs, and the installed base of Deere equipment and dealer relationships—explain why farmers face high barriers to switching to competitors despite their complaints about repair restrictions and data ownership.

## Data Exercises

8. Using the USDA Economic Research Service's Farm Income and Wealth Statistics (<https://www.ers.usda.gov/data-products/farm-income-and-wealth-statistics/>), download annual net farm income and government payments data from 2000 to the present. Plot both on the same chart. Identify boom years (2012-2013, 2021-2022) and bust years (2009, 2015-2016). How do government payments behave during income downturns—do they act as an effective countercyclical stabilizer? Calculate government payments as a share of net farm income for each year.
9. Using the USDA Census of Agriculture (<https://www.nass.usda.gov/AgCensus/>),

compare the number of farms and average farm size (in acres) across the 2002, 2012, and 2022 censuses for one Corn Belt state (Iowa or Illinois) and one Great Plains state (Kansas or North Dakota). Has consolidation—fewer farms, larger average size—proceeded at different rates in these two regions? What differences in crop mix, land values, and farm structure might explain any divergence?

10. Using the USDA Foreign Agricultural Service's Global Agricultural Trade System (<https://apps.fas.usda.gov/gats/>), download US agricultural export data by commodity and destination country for the most recent 5 years. Identify the three largest export commodities by value and the three largest destination countries. How concentrated are US agricultural exports by commodity and by trading partner? How vulnerable would US farmers be to a trade disruption with China or Mexico, given the export patterns you observe?

### **Deeper Investigation**

11. The chapter describes the meatpacking industry as controlled by four firms handling over 80% of beef slaughter, with meatpacker profit margins surging during 2020-2021 while cattle rancher prices stagnated. The Biden administration announced enforcement actions targeting meatpacking concentration. Using USDA Livestock, Dairy, and Poultry Outlook data, Agricultural Marketing Service cattle price reports, and academic research on meatpacking market power (particularly studies using the Lerner index or conduct parameter approaches), investigate whether increased concentration in beef packing has reduced the share of the retail beef dollar going to cattle ranchers over the past two decades. Present your findings graphically and evaluate what structural reforms—mandatory price reporting, captive supply limits, packer ownership restrictions, or new entrant incentives—could increase rancher bargaining power.

# Chapter 17. Leisure and Hospitality

In April 2020, the leisure and hospitality sector lost 8.2 million jobs in a single month—more than any other sector lost during the entire Great Recession. Restaurants went dark. Hotels emptied. Theme parks locked their gates. The pandemic revealed what economists had long known but rarely said plainly: this is the most fragile major sector in the American economy. It is built on discretionary spending, physical presence, and human labor that cannot be performed remotely. When the world shut down, leisure and hospitality was the first casualty and the last to recover.

The sector's structural position is equally striking in normal times. Leisure and hospitality employs roughly 11% of all nonfarm workers in the United States but produces only about 4% of GDP—the largest gap between employment share and output share in the entire economy. That gap tells you almost everything about how this industry works: millions of workers, modest wages, thin margins, and an economic contribution that flows less through value-added per worker than through sheer volume of people cooking, cleaning, serving, and entertaining.

## Overview

### Info:

#### **The Low-Productivity Paradox**

Leisure and hospitality employs more Americans than construction, finance, or information technology. Yet its output per worker is among the lowest of any major sector. The reason is structural: a hotel room must be cleaned by hand, a meal must be prepared to order, a concert must be performed live. These services resist the automation and scaling that drive productivity in manufacturing or technology. The result is an industry that runs on labor volume rather than labor efficiency.

## Size and Scope

- **GDP contribution:** Approximately \$1.1 trillion (~4% of GDP)
- **Employment:** 16.8 million workers (11% of nonfarm employment)

- **Establishments:** Over 1 million restaurants, ~55,000 hotels, plus tens of thousands of entertainment venues, amusement parks, and recreation facilities
- **Annual consumer spending on food away from home:** \$1.1 trillion (2023)
- **Annual hotel revenue:** ~\$220 billion
- **Annual gaming revenue:** ~\$67 billion (commercial casinos)

The sector's employment footprint is enormous relative to its economic output. For comparison, the information sector produces roughly the same share of GDP with one-fifth the workforce. Leisure and hospitality is, in essence, the inverse of technology: labor-intensive, low-margin, and deeply tied to physical place.

## Key Subsectors

Subsector	Employment	Establishments	Annual Revenue
Restaurants and food services	12.4 million	1,000,000+	\$1.1 trillion
Hotels and accommodation	1.9 million	55,000+	\$220 billion
Arts, entertainment, and recreation	2.5 million	130,000+	\$170 billion
Gambling and casinos	700,000	1,000+	\$67 billion
Amusement parks and attractions	200,000	3,000+	\$28 billion

Source: Bureau of Labor Statistics, National Restaurant Association, American Hotel & Lodging Association, American Gaming Association (2023)

[Figure: Figure 17.1: Leisure and hospitality employment by subsector. Restaurants dominate, accounting for nearly three-quarters of all jobs in the sector. Source: BLS (2023)]

Restaurants are the gravitational center. With over 12 million workers, food service alone employs more people than the entire manufacturing sector. Hotels, arts and entertainment, and gaming fill out the rest, but the economics of this industry are overwhelmingly the economics of restaurants.

[Figure: Figure 17.2: Employment share vs. GDP share across major sectors. Leisure and hospitality has the largest gap—11% of workers producing 4% of output. Source: BLS and BEA (2023)]

## How the Industry Works

### Restaurant Economics

The restaurant business is a margin trap. The typical full-service restaurant operates on a cost structure that leaves almost nothing for profit:

- **Food costs:** 28-35% of revenue (the “food cost ratio”)
- **Labor costs:** 28-35% of revenue (including wages, benefits, payroll taxes)
- **Occupancy costs:** 6-10% (rent, utilities, insurance)
- **Other operating costs:** 15-20% (supplies, marketing, repairs, technology)
- **Profit margin:** 3-9% in a good year; many restaurants operate at a loss

This means a restaurant generating \$1 million in annual revenue might clear \$50,000 in profit—before the owner pays themselves. The failure rate is legendary: roughly 60% of restaurants close within their first year, and 80% within five years. Independent restaurants face even steeper odds than chains.

#### □ Note:

#### The “90% Fail” Myth

The often-cited claim that 90% of restaurants fail in the first year is false. Actual first-year closure rates run closer to 60%, and many closures reflect planned exits or ownership transfers rather than bankruptcy. But the underlying reality is harsh enough: restaurants are among the most difficult businesses to sustain. Thin margins, intense competition, and high fixed costs create a sector where even good operators frequently lose money.

Fast food and fast-casual chains achieve better margins (8-15%) through standardization, volume purchasing, and lower labor costs per transaction. A McDonald’s franchise generates average annual sales of roughly \$3.7 million per location, with franchisee profit margins around 15-20% before debt service and franchise fees.

## Hotel Economics

Hotels operate on a different economic logic. The key metric is **RevPAR**—revenue per available room—which combines occupancy rate and average daily rate (ADR) into a single number.

- **Average US hotel occupancy:** ~63% (2023)
- **Average daily rate (ADR):** ~\$155
- **Average RevPAR:** ~\$98

Hotel costs are heavily front-loaded in real estate and construction. A typical limited-service hotel costs \$80,000-\$120,000 per room to build; a luxury property can run \$500,000+ per room. Once built, the marginal cost of filling an empty room is minimal—housekeeping, linens, utilities. This creates powerful incentives to fill rooms even at discounted rates, since empty rooms generate zero revenue against fixed costs.

The industry has converged on three business models:

1. **Franchise model** (dominant): The hotel brand (Marriott, Hilton) licenses its name, reservation system, and standards to a property owner who handles operations. The brand collects franchise fees (4-6% of revenue) with minimal capital at risk.
2. **Management contracts:** The brand manages the property for a fee but does not own it. Common for upscale properties.
3. **Owner-operated:** The brand both owns and operates the property. Increasingly rare among major chains, which prefer “asset-light” models.

## **The Franchise Model**

Franchising is the structural backbone of both the restaurant and hotel industries. In food service, roughly 36% of all restaurants are franchised—but franchised locations account for a disproportionate share of revenue because they skew toward large chains.

The franchise model works because it solves two problems simultaneously. The franchisee gets a proven brand, operating system, and supply chain. The franchisor gets rapid expansion without deploying capital. McDonald's earns most of its revenue not from selling hamburgers but from collecting rent and franchise fees. Marriott does not own most of the buildings bearing its name.

### **□ Info:**

#### **The Real Estate Insight**

McDonald's is often described as a real estate company that happens to sell hamburgers. The corporation owns or leases the land and buildings for most of its franchise locations, then subleases them to franchisees at a markup. This structure gives McDonald's both a steady rental income stream and leverage over franchisees who cannot easily walk away from a location. The company's real estate portfolio is worth an estimated \$40+ billion.

## **Entertainment and Recreation Economics**

The entertainment segment is more diverse and less standardized. Live events (concerts, sports, theater) operate on a “perishable inventory” model similar to hotels: an unsold seat for tonight’s show cannot be sold tomorrow. This drives aggressive dynamic pricing—the same concert ticket might cost \$50 or \$500 depending on when you buy it and where you sit.

Theme parks operate on a “gate plus capture” model: charge admission, then capture additional spending on food, merchandise, and premium experiences inside the park. Disney's domestic theme parks generate roughly \$8-9 billion annually, with per-capita guest spending exceeding \$200 per visit.

Casinos invert the model entirely. Gaming revenue is the draw, but the real money increasingly comes from non-gaming amenities—hotels, restaurants, entertainment, conventions. Las Vegas Strip casinos now derive roughly 65% of revenue from non-gaming sources, up from 40% two decades ago.

## **Seasonality and Cyclical**

Leisure and hospitality is the most cyclical major sector. Consumer spending on restaurants, hotels, and entertainment is discretionary—the first thing cut in a recession and the last to recover. Hotel RevPAR fell 47% during the 2008-2009 recession and took four years to recover. The pandemic was worse: RevPAR fell 47% in a single quarter.

Seasonality compounds the problem. Ski resorts operate five months a year. Beach hotels see 60-70% of annual revenue between Memorial Day and Labor Day. Even urban restaurants face predictable seasonal swings, with December peaks and January troughs. This unevenness forces operators to staff up temporarily and manage cash flow across lean months.

[Figure: Figure 17.3: Leisure and hospitality employment through recessions. The sector consistently suffers deeper losses and slower recoveries than the overall economy. The COVID-19 shock dwarfed all prior downturns. Source: BLS (2000-2024)]

## Industry Structure

The leisure and hospitality sector is simultaneously one of the most concentrated and most fragmented industries in America. A handful of global corporations dominate hotels, fast food, and live entertainment. Yet independent restaurants—single-location, owner-operated businesses—still account for roughly 60% of all restaurant establishments and about 50% of restaurant revenue. No other major industry has this degree of structural dualism.

### Restaurants

**Fast food and fast casual:** The segment is dominated by a small number of enormous chains.

Company	US Locations	US System Sales	Headquarters
McDonald's	13,400	\$53 billion	Chicago, IL
Starbucks	16,300	\$29 billion	Seattle, WA
Chick-fil-A	3,000	\$22 billion	Atlanta, GA
Taco Bell (Yum! Brands)	8,200	\$15 billion	Irvine, CA
Wendy's	5,700	\$12 billion	Dublin, OH
Chipotle	3,500	\$10 billion	Newport Beach, CA

Source: Company filings, Technomic (2023)

Chick-fil-A is the outlier. With fewer than 3,000 locations (compared to McDonald's 13,400), it generates \$22 billion in US sales—an average of over \$7 million per restaurant, roughly double McDonald's per-unit volume. It achieves this while being closed on Sundays. The company's tightly controlled franchise model (operators do not own their locations and can operate only one) and fanatical operational standards produce extraordinary unit economics.

**Casual dining:** Companies like **Darden Restaurants** (Olive Garden, LongHorn Steakhouse; \$11 billion revenue) and **Brinker International** (Chili's, Maggiano's; \$4.4 billion revenue) dominate the sit-down chain segment. But casual dining has struggled for two decades, squeezed between fast-casual chains offering similar quality at lower prices and fine dining offering a superior experience.

**Independent restaurants:** Roughly 600,000 independent restaurants operate across the country, from neighborhood diners to Michelin-starred establishments. They are the lifeblood of local food culture but face structural disadvantages in purchasing power, technology, and brand recognition compared to chains.

## Hotels

The global hotel industry is dominated by five companies that together control over 40% of US rooms:

Company	US Hotels	US Rooms	Revenue	Model
Marriott International	5,900	800,000	\$23.7 billion	Franchise/management
Hilton Worldwide	5,600	660,000	\$10.2 billion	Franchise/management
IHG (Holiday Inn, Crowne Plaza)	3,900	460,000	\$4.3 billion	Franchise/management
Wyndham (Super 8, Days Inn)	5,600	410,000	\$1.4 billion	Franchise
Hyatt Hotels	730	130,000	\$6.7 billion	Franchise/management

Source: Company 10-K filings, STR (2023)

All five have converged on an “asset-light” franchise model. Marriott owns very few of the buildings carrying its name; it collects franchise fees, management fees, and loyalty program revenue. This model generates high returns on capital and insulates the brand from the capital intensity and real estate risk of hotel ownership. The actual hotels are typically owned by real estate investment trusts (REITs) like Host Hotels, Park Hotels, or private equity firms.

## Entertainment

Live entertainment is increasingly consolidated. **Live Nation Entertainment**, which merged with Ticketmaster in 2010, controls approximately 70% of major concert venue ticketing and manages over 500 artists. This vertical integration—artist management, venue operation, and ticketing—gives Live Nation extraordinary market power and has drawn antitrust scrutiny from the Department of Justice.

**Disney** dominates the theme park segment, operating Walt Disney World (Orlando), Disneyland (Anaheim), and parks in Paris, Tokyo, Shanghai, and Hong Kong. Its domestic parks alone generate \$8-9 billion in annual revenue. **Universal Parks** (owned by Comcast/NBCUniversal), **Six Flags/Cedar Fair** (merged in 2024), and **SeaWorld** compete but at much smaller scale.

The casino industry is controlled by a handful of operators: **MGM Resorts**, **Caesars Entertainment**, and **Las Vegas Sands** dominate Las Vegas and Macau. The

expansion of legal sports betting (now live in 38 states) has created a parallel digital gambling market dominated by **FanDuel** (owned by Flutter Entertainment) and **DraftKings**.

## Geographic Distribution

Leisure and hospitality is one of the most geographically uneven sectors in the economy. While every town has restaurants, the higher-value segments—hotels, entertainment, gaming—concentrate intensely in specific places.

### Tourism Destinations

A small number of cities account for a wildly disproportionate share of hotel room revenue and tourism employment:

- **Las Vegas:** 150,000+ hotel rooms, \$15 billion in annual gaming revenue, tourism as the dominant industry. The city is, in economic terms, a single-industry town dressed up as a playground.
- **Orlando:** 130,000+ hotel rooms, driven by Disney World, Universal, and Sea-World. Tourism supports roughly 1 in 3 jobs in the metro area.
- **New York City:** The nation's most valuable hotel market by RevPAR, plus the densest restaurant market in the country (roughly 27,000 restaurants).
- **Honolulu:** Tourism accounts for roughly 20% of Hawaii's GDP—the highest tourism dependence of any state.

### Convention Cities

A second tier of hospitality concentration exists in convention and conference destinations. Cities like Las Vegas, Orlando, Chicago, San Diego, and Nashville have invested heavily in convention center capacity, generating tens of billions in associated hotel, restaurant, and entertainment spending. Chicago's McCormick Place, the largest convention center in North America, drives an estimated \$2 billion in annual economic impact.

### Seasonal Geographies

Many hospitality markets are radically seasonal:

- **Ski towns** (Aspen, Park City, Vail): Packed December through March, quiet in shoulder seasons, with a secondary summer hiking season increasingly important.
- **Beach towns** (Myrtle Beach, Cape Cod, the Outer Banks): 60-70% of annual revenue concentrated in June through August.
- **National park gateways** (Springdale near Zion, Tusayan near Grand Canyon): Economies entirely dependent on park visitation, which has surged post-pandemic to record levels.

These seasonal economies face acute labor challenges—they need workers for four months, but workers need jobs for twelve.

[Figure: Figure 17.4: Hotel room concentration by metro area. Las Vegas, Orlando, and New York dominate, with room inventories far exceeding other cities. Source: STR (2023)]

## The Workforce

### The Largest Low-Wage Employer

Leisure and hospitality is the largest low-wage employer in the American economy. The median hourly wage across the sector is approximately \$16.60—the lowest of any major industry and roughly 60% of the all-industry median. Nearly half of all workers earning at or below the federal minimum wage work in food service.

Occupation	Employment	Median Hourly Wage
Fast food and counter workers	3.9 million	\$13.50
Waiters and waitresses	2.4 million	\$14.20*
Cooks, restaurant	1.4 million	\$15.80
Bartenders	690,000	\$14.50*
Hotel desk clerks	260,000	\$14.70
Maids and housekeeping	840,000	\$14.90
Food service managers	430,000	\$30.80
Chefs and head cooks	160,000	\$28.40
Gaming dealers	80,000	\$13.00*

\* Tipped occupations; reported wages exclude tips. Actual compensation is higher but variable.

Source: Bureau of Labor Statistics, Occupational Employment and Wage Statistics (May 2023)

### The Tipped Wage System

The federal tipped minimum wage has been frozen at \$2.13 per hour since 1991—over three decades without an increase. Employers are legally required to make up the difference if tips do not bring total compensation to the regular minimum wage (\$7.25 federal), but enforcement is uneven. Seven states (California, Oregon, Washington, Nevada, Minnesota, Montana, Alaska) require full minimum wage before tips. The result is dramatic geographic variation in server compensation.

#### Note:

#### **The Tipped Wage Misconception**

Many people assume that restaurant servers are universally low-paid. In reality, compensation varies enormously. A server at a busy upscale restaurant in Manhattan or San Francisco can earn \$60,000-\$80,000 or more annually with tips. A server at a rural Denny's might earn \$22,000. The tipped wage system creates a bimodal distribution: some tipped workers earn well

above the median, while others—especially those in low-traffic locations—earn poverty-level wages with extreme income volatility.

## Demographics and Turnover

The leisure and hospitality workforce is younger, more diverse, and less formally educated than the overall labor force:

- **Age:** Median age of 31 (vs. 42 for all workers). Nearly 30% of workers are under 25.
- **Education:** Over 40% have a high school diploma or less.
- **Immigration:** Foreign-born workers make up roughly 25% of the hospitality workforce—and a much higher share in gateway cities.
- **Turnover:** Annual turnover in restaurants runs approximately 75%, among the highest of any industry. Hotels average 60-70%. This churn imposes enormous recruitment and training costs.

The pandemic permanently altered labor supply dynamics. When 8 million hospitality workers were laid off in spring 2020, many found employment in warehousing, delivery, healthcare, and other sectors—and did not return. The resulting labor shortage forced the fastest wage increases in the sector's history: average hourly earnings in leisure and hospitality rose over 25% between 2020 and 2023, far outpacing economy-wide wage growth.

[Figure: Figure 17.5: Average hourly earnings growth in leisure and hospitality vs. all private-sector workers, 2019-2024. Hospitality wages surged post-pandemic as labor shortages forced employers to compete for workers.  
Source: BLS Current Employment Statistics]

## Regulation and Policy

### Wage and Hour

The Department of Labor's Wage and Hour Division enforces the Fair Labor Standards Act (FLSA), which sets the federal minimum wage (\$7.25/hour), the tipped minimum wage (\$2.13/hour), and overtime rules. But real regulation happens at the state and local level. As of 2024, 30 states and dozens of cities have minimum wages above the federal floor, with significant implications for restaurant labor costs. California's \$20/hour minimum for fast food workers (effective April 2024) represents the most aggressive experiment in hospitality wage regulation.

### State and Local Regulation

Hospitality businesses face a dense web of state and local rules:

- **Liquor licensing:** State-by-state systems that range from relatively open (Texas) to highly restrictive (Pennsylvania, Utah). License scarcity in some markets creates a secondary market where liquor licenses trade for hundreds of thousands of dollars.

- **Health inspections:** Local health departments inspect restaurants, typically 1-3 times per year, with letter grades publicly posted in some jurisdictions (notably New York City).
- **Zoning:** Local zoning laws govern where hotels, restaurants, and entertainment venues can operate, often with contentious community approval processes.
- **Short-term rental regulation:** Cities including New York, Los Angeles, and Barcelona have enacted restrictions on Airbnb and similar platforms to protect hotel markets and housing supply.

## Gaming Regulation

Casino gambling is regulated at the state level through gaming commissions that license operators, approve games, and monitor compliance. Nevada's Gaming Control Board is the model, but each of the 44 states with some form of legal gambling maintains its own regulatory apparatus. The rapid expansion of online sports betting (legalized state by state following the Supreme Court's 2018 Murphy v. NCAA decision) has created a new regulatory frontier.

## Health and Safety

The FDA Food Code provides a model framework for food safety that most states adopt in some form. Fire codes, building codes, and occupancy limits govern entertainment venues. After the 2003 Station nightclub fire in Rhode Island killed 100 people, states significantly tightened regulations on indoor pyrotechnics and venue capacity.

## Tourism Promotion

Destination marketing organizations (DMOs), often funded through hotel occupancy taxes, promote tourism at the city, regional, and state level. The combined spending on tourism promotion by state and local governments exceeds \$2 billion annually. Brand USA, the national tourism marketing entity created in 2010, promotes inbound international travel.

## Trade Associations and Lobbying

Association	Members/Focus	Key Issues
National Restaurant Association	500,000 restaurant businesses	Minimum wage, tip credit, labor regulation
American Hotel & Lodging Association (AHLA)	Hotels and lodging	Short-term rental regulation, labor, tourism promotion
American Gaming Association (AGA)	Casino operators	Sports betting legalization, gaming regulation

Association	Members/Focus	Key Issues
IAAPA (International Association of Amusement Parks)	Theme parks, attractions	Safety standards, seasonal worker visas
National Travel & Tourism Office	Federal agency	International visitation data, Brand USA

Source: Association websites (2024)

The National Restaurant Association—sometimes called “the other NRA”—is one of the most influential trade associations in Washington. Its primary lobbying priorities include preserving the tip credit (which allows employers to count tips toward minimum wage obligations), opposing minimum wage increases, and expanding seasonal and immigrant worker visa programs (particularly H-2B visas). The restaurant industry is heavily dependent on immigrant labor, making immigration policy a perennial lobbying focus.

The American Hotel & Lodging Association has focused increasingly on regulating short-term rental platforms. Hotels argue that Airbnb and similar platforms operate as de facto hotels without meeting the same regulatory, tax, and safety requirements. The lobbying has produced tangible results: New York City’s Local Law 18 (2023) effectively banned most short-term rentals, removing an estimated 15,000 Airbnb listings from the market.

## Recent Trends

### 1. The Post-COVID Labor Recalibration

The pandemic triggered the most significant labor market reset in the sector’s modern history. When hospitality shed 8.2 million jobs between February and April 2020, workers discovered alternative employment in logistics, healthcare, and gig work. Many did not return. The sector did not recover its pre-pandemic employment level until mid-2023, and many operators report that hiring remains more difficult and expensive than before. Average wages rose roughly 25% in three years—a structural shift, not a temporary bump.

### 2. Ghost Kitchens and Delivery Platforms

The pandemic accelerated the rise of delivery-only “ghost kitchens”—commercial cooking spaces that prepare food exclusively for delivery apps. Companies like **CloudKitchens** (backed by former Uber CEO Travis Kalanick) and **Kitchen United** operate shared facilities where multiple restaurant brands cook under one roof. Meanwhile, third-party delivery platforms—**DoorDash** (56% US market share), **Uber Eats** (27%), and **Grubhub** (13%)—have become a permanent feature of the restaurant industry, though their 15-30% commission fees squeeze already-thin restaurant margins.

## □ Key Point:

### The Delivery Platform Dilemma

Third-party delivery creates a painful paradox for restaurants. Refusing to list on DoorDash or Uber Eats means losing access to a growing share of customer demand. But accepting their 15-30% commissions on orders can turn profitable menu items into money-losers. Many restaurants respond by raising delivery prices 15-20% above dine-in prices, effectively passing the commission to the customer. Others create “virtual brands”—delivery-only menu concepts operated from existing kitchens—to capture incremental revenue without cannibalizing dine-in traffic. The platforms, meanwhile, have yet to consistently turn a profit themselves. DoorDash first achieved annual profitability in 2023 after years of losses.

## 3. Technology Adoption

The sector has historically been a technology laggard. That changed abruptly. Pandemic-era necessity drove rapid adoption of:

- **Mobile ordering and payment:** Now standard at most chains. Starbucks generates over 30% of US transactions through its app.
- **Self-service kiosks:** Deployed widely by McDonald's, Panera, and Wawa, reducing labor needs at the point of sale.
- **Dynamic pricing:** Hotels have used revenue management software for decades; restaurants are now experimenting with surge pricing for peak hours.
- **Kitchen automation:** Robotic cooking systems from companies like **Miso Robotics** (Flippy, an automated fry cook) are in early deployment, though widespread adoption remains years away.

## 4. The Experience Economy

Consumers—particularly younger generations—are shifting spending from goods to experiences. This benefits live entertainment, experiential dining, immersive attractions, and travel. Spending on experiences has grown faster than spending on physical goods since 2015, a trend that accelerated post-pandemic. Live Nation's 2023 concert attendance set an all-time record. Disney's domestic park revenue has surpassed pre-pandemic levels despite lower attendance, driven by aggressive per-guest monetization through premium add-ons like Genie+ and Lightning Lane.

## 5. Short-Term Rental Disruption

Airbnb has fundamentally altered the accommodation market since its founding in 2008. The platform now lists over 1.5 million active properties in the United States, ranging from spare bedrooms to entire luxury homes. In many vacation markets, Airbnb supply exceeds traditional hotel supply. This has compressed hotel pricing power in leisure destinations while expanding overall accommodation capacity. The hotel industry's regulatory counterattack has had mixed success: strict in New York City, largely ineffective in most other markets.

## Firm Profiles

### Marriott International

**Quick Facts - Headquarters:** Bethesda, Maryland - **Founded:** 1927 (as a root beer stand by J. Willard Marriott) - **Revenue:** \$23.7 billion (2023) - **Properties:** 8,800+ worldwide (~5,900 in the US) - **Rooms:** 1.6 million worldwide (~800,000 in the US) - **Employees:** ~400,000 (mostly at managed properties) - **Loyalty members:** 200+ million (Marriott Bonvoy)

Marriott is the world's largest hotel company, and its evolution illustrates the industry's defining structural shift. For decades, Marriott built and operated hotels. Today, it owns almost none of them. The company's transformation to an "asset-light" model—collecting franchise fees, management fees, and loyalty program revenue rather than owning buildings—has made it more a brand-and-technology platform than a traditional hotelier.

The 2016 acquisition of Starwood Hotels (\$13.6 billion) was the pivotal deal, combining Marriott's scale in conventional business travel (Courtyard, Fairfield, Residence Inn) with Starwood's lifestyle brands (W Hotels, Westin, St. Regis). The merged company operates 30 distinct brands spanning every price point from budget (Fairfield Inn, ~\$100/night) to ultra-luxury (Ritz-Carlton, \$500+/night).

Marriott Bonvoy, the company's loyalty program with over 200 million members, is arguably its most valuable asset. Loyalty members book directly (avoiding online travel agency commissions), stay more frequently, and pay higher rates. The program's co-branded credit card partnerships with American Express and Chase generate billions in annual fee revenue.

### McDonald's

**Quick Facts - Headquarters:** Chicago, Illinois - **Founded:** 1955 (Ray Kroc's first franchise; original McDonald brothers' restaurant, 1940) - **Revenue:** \$25.5 billion (2023) - **US locations:** ~13,400 - **Global locations:** ~40,000 in 100+ countries - **Employees (corporate):** ~150,000 (millions more at franchise locations) - **Daily customers worldwide:** ~69 million

McDonald's is less a restaurant company than a franchising-and-real-estate machine that happens to sell hamburgers. Approximately 95% of McDonald's locations are operated by independent franchisees. McDonald's owns or leases the underlying real estate for most of these locations, then subleases to franchisees at rents typically set as a percentage of sales (often 8-12%). This structure means McDonald's earns money whether a given restaurant is packed or empty—the franchisee bears the operating risk.

The company's scale is staggering. McDonald's purchases roughly 3% of all potatoes grown in the United States and is one of the nation's largest buyers of beef, chicken, pork, lettuce, and tomatoes. Its supply chain operations are a logistical achievement comparable to military provisioning: standardized products delivered to 40,000 locations daily across more than 100 countries.

Strategically, McDonald's has invested heavily in digital ordering, drive-through optimization, and delivery partnerships. Its mobile app has become one of the most-downloaded food apps in the country, and drive-through sales—always important—now account for roughly 70% of US revenue. The company has also piloted automated order-taking using artificial intelligence at drive-through windows, aiming to reduce labor costs and improve speed.

## Live Nation Entertainment

**Quick Facts - Headquarters:** Beverly Hills, California - **Founded:** 2010 (merger of Live Nation and Ticketmaster) - **Revenue:** \$22.7 billion (2023) - **Concerts promoted annually:** ~50,000 - **Fans attending events:** ~145 million (2023) - **Venues owned/operated:** 350+ - **Employees:** ~65,000

Live Nation Entertainment is the undisputed colossus of live events. The 2010 merger of Live Nation (the largest concert promoter) and Ticketmaster (the dominant ticketing platform) created a vertically integrated company that controls artist management, concert promotion, venue operations, and ticket sales. This integration has made Live Nation the most powerful company in the live entertainment business—and one of the most controversial.

The Ticketmaster platform processes hundreds of millions of tickets annually. Its dominance became a national controversy in November 2022, when the presale for Taylor Swift's Eras Tour crashed the system, leaving millions of fans unable to purchase tickets. The incident triggered Congressional hearings and a Department of Justice antitrust lawsuit filed in May 2024, alleging that Live Nation/Ticketmaster maintained an illegal monopoly over live event ticketing.

Despite the controversy, Live Nation's financial performance has been extraordinary. The post-pandemic boom in live events drove record revenues and attendance in 2023. The company's model is built on multiple revenue streams: ticketing fees, venue concessions, sponsorships, and artist management commissions. In an era when recorded music is nearly free (streaming pays artists fractions of a cent per play), live performance has become the primary way musicians earn money—and Live Nation sits at the center of that economy.

## Key Takeaways

1. **Leisure and hospitality employs 11% of American workers but generates only 4% of GDP**—the largest gap between employment share and output share of any major sector, reflecting the industry's labor intensity and low productivity per worker.
2. **The restaurant industry is the sector's center of gravity**, with over 12 million workers and \$1.1 trillion in annual revenue, yet average profit margins of just 3-9% make it one of the most difficult industries to sustain.
3. **Franchising is the dominant business model** in both restaurants and hotels,

allowing brands like McDonald's and Marriott to scale rapidly while shifting capital risk and operating burden to franchisees and property owners.

4. **The sector is structurally fragile**, with extreme sensitivity to recessions, pandemics, and seasonal variation. The COVID-19 pandemic erased 8.2 million jobs in a single month, exposing the industry's dependence on physical presence and discretionary spending.
5. **The workforce is young, diverse, and poorly paid.** Median hourly wages are the lowest of any major sector, the tipped minimum wage has not increased since 1991, and annual turnover exceeds 70% in restaurants.
6. **Geographic concentration is intense:** Las Vegas, Orlando, New York, and Honolulu capture a disproportionate share of hotel revenue and tourism employment, while seasonal destinations face boom-and-bust labor cycles.
7. **Technology and delivery platforms are reshaping the sector**, from ghost kitchens and mobile ordering to dynamic pricing and automated service—though the fundamental labor intensity of hospitality limits the pace of transformation.

## Data Sources and Further Reading

### Key Data Sources

- **Bureau of Labor Statistics (BLS):** Employment and wage data for leisure and hospitality by subsector and occupation (NAICS 71-72).
- **National Restaurant Association:** Annual State of the Restaurant Industry report with sales forecasts, workforce data, and trend analysis.
- **STR (Smith Travel Research):** The authoritative source for hotel performance data (occupancy, ADR, RevPAR) by market and segment.
- **American Gaming Association:** Annual State of the States report covering commercial casino revenue by state.
- **Bureau of Economic Analysis (BEA):** GDP contribution by industry, including accommodation and food services.

### Further Reading

- Kerry Segrave, *Tipping: An American Social History of Gratuities* (2009)—A thorough history of how tipping became embedded in American dining culture and labor markets.
- Eric Schlosser, *Fast Food Nation: The Dark Side of the All-American Meal* (2001)—The classic investigation of how the fast food industry reshaped American agriculture, labor, and diet.
- Dean Baquet and Julia Moskin, “The Restaurant Industry Was Devastated by Covid-19. It’s Not Going Back to Normal,” *New York Times* (2021)—Reported examination of the pandemic’s structural impact on restaurants.
- Marriott International, 10-K Annual Report (2023)—A detailed view of the asset-light hotel franchise model from the industry’s largest company.

- U.S. Department of Justice, Complaint: United States v. Live Nation Entertainment (2024)—The federal antitrust case laying out the government’s theory of Ticketmaster’s monopoly power in live event ticketing.

## Exercises

### Review Questions

1. Leisure and hospitality employs 11% of American workers but produces only 4% of GDP—the largest gap between employment share and output share in the economy. The chapter calls this the “low-productivity paradox.” Explain why this gap exists, drawing on the chapter’s argument that hotel rooms must be cleaned by hand, meals prepared to order, and concerts performed live. Why do these services resist the automation and scaling that drive productivity gains in manufacturing or technology? Is this gap likely to narrow or persist?
2. The chapter states that McDonald’s is “less a restaurant company than a franchising-and-real-estate machine that happens to sell hamburgers,” noting that McDonald’s owns or leases the land and buildings for most franchise locations, then subleases to franchisees at rents set as a percentage of sales. Explain the economic logic: how does this structure create a different risk profile than actually operating restaurants? Why does McDonald’s earn money “whether a given restaurant is packed or empty”?
3. Average US hotel occupancy is about 63%, with an average daily rate of \$155, yielding RevPAR of roughly \$98. The chapter notes that the marginal cost of filling an empty room is minimal—just housekeeping, linens, and utilities against high fixed costs. Using these economics, explain why hotels engage in aggressive discounting during low-demand periods. How does this “perishable inventory” problem compare to the similar challenge faced by airlines and live entertainment venues?
4. The federal tipped minimum wage has been frozen at \$2.13/hour since 1991, while seven states (including California, Oregon, and Washington) require full minimum wage before tips. The chapter describes a “bimodal distribution” where some servers at upscale restaurants earn \$60,000-80,000+ while others at rural locations earn poverty-level wages with extreme income volatility. Using the chapter’s framework, evaluate the economic arguments for and against eliminating the tip credit. What does California’s experience with a full minimum wage before tips suggest about employment effects?
5. Third-party delivery platforms (DoorDash at 56% market share, Uber Eats at 27%, Grubhub at 13%) charge restaurants 15-30% commissions on orders, potentially turning profitable menu items into money-losers. Yet the chapter notes that DoorDash itself did not achieve annual profitability until 2023 after years of losses. Analyze who in the delivery value chain captures economic value: the platform, the restaurant, the delivery driver, or the consumer. What does this value distribution suggest about the long-term sustainability of the current model?

6. The pandemic caused the sector to lose 8.2 million jobs in a single month (April 2020), and many displaced workers found employment in warehousing, delivery, and healthcare and did not return. The resulting labor shortage forced average hourly earnings up roughly 25% between 2020 and 2023—far outpacing economy-wide wage growth. Using supply-and-demand analysis of the hospitality labor market, explain why this wage increase appears to be a permanent structural shift rather than a temporary cyclical adjustment. What changed about workers' outside options?
7. Live Nation/Ticketmaster controls approximately 70% of major concert venue ticketing and manages over 500 artists, operates 350+ venues, and promotes roughly 50,000 concerts annually. The Taylor Swift Eras Tour presale crash in November 2022 triggered Congressional hearings and a DOJ antitrust lawsuit filed in May 2024. Using the concept of vertical integration, explain how Live Nation's simultaneous control of artist management, concert promotion, venue operations, and ticket sales creates market power that a standalone ticketing company would not possess. What specific competitive harms does this integration enable?

## **Data Exercises**

8. Using the BLS Current Employment Statistics (<https://www.bls.gov/ces/>), download monthly employment data for the Leisure and Hospitality supersector from January 2019 to the present. Create a chart showing the pandemic employment collapse and recovery trajectory. On what date did the sector recover its February 2020 employment level? Compare the pace of hospitality's recovery to overall nonfarm payroll recovery. Calculate how many months the hospitality recovery lagged the broader economy.
9. Using the American Gaming Association's annual State of the States report (<https://www.americangaming.org/resources/state-of-the-states/>), download commercial casino and sports betting revenue data by state for the most recent year available. Create a ranked bar chart of the top 10 states by total gaming revenue. Then calculate what share of total gaming revenue now comes from sports betting versus traditional casino games. How has the legalization wave following the 2018 Murphy v. NCAA decision changed the industry's geographic and revenue profile?
10. Using BLS data, download average hourly earnings for the Leisure and Hospitality supersector (FRED series CES7000000003) and for all private-sector workers (CES0500000003) from January 2019 to the present. Calculate the ratio of hospitality wages to all-sector wages over this period. Has the gap between hospitality and all-sector wages narrowed since the pandemic, as the chapter's discussion of post-COVID wage increases suggests? Plot the ratio over time and identify the inflection point.

## **Deeper Investigation**

11. The chapter describes California's \$20/hour minimum wage for fast food workers (effective April 2024) as "the most aggressive experiment in hospitality wage regulation." Using BLS monthly employment data for the food services sector (NAICS 722) in California versus comparison states with lower minimum wages (Texas, Florida, Georgia), investigate the early effects of this policy since its implementation. Has fast food employment in California declined relative to these comparison states? Using data from restaurant industry sources and company earnings reports, assess whether menu prices have risen, whether chains have closed locations or reduced hours, and whether automation (self-service kiosks, automated cooking) has accelerated. Compare your findings to the predictions of the standard competitive labor market model (which predicts job losses) and the alternative monopsony model (which predicts minimal disemployment). What does the California experiment reveal about the structure of the fast food labor market?

# **Part III: The Financial Architecture**

# Chapter 18: How American Finance Works

Most economic textbooks treat finance as a “veil”—a neutral mechanism for moving funds from savers to borrowers that doesn’t much affect real outcomes. The 2008 financial crisis shattered this comforting illusion. Finance has plumbing, and the plumbing matters. Who holds what assets, how they’re funded, what constraints they face, and how they connect to each other—these institutional details shape credit availability, amplify economic shocks, and occasionally bring the system to near-collapse.

This chapter examines how American finance actually works: the hierarchy of money, how banks create it, how payments flow through the system, the parallel universe of “shadow banking,” and the Federal Reserve’s role as both operator and backstop. Understanding this plumbing is essential for making sense of everything from monetary policy to financial crises to the everyday mechanics of commerce.

## The Hierarchy of Money

### Info:

#### **Key Concept: The Hierarchy of Money**

Not all money is equal. Money exists in layers, with each level a promise to pay the level above. Currency (physical dollars) sits at the top. Bank deposits are promises to pay currency. Shadow money is promises to pay deposits. In a crisis, this hierarchy reveals itself as lower-level promises get tested.

The first insight is that not all money is equal. Money exists in a hierarchy, with each level a promise to pay the level above.

#### **Level 1: Currency (Federal Reserve Notes)**

At the top sits currency—physical dollars issued by the Federal Reserve. If you hold a \$100 bill, no one owes you anything. It is money, full stop. But currency is a tiny fraction of the monetary system:

## The Hierarchy of Money

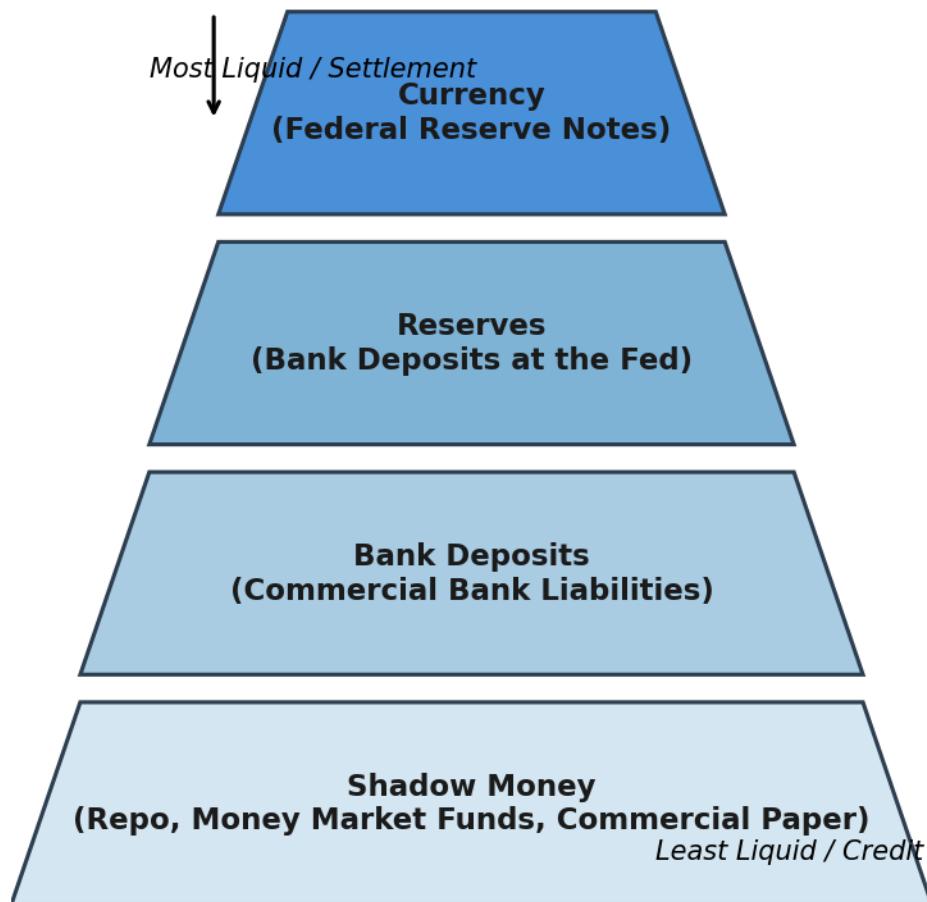


Figure 66: Figure 18.1: The hierarchy of money. Currency sits at the top; reserves, deposits, and shadow money form progressively lower levels, each a promise to pay the level above. In a crisis, lower-level money gets tested against higher-level money.  
Source: Author illustration based on Mehrling

Form	Amount (2024)
Currency in circulation	roughly \$2.3 trillion
Of which: held domestically	roughly \$1.1 trillion
Of which: held abroad	roughly \$1.2 trillion

Source: Federal Reserve Statistical Releases H.4.1, H.6, and Z.1 Financial Accounts, 2024

Most dollars aren't physical. They're entries on balance sheets.

### **Level 2: Reserves (Bank Deposits at the Fed)**

Banks don't settle with each other using currency. They settle using reserves—deposits at the Federal Reserve. When JPMorgan owes Bank of America \$1 billion, JPMorgan's reserve account at the Fed is debited and BofA's is credited. No trucks of cash move.

Period	Reserve Balances
Pre-2008	roughly \$10-50 billion
Post-QE (2014)	roughly \$2.5 trillion
Post-COVID (2022)	roughly \$3.5 trillion
Current	roughly \$3.2 trillion

Source: Federal Reserve Statistical Releases H.4.1, H.6, and Z.1 Financial Accounts, 2024

The explosion of reserves after 2008 reflects quantitative easing—the Fed buying assets and paying with newly created reserves.

### **Level 3: Deposits (Bank Liabilities to the Public)**

What households and firms call "money" is mostly bank deposits—entries on bank balance sheets representing the bank's promise to pay currency or transfer reserves on demand.

Type	Amount (2024)
Checkable deposits	roughly \$5 trillion
Savings deposits	roughly \$12 trillion
Small time deposits	roughly \$0.5 trillion
<b>Total</b>	roughly \$17.5 trillion

Source: Federal Reserve Statistical Releases H.4.1, H.6, and Z.1 Financial Accounts, 2024

Deposits are promises to pay currency/reserves. They're not currency itself. This distinction matters in a crisis: if everyone tries to convert deposits to currency simultaneously, there isn't enough.

## **Level 4: Shadow Money (Private Promises)**

Below bank deposits sits a vast layer of money-like claims issued by non-banks:

Instrument	Amount	Issuer
Money market fund shares	roughly \$6.4 trillion	Asset managers
Repo	roughly \$4.5 trillion	Dealers, hedge funds
Commercial paper	roughly \$1.2 trillion	Corporations

Source: Federal Reserve Statistical Releases H.4.1, H.6, and Z.1 Financial Accounts, 2024

These instruments function as money for their holders—they’re liquid, perceived as safe, and used for transactions. But they’re promises to pay bank deposits, which are promises to pay reserves, which are promises to pay currency. In normal times, the hierarchy is invisible. In a crisis, it reveals itself. Lower-level money gets tested against higher-level money, and the promises that can’t be kept break.

## **How Banks Actually Work**

The most important thing to understand about money: banks create it when they lend.

### **The Textbook Story (Wrong)**

Traditional textbooks tell a money multiplier story: the central bank creates reserves, banks lend out a fraction, those loans become deposits at other banks, those banks lend out a fraction, and so on. This implies the central bank controls the money supply through reserve requirements, with banks as passive conduits.

This is backwards.

#### **□ Note:**

### **The Textbook Is Wrong**

The traditional “money multiplier” story—where banks lend out existing deposits—is backwards. In reality, loans create deposits. When a bank makes a loan, it simultaneously creates a matching deposit by keystroke. The Bank of England confirmed this in 2014: “Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower’s bank account, thereby creating new money.”

### **The Reality: Loans Create Deposits**

When a bank makes a loan, it doesn’t lend out existing deposits. It creates a new deposit:

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#### **Bank Balance Sheet (After Loan)**

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##### **Assets**

+\$100,000 Loan

##### **Liabilities**

+\$100,000 Deposit

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## Bank Balance Sheet (After Loan)

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The borrower now has \$100,000 in their account that didn't exist before. The bank created it by keystroke. The Bank of England stated this clearly in 2014: "Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money."

### What About Reserves?

If banks create money by lending, what role do reserves play? Reserves are for settlement, not lending. When the borrower spends their deposit—paying someone at another bank—the lending bank needs reserves to settle the payment. But banks can always borrow reserves from other banks (federal funds market) or from the Fed (discount window).

The sequence is: 1. Bank identifies profitable loan opportunity 2. Bank makes loan, creating deposit 3. Bank seeks reserves for settlement afterward 4. Fed supplies reserves to keep fed funds at target

This is endogenous money: the money supply responds to demand for credit, not to central bank reserve injections. The Fed sets the price of money (interest rate), not the quantity.

### A Simplified Bank Balance Sheet

Assets	%	Liabilities	%
Cash and reserves	10%	Deposits	80%
Securities (Treasuries, MBS)	25%	Wholesale funding	10%
Loans	60%	Equity capital	10%
Other	5%		

**Assets:** What the bank owns or is owed. Reserves are highly liquid but earn little. Securities are moderately liquid and can be sold or pledged as collateral. Loans are illiquid but higher-yielding.

**Liabilities:** What the bank owes. Deposits are cheap but can be withdrawn (run risk). Wholesale funding is more expensive and more flighty. Equity capital is the buffer that absorbs losses before depositors are affected.

**Net Interest Margin:** Banks make money on the spread between asset yields and funding costs. This margin has compressed over time—from 4%+ in the 1990s to around 3% in the 2020s—reflecting lower rates, competition, and regulation requiring more low-yield liquid assets.

### Maturity Transformation: The Core Function and Core Risk

The essential function of banking is maturity transformation: borrowing short (deposits withdrawable on demand) and lending long (30-year mortgages, multi-year

### The Flow of Funds: How Savings Become Investment

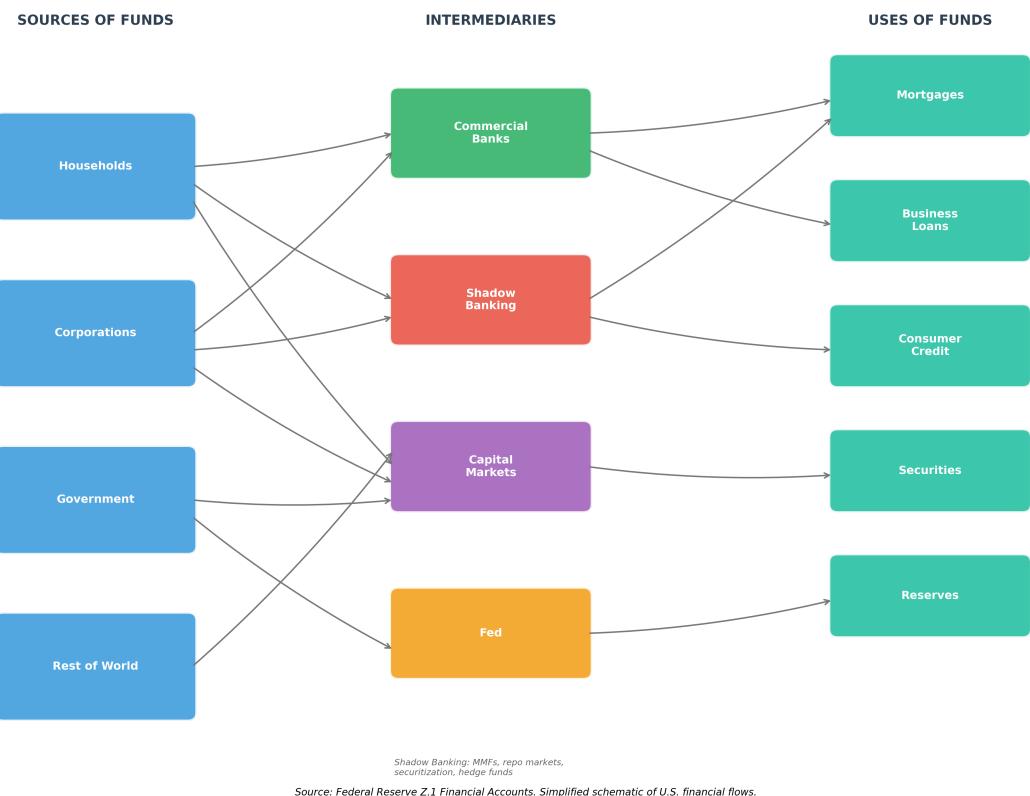


Figure 67: Figure 18.2: The flow of funds: how savings become investment. Money flows from sources (households, corporations, government, rest of world) through financial intermediaries (banks, shadow banks, capital markets) to ultimate uses (mortgages, business loans, consumer credit). The Fed sits at the bottom, providing reserves that lubricate the entire system. Source: Federal Reserve Z.1 Financial Accounts

business loans). This is socially valuable—it funds long-term investment while providing liquidity to savers.

But it's also inherently dangerous. Banks promise more liquidity than they have. If all depositors withdraw simultaneously, the bank cannot pay without fire-selling long-term assets at a loss. This isn't a flaw in poorly-run banks; it's the essence of banking.

Diamond and Dybvig (1983) showed that bank runs can be self-fulfilling equilibria: if you think others will withdraw, you should withdraw first. If everyone thinks this, everyone withdraws. The bank fails even if it was fundamentally solvent.

This is why we have:

- **Deposit insurance (FDIC):** Guarantees deposits up to \$250,000, removing the incentive to run
- **Lender of last resort (Fed):** Lends to solvent but illiquid banks against good collateral
- **Capital requirements:** Force banks to hold an equity buffer against losses
- **Liquidity requirements:** Force banks to hold liquid assets that can meet withdrawals

## The Payments System

Money exists to be spent. The payments system is the infrastructure through which money moves—the plumbing of the financial system.

### Fedwire: The Backbone

Fedwire is the Federal Reserve's real-time gross settlement (RTGS) system. Every payment settles individually, in real time, in central bank money.

Metric	Value
Daily payments	roughly \$4 trillion
Daily transactions	roughly 500,000
Average payment	roughly \$8 million
Operating hours	22 hours/day

Fedwire handles wholesale payments: bank-to-bank transfers, Treasury securities settlement, large corporate transactions. Once a Fedwire payment settles, it cannot be reversed—the recipient has final, unconditional money.

Banks often need to make payments before receiving offsetting inflows. The Fed extends intraday credit (overdrafts) to keep payments flowing, with daily peaks exceeding \$500 billion.

### CHIPS: Private Large-Value Clearing

The Clearing House Interbank Payments System (CHIPS) is a private alternative owned by large banks:

Metric	Value
Daily payments	roughly \$1.8 trillion
Daily transactions	roughly 400,000
Primary use	Cross-border dollar payments, FX settlement

Unlike Fedwire, CHIPS uses netting: payments accumulate during the day, and only net balances settle (in reserves via Fedwire) at day's end. This economizes on reserves—\$1.8 trillion in gross payments might net to \$50 billion in actual reserve movements.

### **SWIFT: Messaging, Not Money**

A common confusion: SWIFT is not a payment system. SWIFT (Society for Worldwide Interbank Financial Telecommunication) is a messaging network—it tells banks what to do but doesn't move money.

System	Function	What Moves
SWIFT	Messaging	Information
Fedwire	Settlement	Reserves
CHIPS	Clearing + Settlement	Net reserve balances

When Russia was excluded from SWIFT in 2022, it couldn't receive payment instructions through the standard network—but the underlying dollar clearing infrastructure remained unchanged. The real chokepoint is access to Fedwire and correspondent banking relationships, not the messaging layer.

### **ACH: Retail Payments**

The Automated Clearing House (ACH) handles smaller, less time-sensitive payments:  
 - Payroll direct deposits  
 - Bill payments  
 - Government benefits (Social Security, IRS refunds)  
 - Consumer transfers (Venmo and Zelle use ACH rails)

Metric	Value
Annual volume	roughly \$80 trillion
Annual transactions	roughly 30 billion
Average payment	roughly \$2,600

ACH is slow by design—payments traditionally took 1-2 business days to settle. The Fed's FedNow (launched 2023) brings real-time retail payments to the US, finally catching up with systems in the UK, India, and elsewhere.

# Shadow Banking

## □ Warning:

### The 2008 Crisis Was a Shadow Bank Run

The financial crisis of 2008 was not primarily about subprime mortgages—it was about the wholesale funding that financed those mortgages. Money market funds, repo markets, and commercial paper all experienced the same panic dynamics as classic bank runs, but without deposit insurance or lender-of-last-resort access. When the run started, trillions fled in weeks.

Shadow banking is credit intermediation outside the traditional banking system. It grew enormously before 2008, shrank during the crisis, and has resumed growing since. Understanding it is essential because the 2008 crisis was fundamentally a shadow bank run.

## What Is Shadow Banking?

Pozsar et al. (2010) defined shadow banking as “credit intermediation involving entities and activities outside the regular banking system.” The key characteristics:

Traditional Banking	Shadow Banking
Deposit insurance (FDIC)	No equivalent
Discount window access	No lender of last resort (before 2008)
Reserve requirements	None
Regulatory capital standards	Limited or none
Regular examination	Minimal oversight

Shadow banks perform the same economic function as banks—maturity transformation, credit transformation, liquidity creation—but without the regulatory infrastructure that makes traditional banking stable.

## The Shadow Banking Ecosystem

### Money Market Funds (roughly \$6.4 trillion)

MMFs invest in short-term paper, repo, and government securities while offering investors checking-like features and instant withdrawal. The defining feature is their stable net asset value—they promise to maintain a \$1 share price. This makes them function like bank deposits for corporate treasurers and wealthy individuals, but without FDIC insurance. When the Reserve Primary Fund “broke the buck” in September 2008 (NAV fell below \$1 after Lehman losses), investors ran—\$300 billion fled prime MMFs in a week.

### The Repo Market (roughly \$4.5 trillion)

A repurchase agreement (repo) is effectively a short-term collateralized loan:

1. Borrower sells a security with an agreement to repurchase it tomorrow at a slightly higher price
2. The difference is the interest rate (the “repo rate”)
3. The security serves as collateral, with a “haircut” (discount to market value) providing buffer

Repo funds the securities holdings of broker-dealers, hedge funds, and other institutions. When haircuts spike—as they did in 2008—the effect is equivalent to a massive margin call across the entire system.

Collateral Type	Typical Haircut (2006)	Haircut (Crisis Peak 2008)
Treasury bonds	2%	2%
Agency MBS	2-4%	5-10%
AAA ABS/CDO	3-5%	50-100% (or no bid)

A haircut increase from 5% to 50% means an institution needs 10x more equity to hold the same position. This forced massive deleveraging.

## Securitization

Securitization pools loans—mortgages, auto loans, credit cards, student loans—and issues securities against the pool. Senior tranches, rated AAA, offer yields above Treasuries with supposed safety; junior tranches absorb losses first. Before 2008, the market assumed that diversification made senior tranches truly safe. When housing prices fell nationally and default correlations approached 100%, AAA tranches that were supposed to be “money good” suffered 30-50% losses.

## Why Shadow Banking Grew

**Regulatory arbitrage:** Banks faced capital requirements; shadow banks didn’t. Banks faced reserve requirements; shadow banks didn’t. Moving activity off-balance-sheet reduced apparent risk while maintaining economic exposure.

**Yield-seeking:** Corporate treasurers and pension funds wanted higher returns than bank deposits offered. MMFs delivered slightly higher yields with perceived deposit-like safety. Structured products promised AAA-rated returns above Treasury yields.

**Government policy:** The GSEs (Fannie Mae, Freddie Mac) subsidized mortgage securitization through their implicit government guarantee. Accounting rules permitted off-balance-sheet treatment of sponsored vehicles.

## The 2008 Run on Shadow Banking

The 2008 crisis was a run on shadow banking—the same dynamics as a classic bank run, but in wholesale funding markets.

**Phase 1 - ABCP Market Freeze (August 2007):** Asset-backed commercial paper outstanding fell from \$1.2 trillion to under \$800 billion in months. Banks had to bring SIV assets back onto their balance sheets.

**Phase 2 - Bear Stearns Repo Run (March 2008):** Repo counterparties refused to roll over financing. Without overnight funding, Bear faced insolvency within days. The Fed arranged JPMorgan's acquisition.

**Phase 3 - General Panic (September 2008):** Lehman's bankruptcy triggered complete breakdown. Money market funds broke the buck. Repo funding for non-banks essentially ceased. The commercial paper market froze.

Only emergency Fed interventions—an alphabet soup of facilities (CPFF, TALF, AMLF, PDCF)—restored functioning. The Fed effectively became lender of last resort for the entire shadow banking system.

## The Federal Reserve's Operational Framework

The Fed controls short-term interest rates, serves as lender of last resort, and operates the core payments infrastructure. Understanding how it actually works has changed dramatically since 2008.

### From Corridor to Floor

#### The Pre-2008 Corridor System

Before 2008, reserves were scarce (roughly \$15-50 billion). The Fed operated a corridor system:

- **Ceiling:** Discount rate (Fed won't lend above this)
- **Target:** Fed funds rate (where trading happens)
- **Floor:** Zero (can't go negative)

Banks actively traded reserves in the federal funds market. Daily volume exceeded \$150 billion. The Fed adjusted reserve supply through open market operations to keep the rate near target.

#### The Post-2008 Floor System

Quantitative easing flooded the system with reserves. With \$3+ trillion in reserves, banks don't need to borrow from each other. The federal funds market shrank.

	Pre-2008	Post-2008
Reserve balances	\$15-50 billion	\$2-4 trillion
Fed funds volume	\$150+ billion/day	\$50-80 billion/day
System	Corridor (scarce reserves)	Floor (abundant reserves)

The Fed now uses a floor system:

- **IORB (Interest on Reserve Balances):** The Fed pays banks interest on reserves, setting a floor
- **ON RRP (Overnight Reverse Repo):** The Fed offers money market funds overnight lending against Treasuries at a rate just below IORB

The Fed controls short-term rates by setting administered rates (IORB, ON RRP), not by adjusting reserve supply.

## Why the Fed Funds Rate Trades Below IORB

In theory, banks should borrow in fed funds at any rate below IORB, deposit at the Fed, and earn risk-free profit. But banks face balance sheet costs:

- **Supplementary Leverage Ratio (SLR):** Large banks must hold capital against reserves—“risk-free” assets still consume capital
- **FDIC Assessment Fees:** Expanding balance sheets increases insurance costs
- **G-SIB Surcharges:** The largest banks face additional charges tied to size

The result: a persistent 5-15 basis point wedge between the effective fed funds rate and IORB. The ON RRP rate effectively sets the floor for money market rates.

## Lender of Last Resort

The Fed’s most critical function is lender of last resort—providing liquidity to solvent institutions that can’t fund themselves in the market. The classic formulation is Bagehot’s rule: lend freely, against good collateral, at a penalty rate.

In 2008, the Fed extended this function far beyond traditional banks—to investment banks (PDCF), money market funds (AMLF), and eventually to corporations (CPFF). In March 2020, the Fed moved even faster, reviving 2008 facilities within weeks and adding new ones for corporate bonds.

This expansion raises hard questions. If the Fed backstops shadow banking during every crisis, shadow banks operate with an implicit guarantee—but without the regulation that accompanies explicit insurance. The moral hazard implications remain unresolved.

## The Credit Channel: How Finance Affects the Real Economy

How does finance affect the real economy? Through the credit channel—the availability and cost of credit to firms and households.

## The Financial Accelerator

The financial accelerator (Bernanke, Gertler, Gilchrist) describes how financial frictions amplify economic shocks:

1. Asset prices fall → borrower net worth declines
2. Lower net worth → higher agency costs → lenders demand higher premiums
3. Credit contracts → investment and consumption fall
4. Economic activity slows → asset prices fall further

The mechanism creates a vicious feedback loop. Small shocks get amplified through the financial system into larger economic downturns.

**Evidence:** Credit spreads—the yield difference between corporate bonds and Treasuries—are strongly countercyclical. In booms, spreads are tight (credit easy). In recessions, spreads blow out (credit tight). The Gilchrist-Zakrajsek “excess bond premium” predicts output declines beyond what asset prices alone predict.

## Procyclical Lending

Bank lending is strongly procyclical. The Fed’s Senior Loan Officer Survey shows:

Measure	Boom	Recession
Standards tightening	-20% (easing)	+60% (tightening)
Demand increasing	+30%	-40%
Spreads	Narrow	Wide

In booms, banks compete by easing terms: lower down payments, fewer covenants, lower spreads. In recessions, banks tighten dramatically: raising standards, cutting credit lines, demanding more collateral.

This is individually rational but collectively harmful—credit contraction deepens recessions.

## Credit Rationing

A key insight from Stiglitz and Weiss: credit markets don’t clear like commodity markets. Banks may ration credit—denying loans entirely—rather than raise rates.

Why? If banks raise rates to clear excess demand, they attract only the riskiest borrowers (adverse selection) and encourage gambling (moral hazard). Bank profits peak at an interior interest rate. Beyond that rate, expected repayment falls.

This means credit availability matters as much as credit cost. Monetary policy that lowers rates may not help if banks won’t lend.

## Monetary Policy Transmission: The 2022-2023 Tightening Cycle

The Federal Reserve’s rapid rate increases from 2022 to 2023 provide a vivid case study of how monetary policy transmits through the financial system to the real economy—and how that transmission can create unexpected stresses.

### The Shock: 525 Basis Points in 16 Months

Beginning in March 2022, the Fed raised the federal funds rate from near zero to 5.25-5.50%—the fastest tightening cycle in 40 years. The goal was to combat inflation that had reached 9%, the highest since 1981. But the transmission of this shock through the economy revealed both expected channels and unanticipated vulnerabilities.

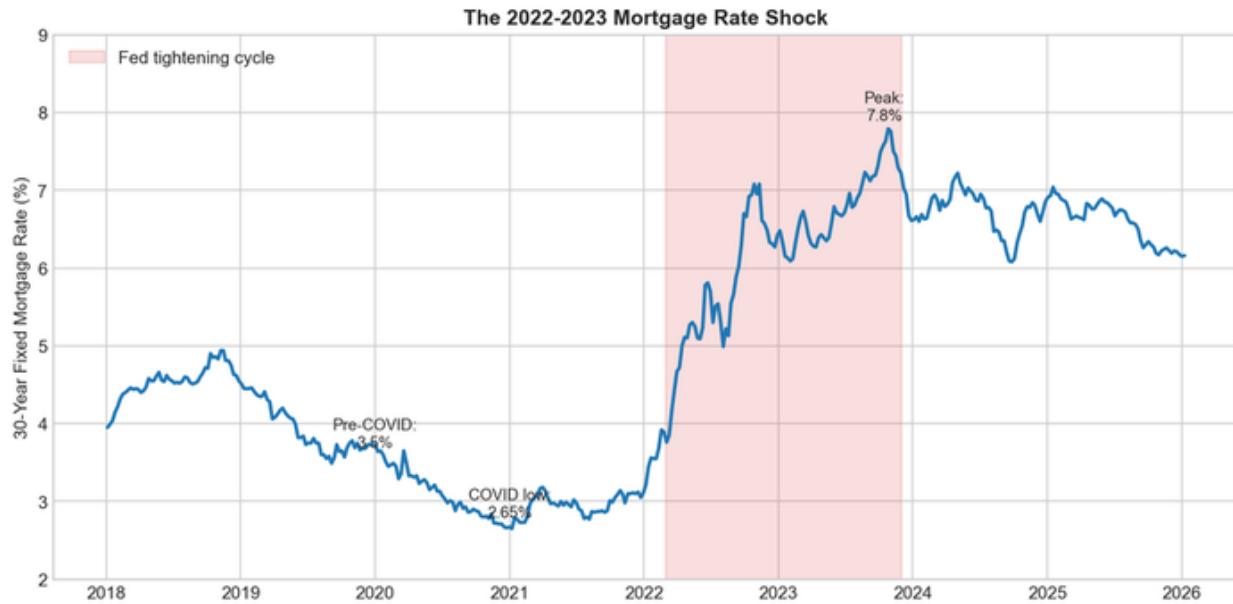


Figure 68: Figure 18.2: The 30-year fixed mortgage rate doubled from 3% to over 7% in just 18 months, the most rapid increase since the Volcker disinflation of 1981-82. Source: FRED

### The Primary Transmission Channel: Mortgage Rates

The most visible transmission occurred through mortgage rates. The 30-year fixed mortgage rate—the benchmark for American homebuyers—doubled from roughly 3% in late 2021 to over 7% by late 2022. This translated directly into housing affordability:

- **Payment shock:** A \$400,000 mortgage at 3% requires monthly payments of \$1,686. At 7%, the same loan costs \$2,661—a 58% increase.
- **Purchasing power collapse:** A family that could afford a \$500,000 home at 3% rates could afford only \$330,000 at 7% rates, holding monthly payments constant.
- **Transaction freeze:** Existing homeowners locked into 3% mortgages refused to sell, since moving meant taking on a 7% mortgage. Existing home sales fell 35% from 2021 to 2023.

Housing starts declined by roughly 20% as builders faced both higher financing costs and reduced buyer demand. Construction employment, which had boomed during the pandemic housing surge, contracted modestly.

### The Secondary Channel: Asset Prices and Bank Balance Sheets

The rate increases transmitted through asset prices in ways that exposed unexpected vulnerabilities.

**Bond Math:** When interest rates rise, bond prices fall. A 30-year Treasury yielding 1.5% loses roughly 40% of its market value when rates rise to 4.5%. This is mechani-



Figure 69: Figure 18.3: Housing starts fell sharply as mortgage rates rose, demonstrating the Fed's primary transmission mechanism to the real economy. Source: Census Bureau

cal: the fixed coupons become less valuable relative to new market rates.

**Bank Portfolios:** During the 2020-2021 period of near-zero rates, banks bought long-duration bonds—Treasuries and agency mortgage-backed securities—to earn some yield on their swelling deposits. When rates rose, these securities lost substantial market value. By early 2023, US banks held roughly \$620 billion in unrealized losses on their securities portfolios.

**Accounting Treatment:** Banks could avoid realizing these losses by classifying securities as “held-to-maturity” (HTM). Under HTM accounting, securities are carried at purchase price, not market value. On paper, banks appeared well-capitalized. In economic reality, many had lost substantial equity.

## Silicon Valley Bank: When the Channel Breaks

The transmission mechanism from monetary policy to bank balance sheets produced the most significant bank failures since 2008.

Silicon Valley Bank exemplified the vulnerability: - **Asset side:** Heavy investment in long-duration MBS and Treasuries, now worth \$15 billion less than purchase price - **Liability side:** Concentrated deposits from tech startups and venture capital—94% uninsured, highly networked, capable of moving funds instantly - **Trigger:** When SVB announced it needed to raise capital to offset securities losses, depositors fled—\$42 billion in a single day

The Fed had raised rates to slow inflation by tightening financial conditions. It succeeded—but the tightening also created a pathway for bank runs. The rate

increases that made mortgages expensive also made bank bond portfolios worth less, creating fragility that manifested in the fastest bank run in American history.

## Geographic and Sectoral Variation

The monetary policy shock affected different regions and sectors unevenly:

**Rate-Sensitive Sectors:** Housing, automobiles (which depend on financing), and commercial real estate bore the brunt. Office building transactions essentially froze as buyers and sellers couldn't agree on values appropriate to the new rate environment.

**Cash-Rich Tech:** Companies like Apple and Google, sitting on billions in cash, faced minimal impact. Venture-backed startups that depended on equity financing saw their funding environment collapse.

**Regional Banks:** Banks concentrated in commercial real estate lending (Signature Bank, First Republic) faced particular stress. Unlike diversified money-center banks, they lacked offsetting businesses and deposit stability.

**Sunbelt Housing Markets:** Markets that had boomed during low-rate pandemic migration—Austin, Phoenix, Boise—saw the sharpest affordability declines as rates rose.

## Policy Response: Extending the Safety Net

The Fed responded to the banking stress it had inadvertently triggered by creating the Bank Term Funding Program (BTFP), which allowed banks to borrow against securities at par value rather than market value. This effectively papered over the unrealized losses, preventing fire sales that could have cascaded through the banking system.

The episode illustrated a recurring pattern in monetary policy transmission: rate changes designed to affect one target (inflation, via spending) also affect other parts of the financial system in ways that can threaten stability. The Fed was simultaneously tightening policy to fight inflation and easing through emergency lending facilities to prevent bank failures—a contradiction that underscored the complexity of monetary transmission.

## Lessons for Understanding Monetary Transmission

The 2022-2023 tightening demonstrates several principles:

- **Transmission channels multiply:** Monetary policy works through mortgage rates, asset prices, bank balance sheets, and credit availability—all simultaneously
- **Lags vary by channel:** Mortgage rates respond immediately; housing starts respond over months; full employment effects take 1-2 years
- **Vulnerabilities accumulate in low-rate periods:** The duration mismatch that sank SVB was built during years of near-zero rates

- **Distribution matters:** The same rate increase helps savers (higher deposit rates) while hurting borrowers (higher mortgage costs)

## The Regulatory Architecture

Bank regulation aims to prevent failures, protect depositors, and ensure credit availability while managing moral hazard.

### Capital Requirements

Basel III requires banks to hold capital buffers against losses:

Requirement	Minimum	With Buffers
Common Equity Tier 1 (CET1)	4.5%	7.0%+
Total Capital	8.0%	10.5%+
Leverage Ratio	3.0%	5.0% (US)

Different assets require different amounts of capital. Cash and Treasuries carry 0% risk weight. Residential mortgages carry 50%. Corporate loans carry 100%. This encourages banks to hold “safe” assets—though March 2023 revealed that long-duration Treasuries and agency MBS can sink a bank through interest rate risk even with zero credit risk.

The largest banks (G-SIBs) face additional surcharges of 1-3.5% based on size, interconnectedness, and complexity.

### Liquidity Requirements

Post-2008 regulation added liquidity requirements. The Liquidity Coverage Ratio (LCR) requires banks to hold high-quality liquid assets—Treasuries, reserves, high-grade bonds—sufficient to cover 30 days of net cash outflows in stress. The Net Stable Funding Ratio (NSFR) addresses longer-term funding mismatches.

### Stress Testing

Annual stress tests assess whether banks can survive hypothetical crises. The Fed’s Comprehensive Capital Analysis and Review (CCAR) subjects large banks to severe scenarios: recession, market crashes, unemployment spikes. Banks that fail face restrictions on dividends and stock buybacks.

### The Regulatory Alphabet

Agency	Jurisdiction
Federal Reserve	Bank holding companies, state member banks, systemic supervision
OCC	National banks
FDIC	Deposit insurance, state nonmember banks
SEC	Securities firms, investment funds
CFPB	Consumer financial products
State regulators	Insurance companies, state-chartered banks

This fragmented structure reflects historical accidents more than rational design. The 2008 crisis exposed gaps—no one supervised AIG’s Financial Products unit adequately—but consolidation has proven politically impossible.

## March 2023: Runs in the Modern Era

The failures of Silicon Valley Bank, Signature Bank, and First Republic demonstrated that run risk remains—and revealed new dynamics.

**SVB’s Problem:** The bank invested heavily in long-duration securities when rates were near zero. When rates rose sharply in 2022-23, these securities lost substantial market value. But because SVB classified them as “held-to-maturity,” the \$15 billion in unrealized losses didn’t appear in regulatory capital. On paper, well-capitalized. In reality, one forced sale away from insolvency.

**The Run:** SVB’s depositors were concentrated among tech startups—sophisticated, well-networked, with deposits far exceeding the \$250,000 FDIC insurance limit (94% uninsured). When word spread that SVB needed capital, \$42 billion fled in a single day. Social media and digital banking compressed what might have taken weeks into hours—the fastest bank run in history.

**Lessons:** 1. Uninsured depositors run; insured depositors don’t need to 2. “Safe” assets can sink banks through duration mismatch 3. HTM accounting can hide interest rate risk 4. Social media accelerates coordination

Despite the \$250,000 insurance limit, regulators guaranteed all SVB deposits to prevent contagion—effectively extending unlimited insurance during stress. The implicit guarantee expanded again.

## Recent Trends

**Private Credit Boom:** As banks face tighter regulation, private credit funds (roughly \$1.7 trillion) have grown rapidly, lending to middle-market companies that banks won’t serve. This moves risk outside the regulated system—potentially safer for banks, but raising questions about where losses will land in a downturn.

**Fintech:** Digital-only banks (Chime, Revolut), payments platforms (PayPal, Square), and buy-now-pay-later providers (Affirm, Klarna) compete with traditional banks.

Many operate outside traditional bank regulation, raising questions about consumer protection and systemic risk.

**Stablecoins:** Crypto tokens pegged to the dollar (Tether, USDC) function as money-like claims outside the banking system. They promise instant redemption at \$1 but aren't backed by FDIC insurance or Fed access. In essence, they're unregulated money market funds—the same structure that broke during the 2008 crisis.

**Central Bank Digital Currencies:** The Fed is studying a potential digital dollar (CBDC) that would give the public direct access to central bank money—currently available only to banks. This could disintermediate the banking system or simply provide a safer form of digital cash.

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## Firm Profile: Fedwire and CHIPS

**Quick Facts - Operator (Fedwire):** Federal Reserve Banks - **Operator**

**(CHIPS):** The Clearing House (owned by major banks) - **Daily Fedwire**

**Volume:** \$4+ trillion across 500,000 transactions - **Daily CHIPS Volume:**

\$1.8 trillion across 400,000 transactions

Fedwire and CHIPS are the two large-value payment systems that settle virtually all wholesale dollar transactions in the United States. Together they move over \$5 trillion daily—more than the annual GDP of Japan—with almost no public awareness of their existence.

Fedwire, operated by the Federal Reserve since 1918, is a real-time gross settlement (RTGS) system. Every payment settles individually and immediately in central bank money. When a Fedwire payment completes, the recipient has final, irrevocable funds—there is no counterparty risk. The system operates 22 hours per day, closing only briefly for maintenance. Major banks make thousands of Fedwire payments daily for securities settlement, interbank transfers, and large commercial transactions.

CHIPS (Clearing House Interbank Payments System), owned by a consortium of large banks, handles primarily cross-border dollar payments and foreign exchange settlement. Unlike Fedwire's gross settlement, CHIPS uses multilateral netting: payments accumulate during the day, offsetting credits and debits, with only net balances settling in reserves at day's end. This economizes on liquidity—\$1.8 trillion in gross payments might net to \$50 billion in actual reserve movements. The two systems complement each other: CHIPS handles routine high-volume flows efficiently, while Fedwire provides the ultimate settlement layer and handles time-critical payments.

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## Firm Profile: JPMorgan Chase

**Headquarters:** New York, NY **Total Assets:** \$3.9 trillion (2024) **Employees:** roughly 310,000 **Market Cap:** roughly \$600 billion

JPMorgan Chase is the largest US bank by assets, formed through the 2000 merger of Chase Manhattan and J.P. Morgan & Co. (itself the successor to the House of Morgan, the most powerful financial institution of the early 20th century). The 2008 acquisition of Bear Stearns (arranged by the Fed) and Washington Mutual (in FDIC receivership) expanded its footprint further.

The bank operates across four major segments: Consumer & Community Banking (deposits, mortgages, credit cards, auto lending), Commercial Banking (middle-market lending), Corporate & Investment Bank (trading, M&A advisory, securities underwriting), and Asset & Wealth Management. Its investment bank consistently ranks #1 globally in fees.

Under CEO Jamie Dimon (since 2005), JPMorgan navigated the 2008 crisis better than peers—a combination of conservative risk management and opportunistic acquisitions. The bank paid \$13 billion in 2013 settlements related to mortgage practices but remained solidly profitable throughout. Its dominance makes it definitionally systemically important: whatever happens to JPMorgan affects the entire financial system.

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## Firm Profile: The Federal Reserve System

**Headquarters:** Washington, DC (Board of Governors) **Regional Banks:** 12 (Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, San Francisco) **Balance Sheet:** roughly \$7.5 trillion (2024)

**Employees:** roughly 24,000

The Federal Reserve System is the central bank of the United States, created by the Federal Reserve Act of 1913 after the Panic of 1907 demonstrated the need for a lender of last resort. Its unusual structure—a public board in Washington governing quasi-private regional Reserve Banks owned by member banks—reflects political compromises between centralization and regional autonomy.

The Fed has three main functions: monetary policy (setting interest rates via the Federal Open Market Committee), bank supervision (examining banks for safety and soundness), and payments system operation (running Fedwire, providing currency, serving as the banks' bank).

The Fed's balance sheet exploded from under \$1 trillion before 2008 to over \$8 trillion after COVID-era quantitative easing. It now holds more than 20% of outstanding Treasury securities and a substantial portion of agency MBS. This transformation from a small institution that occasionally intervened to a dominant holder of financial assets is the most significant change in American finance in a century.

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## Firm Profile: BlackRock

**Headquarters:** New York, NY **Assets Under Management:** roughly \$10 trillion (2024) **Employees:** roughly 20,000 **Market Cap:** roughly \$120 billion

BlackRock is the world's largest asset manager, having grown from a small bond manager founded in 1988 to a colossus that manages more money than the GDP of every country except the US and China. Its 2009 acquisition of Barclays Global Investors (including the iShares ETF platform) made it the dominant player in both active and passive investing.

The firm operates through three main channels: institutional (pension funds, insurance companies, sovereign wealth funds), retail (mutual funds and ETFs sold to individuals), and technology (the Aladdin risk management platform used by many other institutions). iShares is the largest ETF provider globally, with over \$3 trillion in assets across hundreds of funds tracking every conceivable market segment.

BlackRock's scale creates both influence and scrutiny. Its holdings make it a top-five shareholder in most large US companies, raising questions about common ownership and corporate governance. CEO Larry Fink's annual letters on ESG issues drew both praise and criticism. The firm has become a target for politicians on both left (too powerful, extractive) and right (too "woke" on climate). Its Aladdin platform, used to manage over \$20 trillion in assets across the industry, makes it critical infrastructure for global finance.

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## Data Sources and Further Reading

### Government Sources

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- **Federal Reserve Z.1 Release:** Flow of Funds accounts (comprehensive financial positions)
- **FDIC Quarterly Banking Profile:** Bank balance sheet aggregates, profitability
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## **Exercises**

### **Review Questions**

1. The chapter describes money as existing in a hierarchy, with each level a “promise to pay” the level above. Explain how this hierarchy became visible during the 2008 financial crisis. Specifically, trace what happened when money market fund shares (Level 4) were tested against bank deposits (Level 3)—what broke, and how did the Federal Reserve’s interventions restore the hierarchy?
2. The traditional “money multiplier” model says banks lend out existing deposits, and the central bank controls the money supply through reserve requirements. The chapter argues this is backwards. Explain the endogenous money view: in what order do loans, deposits, and reserves actually appear? Why does the Fed set the price of money (the interest rate) rather than the quantity?
3. Fedwire settles payments in real-time gross settlement (RTGS), while CHIPS uses multilateral netting. Explain why \$1.8 trillion in gross CHIPS payments might net to only \$50 billion in actual reserve movements. What are the trade-offs between the two approaches in terms of liquidity efficiency and counterparty risk? Why might a bank prefer one system over the other for a given transaction?
4. The chapter describes how repo market haircuts on AAA asset-backed securities rose from 3-5% to 50-100% during the 2008 crisis. Explain why a haircut increase of this magnitude functions as a massive margin call across the entire financial system. How does this mechanism connect the shadow banking system to the real economy through forced deleveraging?
5. Before 2008, the Fed operated a “corridor” system with roughly \$15-50 billion in reserves. After quantitative easing, reserves exceeded \$3 trillion, and the Fed shifted to a “floor” system using IORB and the ON RRP facility. Explain why the effective federal funds rate trades 5-15 basis points below IORB, even though arbitrage should close the gap. What specific balance sheet costs—the Supplementary Leverage Ratio, FDIC assessment fees, and G-SIB surcharges—prevent banks from exploiting this spread?
6. Silicon Valley Bank’s depositors withdrew \$42 billion in a single day—the fastest bank run in American history. Drawing on the chapter’s discussion of SVB’s asset composition (long-duration MBS and Treasuries), liability structure (94% uninsured deposits from networked tech firms), and the role of social media, explain the structural features that made SVB uniquely vulnerable. Why did the run happen in hours rather than days?

7. The chapter notes that the Fed responded to the March 2023 banking stress by creating the Bank Term Funding Program (BTFP), which allowed banks to borrow against securities at par value rather than market value. Explain the tension in this response: the Fed was simultaneously tightening monetary policy to fight inflation and easing through emergency lending facilities to prevent bank failures. What does this episode reveal about the limits of using a single tool (interest rates) to achieve multiple objectives?

## Data Exercises

1. **Tracking the Hierarchy of Money.** Using the Federal Reserve's H.6 Money Stock release (<https://www.federalreserve.gov/releases/h6/current/>) and the Z.1 Financial Accounts (<https://www.federalreserve.gov/releases/z1/>), compare the current levels of M1 (currency + checkable deposits), M2 (M1 + savings + small time deposits), and money market fund assets. Then pull reserve balances from the H.4.1 release (<https://www.federalreserve.gov/releases/h41/current/>). Construct a table showing each level of the money hierarchy and its current size. How has the ratio of reserves to deposits changed since 2007? What does this tell you about the shift from a scarce-reserves to an abundant-reserves regime?
2. **Measuring Procyclical Lending.** Download the Federal Reserve's Senior Loan Officer Opinion Survey (SLOOS) data from FRED (series DRTSCILM for tightening standards on C&I loans, and DRTSSP for spreads). Plot the net percentage of banks tightening standards over the past 20 years. Identify the periods when standards tightened most sharply and compare them to NBER recession dates. Then pull the Gilchrist-Zakrjsek excess bond premium from the Federal Reserve's website (<https://www.federalreserve.gov/econres/notes/feds-notes/updating-the-recession-risk-and-the-excess-bond-premium-20161006.html>). Does the excess bond premium lead recessions, as the chapter claims? By how many quarters?
3. **The SVB Balance Sheet.** Access SVB Financial Group's final 10-K filing on the SEC's EDGAR system (<https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0000719739>). Examine the breakdown of SVB's securities portfolio between "available-for-sale" (AFS) and "held-to-maturity" (HTM) classifications. What was the fair market value of HTM securities versus their carrying value? Calculate the unrealized losses as a percentage of SVB's total equity capital. How did the accounting treatment of HTM securities mask the bank's true economic condition?

## Deeper Investigation

**The Expanding Safety Net.** The chapter traces how the Federal Reserve's lender-of-last-resort function has expanded in each successive crisis: from traditional banks (pre-2008) to investment banks, money market funds, and the commercial paper market (2008) to corporate bond markets and the BTFP (2020-2023). Research this expansion in detail, drawing on the Fed's own facility documentation and academic analyses by Mehrling (2011), Gorton and Metrick (2012), and others. Write a research paper addressing: What are the boundaries of the Fed's backstop today? Has each

crisis permanently expanded the set of institutions and markets that receive implicit government support? What are the moral hazard consequences of this expansion for shadow banking—if private credit funds and stablecoins expect Fed support during the next crisis, how does that affect their risk-taking today? Propose a framework for deciding which institutions deserve backstop access and what regulatory obligations should accompany it.

# Chapter 19: Capital Markets

Every day, \$1.5 trillion changes hands on American stock exchanges alone. Add in bonds, derivatives, and private markets, and you have a capital allocation machine that dwarfs the rest of the world combined: 42% of global stock market value, 55% of private equity, half of all venture capital. This dominance is not an accident. It is the product of specific institutions—exchanges, clearinghouses, broker-dealers, and regulators—that have evolved over two centuries to do one thing: match people with money to people who need it.

This chapter focuses on institutional structure rather than pricing theory—the practical plumbing of how capital gets allocated. We examine the stock exchanges where equities trade, the bond markets where governments and corporations borrow, the derivatives markets that enable risk transfer, and the private markets where venture capital and private equity operate.

## Size and Scope

American capital markets dwarf those of any other nation.

**Table 19.1: U.S. Capital Markets Overview (2023)**

Market	Size	Global Share
Stock market capitalization	\$51 trillion	42%
Treasury debt held by public	\$26 trillion	—
Corporate bonds outstanding	\$10 trillion	39%
Municipal bonds outstanding	\$4 trillion	—
Mortgage-backed securities	\$12 trillion	—
Listed derivatives (notional)	\$95 trillion	33%
Private equity AUM	\$4.7 trillion	55%
Venture capital AUM	\$1.2 trillion	50%

Sources: World Federation of Exchanges; SIFMA; Preqin

The dominance is no accident. Deep capital markets require legal infrastructure (property rights, contract enforcement, bankruptcy procedures), sophisticated intermediaries, large pools of domestic savings, and network effects that attract foreign capital. The United States developed these advantages over more than a century, and they compound: liquidity attracts liquidity.

## Total U.S. Equity Market Capitalization

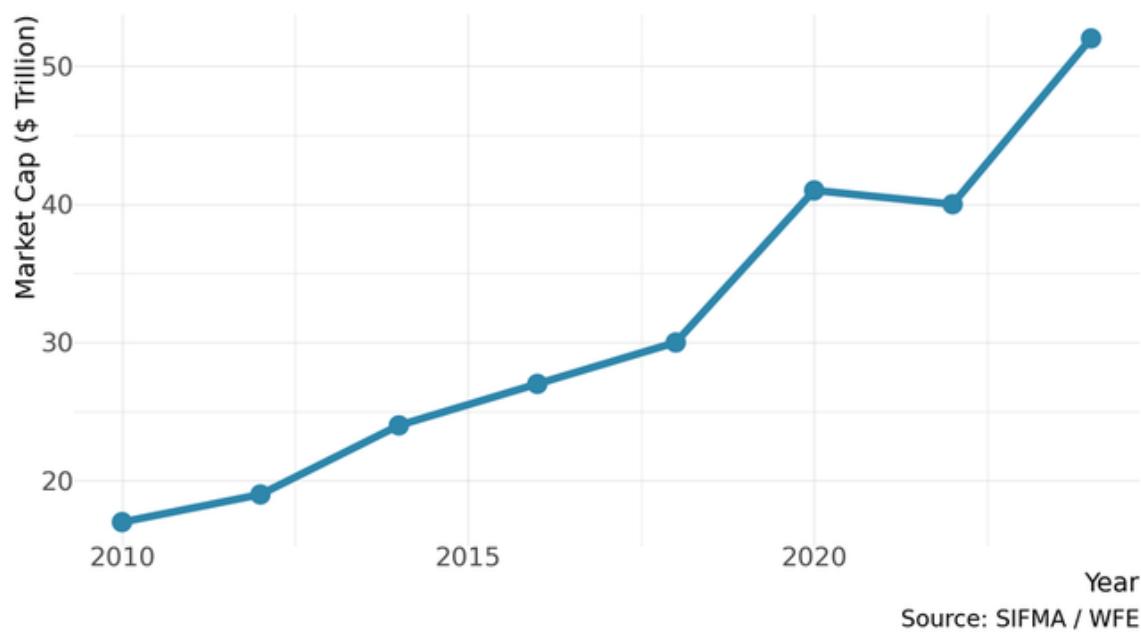


Figure 70: Figure 19.1: U.S. stock market capitalization dwarfs all other markets. The “Big Three” exchanges (NYSE, NASDAQ, and their affiliates) account for over 40% of global equity market value. Source: World Federation of Exchanges

# Equity Markets

## The Major Exchanges

American stock trading is dominated by two exchange families, though the landscape is more fragmented than it appears.

**The New York Stock Exchange (NYSE)** remains the world's largest exchange by market capitalization of listed companies (roughly \$28 trillion). Originally a specialist-based floor trading operation dating to 1792, the NYSE has evolved into a hybrid model combining electronic matching with designated market makers (DMMs) who provide liquidity for assigned stocks. The trading floor at 11 Wall Street, while largely ceremonial for routine trading, still handles complex orders and the opening/closing auctions.

The NYSE is owned by Intercontinental Exchange (ICE), an Atlanta-based exchange conglomerate that acquired NYSE Euronext in 2013 for \$8.2 billion. ICE also owns ICE Futures (commodities and financial futures), ICE Clear (clearinghouses), and a data services business.

**NASDAQ** began in 1971 as the first electronic stock market—the National Association of Securities Dealers Automated Quotations system. Originally a quotation display system for over-the-counter stocks, it evolved into a full exchange and is now the second-largest globally by market capitalization (roughly \$23 trillion). NASDAQ's all-electronic model and lower listing fees attracted technology companies, creating a self-reinforcing concentration: tech firms list on NASDAQ because other tech firms are there.

NASDAQ Inc. also owns NASDAQ Nordic/Baltic exchanges, The NASDAQ Options Market, and several data businesses. The company is headquartered in Times Square.

**Table 19.2: Major U.S. Stock Exchanges (2023)**

Exchange	Market Cap Listed	Share Volume	Headquarters
NYSE	\$28 trillion	25%	New York
NASDAQ	\$23 trillion	32%	New York
CBOE	—	17%	Chicago
IEX	—	3%	New York
MEMX	—	7%	New York
NYSE Arca	—	10%	New York

Note: Volume shares approximate. Multiple exchanges may trade same securities.

Source: World Federation of Exchanges, 2024

## Market Structure and Fragmentation

Stocks listed on NYSE or NASDAQ don't trade only on those exchanges. The National Market System (NMS) created by Regulation NMS (2005) allows any registered ex-

change or alternative trading system (ATS) to execute trades in any listed stock. This promotes competition but fragments liquidity across dozens of venues.

**Alternative Trading Systems (ATSSs)** and dark pools handle significant volume. Dark pools—private trading venues that don’t display quotes publicly—emerged to help institutional investors execute large orders without moving prices. Major dark pools include Credit Suisse Crossfinder, UBS MTF, and Goldman Sachs Sigma X. They handle roughly 15% of equity volume.

**Payment for Order Flow (PFOF)** has become central to retail trading economics. Retail brokers like Robinhood, Charles Schwab, and E\*TRADE route customer orders to wholesale market makers—Citadel Securities, Virtu Financial, and others—who pay for the order flow. The market makers profit from the spread between their buy and sell prices; the brokers profit from PFOF; retail investors get commission-free trades and often modest price improvement versus displayed quotes. Critics argue the system creates conflicts of interest; defenders note retail execution quality has improved.

**High-Frequency Trading (HFT)** firms now dominate market making. Citadel Securities handles roughly 27% of all U.S. equity volume. Virtu Financial, Jane Street, and Two Sigma are other major players. These firms use co-located servers (physically near exchange matching engines), sophisticated algorithms, and massive technology investment to capture tiny spreads across millions of trades. HFT has compressed bid-ask spreads but raised concerns about flash crashes and market stability.

## Market Indices

Stock indices serve as benchmarks for investment performance and as underlying assets for index funds and derivatives.

**The S&P 500**, maintained by S&P Dow Jones Indices (a subsidiary of S&P Global), tracks 500 large-cap U.S. stocks selected by committee. It’s market-cap weighted, meaning larger companies have more influence. The S&P 500 represents roughly 80% of U.S. market capitalization and has become the default benchmark for U.S. equity performance.

**The Dow Jones Industrial Average**, despite its fame, is a price-weighted index of only 30 stocks—an anachronistic methodology that gives higher-priced stocks more weight regardless of company size.

**NASDAQ Composite** includes all NASDAQ-listed stocks (over 3,000), creating a tech-heavy benchmark.

**Russell 2000** tracks small-cap stocks and is the standard benchmark for that segment.

Index composition matters enormously because roughly \$15 trillion tracks the S&P 500 directly or in benchmarked strategies. When a stock enters or leaves the index, passive funds must buy or sell, creating predictable price movements that active traders exploit.

## IPOs and Capital Raising

The Initial Public Offering (IPO) process brings private companies to public markets. Investment banks underwrite IPOs, meaning they commit to buy shares from the issuing company and resell them to investors, bearing the risk of price declines.

The IPO process typically involves:

1. **Selecting underwriters:** Lead (“bookrunner”) and co-managing banks
2. **Due diligence and SEC filing:** S-1 registration statement
3. **Roadshow:** Management presentations to institutional investors
4. **Book building:** Underwriters collect indications of interest
5. **Pricing:** Final offer price set the night before trading begins
6. **Allocation:** Shares distributed to institutional and retail investors
7. **First-day trading:** Stock begins trading on exchange

Underwriters typically receive 5-7% of gross proceeds as fees. Goldman Sachs, Morgan Stanley, and JPMorgan dominate IPO underwriting, with boutiques handling smaller deals.

**Table 19.3: U.S. IPO Activity**

Year	Number of IPOs	Gross Proceeds
2019	232	\$63 billion
2020	480	\$168 billion
2021	1,035	\$315 billion
2022	181	\$22 billion
2023	154	\$26 billion

Source: Renaissance Capital

The IPO boom of 2020-2021 was fueled by low interest rates, pandemic stimulus, and the SPAC (Special Purpose Acquisition Company) phenomenon. SPACs—blank-check companies that raise money through IPO and then acquire private companies—offered an alternative path to public markets. After more than 600 SPAC IPOs in 2021, the market collapsed amid poor performance and regulatory scrutiny.

**Direct listings** allow companies to go public without raising new capital or using underwriters. Spotify and Coinbase used this approach. The NYSE and NASDAQ have both expanded rules to accommodate direct listings.

## Stock Buybacks and Capital Return

While IPOs channel capital into corporations, established companies increasingly return capital to shareholders through dividends and stock repurchases (“buybacks”).

**Stock buybacks** allow companies to repurchase their own shares on the open market. When a company buys back stock, the shares are retired, reducing shares outstanding and increasing earnings per share (EPS) for remaining shareholders. Buybacks have

become the dominant form of capital return, surpassing dividends for most large companies.

**Table 19.3a: S&P 500 Capital Return (billions)**

Year	Buybacks	Dividends	Total
2019	\$729	\$485	\$1,214
2020	\$520	\$480	\$1,000
2021	\$882	\$511	\$1,393
2022	\$923	\$565	\$1,488
2023	\$795	\$590	\$1,385

Source: S&P Dow Jones Indices

Why do companies prefer buybacks? Several reasons:

- **Tax efficiency:** Shareholders who don't sell pay no immediate tax; dividends are taxed when paid
- **Flexibility:** Unlike dividends (which markets expect to be maintained), buybacks can vary with cash flow
- **EPS management:** Reducing share count boosts EPS even without earnings growth
- **Executive compensation:** Stock-based pay benefits from higher share prices

Critics argue buybacks prioritize short-term stock prices over long-term investment. The Inflation Reduction Act of 2022 imposed a 1% excise tax on buybacks, the first U.S. tax specifically targeting repurchases.

The scale of buybacks means many large corporations are net withdrawers of equity capital rather than net raisers—the opposite of the textbook function of equity markets. Apple alone has repurchased over \$600 billion of stock since 2012.

## The Equity Premium Puzzle

A persistent finding in finance: stocks have historically returned far more than bonds, even after adjusting for risk. The “equity premium”—the excess return of stocks over Treasury bills—has averaged roughly 6% annually over the past century.

This premium is difficult to explain with standard economic models. Risk aversion would have to be implausibly high to justify avoiding stocks given historical returns. Various explanations have been proposed:

- **Rare disasters:** Investors fear extreme events (wars, pandemics) that could devastate equity values
- **Myopic loss aversion:** Investors evaluate portfolios too frequently and overweight short-term losses
- **Liquidity preferences:** Stocks are less liquid than they appear in a crisis
- **Habit formation:** Risk aversion varies with consumption relative to habit

The practical implication: long-term investors have historically been rewarded for bearing equity risk, even if theory can't fully explain why.

# Bond Markets

## Treasury Securities

The U.S. Treasury market is the world's largest, most liquid government bond market. Treasury securities are the benchmark "risk-free" rate against which all other debt is priced.

### Treasury securities come in several forms:

Type	Maturity	Features
Treasury bills (T-bills)	4, 8, 13, 26, 52 weeks	Zero-coupon (sold at discount)
Treasury notes	2, 3, 5, 7, 10 years	Semi-annual coupon
Treasury bonds	20, 30 years	Semi-annual coupon
TIPS	5, 10, 30 years	Principal adjusts with CPI
FRNs	2 years	Floating rate, tied to T-bill rate

The Treasury Department issues securities through regular auctions. Primary dealers—currently 24 banks and broker-dealers—are required to bid at every auction and make markets in Treasury securities. Primary dealers include JPMorgan, Goldman Sachs, Citigroup, Bank of America, and foreign banks like BNP Paribas and Nomura.

### Who holds Treasury securities:

Holder	Amount	Share
Federal Reserve	\$4.7 trillion	18%
Foreign official	\$3.5 trillion	13%
Foreign private	\$3.8 trillion	15%
Mutual funds	\$3.2 trillion	12%
Banks	\$1.5 trillion	6%
State/local governments	\$1.1 trillion	4%
Pension funds	\$1.0 trillion	4%
Other	\$7.2 trillion	28%

Source: Treasury Bulletin; figures approximate

Foreign holdings of Treasury securities peaked around 35% and have declined as the Fed expanded its balance sheet. China and Japan remain the largest foreign holders, each with roughly \$1 trillion.

## The Term Structure of Interest Rates

The yield curve—the relationship between bond yields and maturities—conveys information about expectations and risk.

Normally, longer-term bonds yield more than shorter-term bonds because: 1. **Expectations**: Future short rates may rise 2. **Term premium**: Investors require compensation for duration risk 3. **Liquidity preference**: Shorter bonds are generally more liquid

□ **Note:**

### The Yield Curve as Recession Indicator

An inverted yield curve—when short-term rates exceed long-term rates—has preceded every U.S. recession since 1955. The 2022-2023 inversion was the deepest since the early 1980s.

The 2022-2023 inversion (2-year yields exceeding 10-year yields) sparked recession warnings, though the timing of subsequent downturns has historically varied from 6 to 24 months.

The **10-year Treasury yield** is the benchmark rate for the U.S. economy, influencing mortgage rates, corporate borrowing costs, and equity valuations. When 10-year yields rise, other rates follow, tightening financial conditions economy-wide.

## Corporate Bonds

[Figure: Figure 19.2: U.S. bond markets by segment. Treasury securities dominate, followed by mortgage-backed securities and corporate bonds. The \$50+ trillion market dwarfs equities by outstanding value. Source: SIFMA]

Corporations borrow in bond markets to fund operations, acquisitions, and capital expenditures. The corporate bond market totals roughly \$10 trillion outstanding.

**Investment grade bonds** (rated BBB- or higher by S&P) from established companies trade in liquid markets with tight spreads over Treasuries. Major issuers include Apple, Microsoft, JPMorgan, and other blue chips.

**High-yield bonds** (rated BB+ or lower), also called “junk bonds,” offer higher coupons to compensate for default risk. The high-yield market developed in the 1980s, pioneered by Drexel Burnham Lambert’s Michael Milken. Today, high-yield issuers include leveraged buyout targets, distressed companies, and growing firms without investment-grade ratings.

**Credit spreads**—the yield difference between corporate bonds and Treasuries—widen during economic stress and narrow during expansions. The ICE BofA High Yield Spread, tracking the average spread over Treasuries for high-yield bonds, ranges from roughly 300 basis points (3%) in good times to 1,000+ basis points (10%) during crises.

**Table 19.4: Corporate Bond Spreads (basis points over Treasuries)**

Rating	Normal Spread	Crisis Spread (2008)
AAA	50-100	250
A	100-150	400

Rating	Normal Spread	Crisis Spread (2008)
BBB	150-250	650
BB	300-400	1,200
B	500-600	2,000

Source: SIFMA, US Bond Market Statistics, 2024

Corporate bond issuance is underwritten by investment banks, similar to equity IPOs. Large issuers maintain relationships with multiple banks and can tap markets opportunistically when spreads are tight.

## Municipal Bonds

State and local governments issue municipal bonds to fund infrastructure, schools, and operations. The \$4 trillion municipal market has a unique feature: interest income is generally exempt from federal income tax (and often state tax for in-state investors).

**General obligation (GO) bonds** are backed by the issuer's taxing power. **Revenue bonds** are backed by specific revenue streams (toll roads, airports, water systems).

The tax exemption means municipal yields are lower than taxable bonds—but the after-tax return can be higher for investors in high tax brackets. A “muni” yielding 3% is equivalent to a taxable bond yielding roughly 5% for an investor in the 40% combined tax bracket.

Credit quality varies widely. Most states maintain investment-grade ratings, but some municipalities have defaulted—most notably Detroit (2013) and Puerto Rico (2015-2022, the largest municipal bankruptcy).

The municipal market is less liquid than Treasury or corporate markets, with thousands of individual issuers and issues. Retail investors hold roughly 45% of municipal bonds, often through municipal bond funds.

## Derivatives Markets

Derivatives—contracts whose value derives from an underlying asset—enable risk transfer, hedging, and speculation. American derivatives markets are among the world’s largest.

### Exchange-Traded Derivatives

**Futures contracts** obligate parties to buy or sell an asset at a specified future date and price. Major U.S. futures exchanges:

- **CME Group** (Chicago): Owns CME, CBOT, NYMEX, COMEX. Trades interest rate futures (SOFR, Treasury), equity index futures (S&P 500, NASDAQ), commodities (oil, gold, corn, cattle), and currencies. CME is the world’s largest derivatives exchange by volume.

- **Intercontinental Exchange (ICE)**: Trades energy futures, agricultural products, equity index futures.
- **CBOE Global Markets** (Chicago): Dominates equity options, trades VIX futures, and operates stock exchanges.

**Table 19.5: Major U.S. Futures Contracts (2023)**

Contract	Exchange	Notional Value/Day
E-mini S&P 500	CME	\$350 billion
10-Year Treasury	CBOT	\$250 billion
SOFR (3-month)	CME	\$150 billion
Crude Oil (WTI)	NYMEX	\$100 billion
E-mini NASDAQ 100	CME	\$120 billion

Note: SOFR futures replaced Eurodollar futures after LIBOR discontinuation in June 2023.

Source: World Federation of Exchanges, 2024

**Options contracts** give the holder the right (not obligation) to buy or sell. The Chicago Board Options Exchange (CBOE) pioneered listed equity options in 1973. Today, options volume exceeds underlying stock volume by several multiples as traders use options for leverage, hedging, and income generation.

The **VIX**—the CBOE Volatility Index—measures expected S&P 500 volatility derived from options prices. Called the “fear gauge,” VIX spikes during market stress (hitting 80+ during March 2020) and falls during calm periods (below 15 in normal times).

## Over-the-Counter Derivatives

Most derivatives by notional value trade over-the-counter (OTC), negotiated bilaterally between parties rather than on exchanges.

**Interest rate swaps**—agreements to exchange fixed for floating interest payments—dominate OTC markets. Companies use swaps to manage interest rate exposure; banks use them to hedge loan portfolios. The interest rate swap market exceeds \$500 trillion in notional value, though the actual economic exposure (reflecting netting) is far smaller.

**Credit default swaps (CDS)** provide insurance against default. The buyer pays periodic premiums; the seller pays out if the reference entity defaults. CDS played a central role in the 2008 crisis when AIG’s enormous CDS positions threatened systemic collapse.

Post-2008 reforms pushed OTC derivatives toward central clearing. The Dodd-Frank Act mandated clearing through central counterparties (CCPs) for standardized swaps. LCH (owned by London Stock Exchange Group) and ICE Clear are major swap clearinghouses.

# Private Markets

## Private Equity

Private equity (PE) firms raise capital from institutional investors (pension funds, endowments, sovereign wealth funds) and acquire companies—either taking public companies private or buying private companies—with the goal of improving operations and selling at a profit.

**The PE model:** 1. Raise a fund with committed capital from limited partners (LPs) 2. Identify acquisition targets 3. Acquire companies using significant debt (leveraged buyouts) 4. Improve operations over 3-7 years 5. Exit through sale or IPO 6. Return capital to LPs; collect 20% carried interest on profits

### Major PE firms:

Firm	AUM	Headquarters	Notable Deals
Blackstone	\$1.0 trillion	New York	Hilton, Refinitiv
KKR	\$500 billion	New York	RJR Nabisco, First Data
Apollo	\$600 billion	New York	ADT, Caesars
Carlyle	\$400 billion	Washington, DC	Booz Allen, Hertz
TPG	\$220 billion	San Francisco	Spotify, Airbnb

Private equity now manages more assets than hedge funds. Supporters argue PE improves operational efficiency and provides patient capital for transformations. Critics note heavy debt loads can destabilize companies, workers often face layoffs, and the carried interest tax treatment (taxed as capital gains rather than ordinary income) represents an unjustified subsidy.

## Venture Capital

Venture capital (VC) funds early-stage companies with high growth potential in exchange for equity stakes. The VC ecosystem is concentrated in a few geographic clusters, particularly Silicon Valley.

**The VC model:** 1. Raise fund from LPs (endowments, foundations, wealthy individuals) 2. Make investments across a portfolio of startups 3. Provide mentorship, board seats, and follow-on funding 4. Hope that a few “home runs” more than offset losses on failed investments 5. Exit through IPO or acquisition

### Major VC firms:

Firm	Focus	Notable Investments	Location
Sequoia Capital	Tech, healthcare	Apple, Google, Airbnb	Menlo Park
Andreessen Horowitz	Tech	Facebook, Coinbase, Instacart	Menlo Park
Accel	Tech	Dropbox, Spotify, Slack	Palo Alto
Kleiner Perkins	Tech, cleantech	Amazon, Google, Twitter	Menlo Park
Founders Fund	Tech	SpaceX, Palantir, Airbnb	San Francisco

VC investment totaled \$170 billion in 2021 (a record driven by zero interest rates) before falling to \$67 billion in 2023 as monetary tightening reduced risk appetite.

**Table 19.6: U.S. Venture Capital Investment**

Year	Deal Value	Deal Count
2019	\$137 billion	11,000
2020	\$164 billion	12,000
2021	\$345 billion	18,000
2022	\$238 billion	15,000
2023	\$170 billion	13,000

Source: PitchBook

The geographic concentration is striking: California accounted for 45% of VC deals and 50% of deal value in 2023. New York is second, followed by Massachusetts (Boston), Texas (Austin), and Washington (Seattle).

## The Geography of Capital Markets

Capital markets activity concentrates heavily in a few locations.

**New York City** dominates. Lower Manhattan houses NYSE and major bank headquarters. Midtown contains the offices of investment banks, asset managers, hedge funds, and PE firms. The New York Fed, located on Liberty Street, conducts monetary policy operations. Roughly 330,000 people work in financial services in New York City.

**Chicago** is the derivatives capital. CME Group, CBOE, and associated trading firms are headquartered there. The city's role dates to the 19th century grain trade; today it hosts the world's most important futures and options markets.

**Boston** has the largest concentration of mutual fund companies (Fidelity, State Street, MFS) outside New York, a legacy of the Massachusetts Investors Trust (1924), America's first mutual fund.

**Connecticut** (Greenwich and Stamford) houses major hedge funds, attracted by proximity to New York and favorable state tax treatment.

**San Francisco Bay Area** dominates venture capital, with Sand Hill Road in Menlo Park as the symbolic center.

**Charlotte** hosts major bank operations (Bank of America, Wells Fargo, Truist) but relatively little capital markets activity.

**Table 19.7: Financial Services Employment by Metro (2023)**

Metro Area	Finance Employment	Specialization
New York	495,000	Full-service

Metro Area	Finance Employment	Specialization
Chicago	155,000	Derivatives
Los Angeles	140,000	Entertainment finance
Boston	130,000	Asset management
San Francisco	85,000	VC, tech
Dallas	120,000	Regional banking
Charlotte	80,000	Bank operations

Source: BLS QCEW

## Regulation and Infrastructure

### Regulatory Structure

Capital markets regulation in the United States is fragmented across multiple agencies.

**Securities and Exchange Commission (SEC)** regulates securities markets, including stock exchanges, broker-dealers, investment advisers, and mutual funds. The SEC enforces securities laws, requires public disclosure, and pursues fraud.

**Commodity Futures Trading Commission (CFTC)** regulates futures, options, and swap markets. The division between SEC (securities) and CFTC (commodities) dates to historical happenstance and creates occasional jurisdictional confusion (is a Bitcoin futures contract a security or a commodity?).

**Financial Industry Regulatory Authority (FINRA)** is a self-regulatory organization that oversees broker-dealers. FINRA examines firms, enforces rules, and operates dispute resolution for investor complaints.

**Federal Reserve** oversees bank holding companies and has expanded its supervision of capital markets activities post-2008.

**Office of Financial Research (OFR)**, created by Dodd-Frank, monitors systemic risk and produces data and analysis.

### Market Infrastructure

The plumbing of capital markets—clearinghouses, depositories, payment systems—is invisible but essential.

**Clearinghouses** stand between buyers and sellers, guaranteeing trade settlement and reducing counterparty risk. If one party fails, the clearinghouse absorbs the loss (up to its resources). DTCC (Depository Trust & Clearing Corporation) clears and settles most U.S. equity and bond trades. OCC (Options Clearing Corporation) clears equity options. CME Clearing handles futures.

**Settlement cycles** have shortened to reduce risk. The U.S. moved to **T+1 settlement** (trade date plus one business day) in May 2024—down from T+2, itself reduced

from T+3 in 2017. Faster settlement reduces the time during which counterparty risk exists.

**Depositories** hold securities electronically. DTCC's Depository Trust Company (DTC) holds virtually all U.S. stock and bond certificates in "street name." Transfers between brokers simply update DTC's records rather than moving physical certificates.

**Securities lending** allows owners to lend shares to short-sellers in exchange for fees. Short selling—betting that a stock price will fall by borrowing shares, selling them, and repurchasing later at (hopefully) a lower price—requires borrowing shares from current owners. Banks and custodians run securities lending programs for their clients.

**Trade reporting** has expanded post-2008. TRACE (Trade Reporting and Compliance Engine) publishes bond trade prices. Swap data repositories collect derivatives information.

## Recent Trends

### The Passive Investing Revolution

Index funds and ETFs have captured an ever-larger share of equity assets. Roughly 50% of U.S. equity mutual fund and ETF assets now track indices, up from 20% in 2010.

The implications are profound: - **Fee compression:** Average equity fund fees have fallen from 1%+ to 0.5% as money flows to low-cost index funds - **Index concentration:** Massive inflows to S&P 500 funds concentrate ownership (the "Big Three"—BlackRock, Vanguard, State Street—hold 20%+ of major companies) - **Common ownership:** The same institutions own large stakes in competing firms, raising antitrust concerns - **Price discovery:** If fewer investors actively analyze stocks, do prices still reflect information efficiently?

### Private Market Expansion

Private markets have grown faster than public markets. The number of U.S. public companies has declined from 8,000 in 1996 to roughly 4,400 today, while private equity-backed companies have multiplied.

Companies stay private longer, completing more funding rounds before going public. When they do IPO, valuations are often in the tens of billions. This means retail investors can access companies only after much of the growth has occurred.

"Private credit"—direct lending by non-bank investors—has grown from nearly nothing to a \$1.7 trillion market as banks retreated post-2008 and PE firms created credit affiliates.

## The Retail Trading Renaissance

The pandemic triggered a surge in retail stock trading, enabled by commission-free brokerages and social media coordination.

The “**meme stock**” phenomenon of January 2021 exemplified this shift. Retail traders on Reddit’s WallStreetBets forum coordinated purchases of GameStop (GME), a struggling video game retailer whose stock was heavily shorted by hedge funds. GameStop’s share price rose from \$17 to \$483 in two weeks, inflicting billions in losses on short-sellers and forcing several hedge funds into distressed positions. Similar dynamics affected AMC Entertainment, BlackBerry, and other heavily-shorted stocks.

The episode raised fundamental questions about market structure:

- **Democratization or manipulation?** Retail traders argued they were beating hedge funds at their own game; critics saw potential market manipulation through coordinated buying
- **Payment for order flow:** Robinhood’s temporary halt on GameStop purchases during the frenzy (due to clearinghouse capital requirements) fueled accusations that brokers protected institutional clients over retail
- **Short selling disclosure:** The episode exposed how little is known publicly about short positions

The SEC ultimately proposed but did not implement PFOF restrictions, instead requiring enhanced disclosure. Retail trading volumes have moderated from 2021 peaks but remain elevated compared to pre-pandemic levels, with options trading particularly popular among individual investors.

## Cryptocurrency and Digital Assets

Cryptocurrency markets have developed alongside traditional capital markets, though with more volatility and less regulation.

Bitcoin, the largest cryptocurrency by market cap (roughly \$800 billion), trades on crypto exchanges (Coinbase, Kraken) and, since January 2024, through SEC-approved spot Bitcoin ETFs. Ethereum (roughly \$280 billion) is the second-largest.

The SEC has aggressively pursued crypto platforms for alleged securities law violations, while the industry argues most tokens aren’t securities. Resolution remains pending in courts and Congress.

**Stablecoins**—cryptocurrencies pegged to the dollar—have become important for crypto trading (Tether, USDC) but raise monetary policy questions about private money creation.

## AI and Market Structure

Machine learning increasingly drives trading strategies, risk management, and research. Natural language processing analyzes earnings calls, news, and social media for trading signals. Quantitative hedge funds like Renaissance Technologies, Two Sigma, and D.E. Shaw deploy sophisticated ML models.

Concerns about AI in markets include:

- **Herd**: If models reach similar conclusions, correlated trading could amplify volatility
- **Opacity**: Complex models may create risks that humans don't understand
- **Speed**: Faster-than-human reaction could disadvantage traditional investors

## Firm Profiles

### NYSE (Intercontinental Exchange)

The New York Stock Exchange traces its origins to the Buttonwood Agreement of 1792, when 24 brokers agreed to trade securities under a buttonwood tree on Wall Street. For two centuries, NYSE was a member-owned cooperative, with "seats" (memberships) trading for as much as \$4 million.

The exchange demutualized (converted from cooperative to corporation) in 2006 and merged with Archipelago, an electronic exchange. After a brief combination with Euronext (European exchanges), NYSE was acquired by Intercontinental Exchange in 2013.

ICE, founded in 2000 as an electronic energy trading platform, has grown through acquisitions into a diversified exchange and data company. Beyond NYSE, ICE operates commodity futures exchanges, mortgage technology platforms (including Ellie Mae), and a substantial fixed income data business.

Today, NYSE lists roughly 2,400 companies with combined market capitalization exceeding \$28 trillion. The iconic trading floor at 11 Wall Street employs roughly 300 people—down from 1,500 in the 1990s—but remains symbolically important for IPOs, media appearances, and the opening/closing bells.

**Key statistics (2023):**

- ICE revenue: \$8 billion
- NYSE listed companies: 2,400
- Average daily equity volume: 4 billion shares
- IPO proceeds: \$15 billion
- Employees (ICE total): 12,000

### CME Group

CME Group is the world's largest derivatives exchange, formed through the 2007 merger of the Chicago Mercantile Exchange and Chicago Board of Trade. Subsequent acquisitions added NYMEX (energy), COMEX (metals), and other exchanges.

The company traces to the founding of the Chicago Board of Trade in 1848 to standardize grain trading. The Chicago Mercantile Exchange, established in 1898 as the Chicago Butter and Egg Board, pioneered financial futures in the 1970s—currency futures (1972), Treasury futures (1976), stock index futures (1982).

Today, CME Group trades roughly 6 billion contracts annually, including:

- Interest rate futures (SOFR, Treasury)
- Equity index futures (S&P 500, NASDAQ, Dow)
- Energy (crude oil, natural gas)
- Agricultural (corn, wheat, soybeans, cattle)
- Metals (gold, silver, copper)
- Foreign exchange

The E-mini S&P 500 futures contract is arguably the world's most important derivative, used for hedging, speculation, and portfolio management. Its overnight movements indicate how U.S. markets will open.

**Key statistics (2023):** - Revenue: \$5.5 billion - Average daily volume: 24 million contracts - Open interest: 120 million contracts - Clearing members: 55 - Employees: 4,500

## Sequoia Capital

Sequoia Capital, founded in 1972 by Don Valentine, is arguably the most successful venture capital firm in history. Valentine, a former Fairchild Semiconductor sales manager, raised Sequoia's first fund of \$3 million.

Early investments included Apple (1978), Cisco (1987), and Oracle (1986). More recent successes include Google (1999), YouTube (2005), LinkedIn (2003), Airbnb (2009), and Stripe (2011). The firm's cumulative return statistics are closely guarded but legendary—a \$6 million investment in WhatsApp returned \$3 billion when Facebook acquired it.

Sequoia's model emphasizes long-term relationships with founders and "company building" beyond capital. Partners often take board seats and provide operational guidance. The firm tends toward growth and technology investments, with particular strength in enterprise software and consumer internet.

Unlike most VC firms that return capital to investors after each fund, Sequoia in 2021 restructured to hold investments indefinitely through a permanent structure—a recognition that the best companies may never need to exit.

**Key statistics:** - AUM: roughly \$85 billion - Active portfolio companies: 300+ - IPOs/acquisitions: 400+ - Locations: Menlo Park, London, India, China, Southeast Asia - Partners: roughly 60

## Firm Profile: Vanguard Group

**Quick Facts - Headquarters:** Malvern, Pennsylvania - **Assets Under Management:** \$9.3 trillion (2024) - **Structure:** Owned by its funds (and thus by fund shareholders) - **Employees:** 20,000+

Vanguard is the world's largest mutual fund company and the second-largest asset manager, having pioneered low-cost index investing and transformed how Americans save for retirement. The company's unique ownership structure—Vanguard is owned by its funds, which are owned by their shareholders—means profits flow back to investors through lower fees rather than to outside shareholders.

John Bogle founded Vanguard in 1975 after being fired from Wellington Management. His contrarian insight: most active managers fail to beat the market after fees, so investors are better served by low-cost funds that simply track market indices. The first retail index fund, tracking the S&P 500, launched in 1976 to industry ridicule ("Bogle's Folly"). Today that fund holds over \$1 trillion.

Vanguard's relentless cost reduction has driven average expense ratios across the industry down from over 1% to around 0.5%. The company's largest funds charge just 0.03-0.04% annually—\$3-4 per \$10,000 invested. This compounding cost advantage has attracted enormous inflows: Vanguard grew from \$1 trillion in 2008 to \$9+ trillion today, largely through organic growth rather than acquisitions. Along with BlackRock and State Street, Vanguard forms the “Big Three” passive managers whose combined holdings make them top shareholders in most large American companies—a concentration that raises questions about market competition, corporate governance, and index investing’s effects on price discovery.

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## Conclusion

American capital markets are the world’s largest and most sophisticated, channeling trillions of dollars from savers to borrowers and from passive investors to active managers. Their depth and liquidity give U.S. companies access to capital that firms in other countries cannot match.

Yet capital markets also concentrate wealth and power. The three largest asset managers hold enormous stakes in most major corporations. Private equity firms control large swaths of the economy with minimal public disclosure. High-frequency traders profit from speed advantages unavailable to ordinary investors. The shift from public to private markets means growth increasingly occurs outside the reach of regular investors.

These markets are not self-regulating. The 2008 crisis demonstrated how interconnected markets can transmit and amplify shocks. Post-crisis regulation has reduced some risks while potentially creating new ones (concentration in clearinghouses, for example). The rise of crypto, AI trading, and private credit creates regulatory challenges that authorities are still working to address.

For the American economy, capital markets serve as the circulatory system—moving resources to their highest-valued uses, enabling risk sharing, and providing price signals that guide investment. How well they perform that function depends on market structure, regulation, and the incentives of participants.

## Data Sources and Further Reading

### Data Sources

- **SEC:** EDGAR for filings, market structure data
- **FINRA:** TRACE bond data, trading statistics
- **SIFMA:** Securities Industry and Financial Markets Association research
- **World Federation of Exchanges:** Global exchange statistics
- **PitchBook/Preqin:** Private markets data
- **NVCA:** Venture capital statistics
- **Federal Reserve:** Flow of funds, financial accounts
- **BIS:** Global derivatives statistics

## Further Reading

- **Mehrling, Perry.** *The New Lombard Street* (2011)—how the Fed backstops capital markets
  - **Bernstein, Peter.** *Capital Ideas* (1992)—intellectual history of modern finance
  - **Lewis, Michael.** *Flash Boys* (2014)—high-frequency trading
  - **Fox, Justin.** *The Myth of the Rational Market* (2009)—efficient markets debate
  - **Appelbaum & Batt.** *Private Equity at Work* (2014)—critical examination of PE
- 

## Exercises

### Review Questions

1. The chapter notes that roughly \$15 trillion tracks the S&P 500 directly or in benchmarked strategies. When a stock is added to or removed from the index, passive funds must mechanically buy or sell. Explain the price dynamics this creates around index reconstitution events. If passive investing continues growing (now roughly 50% of equity mutual fund and ETF assets, up from 20% in 2010), what are the implications for price discovery? Could a market dominated by passive investors still be informationally efficient?
2. Regulation NMS (2005) allows any registered exchange or alternative trading system to execute trades in any listed stock. The chapter describes how this fragmented trading across dozens of venues, including dark pools that handle roughly 15% of equity volume. Explain the trade-off between competition among venues (which may improve execution quality) and fragmentation of liquidity (which may impair price discovery). Why would an institutional investor route a large order to a dark pool rather than a lit exchange?
3. The chapter presents IPO data showing 1,035 IPOs raising \$315 billion in 2021, followed by just 154 IPOs raising \$26 billion in 2023. What macroeconomic and market conditions explain this collapse? The chapter also notes that the number of U.S. public companies has declined from 8,000 in 1996 to roughly 4,400 today. What are the consequences for retail investors if companies complete most of their growth while still private?
4. The yield curve inverted in 2022-2023, with 2-year yields exceeding 10-year yields—the deepest inversion since the early 1980s. The chapter notes that an inverted yield curve has preceded every U.S. recession since 1955. Explain the two main theories for why inversion predicts recessions: (a) the expectations hypothesis (what does inversion imply about the market’s forecast of future short-term rates?) and (b) the bank lending channel (how does inversion compress banks’ net interest margins and affect their willingness to lend?).
5. The chapter describes the “meme stock” phenomenon of January 2021, when retail traders on Reddit’s WallStreetBets drove GameStop’s share price from \$17 to \$483 in two weeks by coordinating purchases of a heavily-shorted stock. Robinhood then halted GameStop purchases, citing clearinghouse capital re-

quirements. Explain how the T+2 settlement cycle (in effect at the time) created the capital call that forced Robinhood's hand. Would the move to T+1 settlement (implemented in May 2024) have prevented or reduced this problem? Why or why not?

6. The chapter notes that credit default swaps (CDS) "played a central role in the 2008 crisis when AIG's enormous CDS positions threatened systemic collapse," and that post-2008 reforms pushed OTC derivatives toward central clearing through CCPs. Explain why bilateral CDS trading created systemic risk (think about counterparty chains and AIG's role as a single point of failure). How does central clearing through a CCP reduce this risk? What new systemic risk does it create by concentrating exposure in the clearinghouse itself?
7. The chapter describes the "Big Three" passive managers—BlackRock, Vanguard, and State Street—as collectively holding 20%+ of most major companies. This creates a "common ownership" problem: the same institutions own large stakes in competing firms (for example, all major airlines). Using the chapter's discussion of passive investing, explain why common ownership might reduce competitive intensity. What mechanisms would translate common ownership into less aggressive pricing or investment behavior?

## Data Exercises

1. **Mapping the Yield Curve.** Using FRED, download the following Treasury yield series: DGS1MO (1-month), DGS3MO (3-month), DGS1 (1-year), DGS2 (2-year), DGS5 (5-year), DGS10 (10-year), and DGS30 (30-year). Plot the yield curve for three dates: (a) January 2021 (near-zero rates), (b) October 2022 (peak inversion), and (c) today. Calculate the 2-year/10-year spread (known as the "2s10s") for each date. Then pull the ICE BofA US High Yield Option-Adjusted Spread from FRED (series BAMLH0A0HYM2) and plot it alongside the 2s10s spread over the past 20 years. How do credit spreads behave during and after yield curve inversions?
2. **Tracking the Passive Revolution.** The Investment Company Institute publishes annual data on index fund and ETF market share (<https://www.ici.org/research/stats>). Download the most recent ICI Fact Book and construct a time series showing the share of U.S. equity fund assets in index-tracking vehicles from 2000 to the present. Then use FRED to pull total stock market capitalization (series BOGZ1FL073164003Q from the Z.1 Financial Accounts). Estimate the dollar value of passively managed U.S. equity assets. Compare this to the combined assets under management of BlackRock (iShares), Vanguard, and State Street (SPDR) using their most recent public filings. What fraction of passive assets do the Big Three control?
3. **Venture Capital Geography.** Using the National Venture Capital Association's yearbook (<https://nvca.org/research/nvca-yearbook/>) or PitchBook data, compile VC deal value by state for the most recent year available. Calculate each state's share of total U.S. VC investment. The chapter reports California at 45% of deals and 50% of deal value. Has concentration increased or decreased over the past five years? Identify any emerging VC hubs (the chapter mentions Austin, Texas,

and Seattle, Washington). Compare your state-level VC figures with the BLS Quarterly Census of Employment and Wages (<https://www.bls.gov/cew/>) data on financial services employment in those same metros.

## Deeper Investigation

**The Decline of Public Markets.** The chapter documents that the number of U.S. public companies fell from 8,000 in 1996 to roughly 4,400 today, while private equity-backed companies have multiplied and companies stay private longer. Write a research paper examining the causes and consequences of this shift. Draw on SEC filing data (EDGAR), academic work by Doidge, Karolyi, and Stulz (“The U.S. Listing Gap,” 2017), and Ewens and Farre-Mensa (“The Deregulation of the Private Capital Markets,” 2020). Address the following questions: What regulatory, technological, and market structure changes have made staying private more attractive? How has the JOBS Act of 2012 affected the threshold for going public? What are the distributional consequences—if ordinary retail investors can only access companies after they IPO at multi-billion-dollar valuations, who captures the growth-stage returns? Evaluate policy proposals to either encourage public listing or expand retail access to private markets (such as SEC proposals to broaden “accredited investor” definitions).

# Chapter 20: Corporate Finance in Practice

How do American corporations finance themselves? The textbook answer—firms raise capital by issuing stocks and bonds—is mostly wrong. In practice, corporations finance investment overwhelmingly from internal funds: retained earnings and depreciation allowances. When they do access external markets, they strongly prefer debt to equity. And for the past decade, large corporations have been net returners of capital to shareholders through buybacks and dividends, not net raisers.

This chapter examines how corporate finance actually works: the pecking order of funding sources, the practitioners who execute deals, the governance structures that shape decisions, and the recent trends reshaping American corporations.

## The Pecking Order in Practice

### How Corporations Actually Finance Investment

The Federal Reserve's Financial Accounts (Z.1) reveal the true picture of corporate financing:

**Table 20.1: Sources of Corporate Funds (2023)**

Source	Amount	Share
Internal funds (retained earnings + depreciation)	\$3.0 trillion	76%
Net debt issuance	\$0.9 trillion	24%
Net equity issuance	-\$0.8 trillion	Negative

Source: Federal Reserve Z.1 Financial Accounts, 2024

The negative equity figure means corporations bought back more stock than they issued—a pattern that has persisted for most of the past two decades. American corporations are not tapping equity markets for expansion capital; they're returning equity capital to shareholders.

This pattern confirms the **pecking order theory** of corporate finance: firms prefer internal funds first, then debt, then equity as a last resort. The reasons are straightforward:

## Sources of U.S. Corporate Financing (Flows)



Figure 71: Figure 20.1: How corporations finance investment. Internal funds dominate; net equity issuance is negative as buybacks exceed new issues. Source: Federal Reserve Z.1

- **Internal funds have no transaction costs:** No underwriting fees, no disclosure requirements, no market timing risk
- **Debt is tax-advantaged:** Interest payments are deductible; dividends are not
- **Equity issuance signals weakness:** Markets often interpret stock offerings as a sign that management believes shares are overvalued

## Capital Structure by Industry

Different industries have systematically different capital structures, reflecting their asset bases and cash flow patterns.

**Table 20.2: Typical Capital Structure by Industry**

Industry	Debt/Capital	Characteristics
Utilities	50-60%	Regulated returns, stable cash flows
Telecoms	40-50%	Heavy infrastructure, predictable revenue
Real estate (REITs)	40-50%	Tangible collateral, REIT tax rules
Manufacturing	25-35%	Cyclical, some tangible assets
Retail	25-35%	Lease obligations (off-balance sheet)
Technology	5-15%	High margins, intangible assets
Pharma/Biotech	10-20%	R&D-intensive, uncertain cash flows

Technology companies carry minimal debt despite having the financial capacity for more. Their intangible assets (software, patents, brand) make poor collateral, and their high profit margins generate abundant internal funds. Apple typically borrows at the tightest spreads in the market—but historically chose to maintain minimal debt until it discovered that issuing bonds to fund buybacks was more tax-efficient than repatriating overseas cash. (For technology firms, “internal funds” are often boosted by stock-based compensation: by paying employees in equity rather than cash, companies preserve liquidity, though this creates dilution that buybacks must later offset.)

## The Rise of Corporate Cash Piles

Large corporations—especially technology firms—accumulated enormous cash balances in the 2010s:

Company	Peak Cash Holdings	Year
Apple	\$285 billion	2017
Microsoft	\$136 billion	2020
Alphabet	\$140 billion	2023
Amazon	\$86 billion	2022
Berkshire Hathaway	\$325 billion	2024

Several forces drove cash accumulation:

- **Overseas earnings:** Before the 2017 tax reform, repatriating foreign profits triggered a 35% tax. Firms held cash abroad.

- **Precautionary motives:** The 2008 crisis demonstrated that even healthy firms can face sudden liquidity crunches
- **Lack of investment opportunities:** The “investment drought” puzzle—high profits but weak capital spending
- **M&A optionality:** Cash on hand enables quick deal execution

The 2017 Tax Cuts and Jobs Act eliminated the repatriation penalty, triggering a one-time wave of cash returning to the U.S. Much of it funded buybacks rather than investment.

## The Corporate Bond Market

### Investment Grade Issuers

The corporate bond market totals roughly \$10 trillion outstanding, dominated by large investment-grade issuers.

#### Who Borrows Most:

The largest corporate bond issuers are no longer industrial giants—they’re technology companies and banks:

Company	Bonds Outstanding	Credit Rating
Apple	\$100+ billion	AA+
Microsoft	\$80+ billion	AAA
Amazon	\$60+ billion	AA
JPMorgan Chase	\$200+ billion	A+
Bank of America	\$180+ billion	A
AT&T	\$140+ billion	BBB+
Verizon	\$120+ billion	BBB+

#### The AAA Club:

Only two American corporations maintain AAA credit ratings: **Microsoft** and **Johnson & Johnson**. The club has shrunk from dozens in the 1980s as companies embraced leverage, pursued acquisitions, and prioritized shareholder returns over balance sheet strength.

The loss of a AAA rating rarely matters operationally—borrowing costs for AA companies are only marginally higher—but it symbolizes the shift toward financial optimization and away from fortress balance sheets.

#### Warning:

### The BBB Cliff: Systemic Risk in Investment Grade

The largest segment of the investment-grade bond market is now rated BBB—the lowest investment-grade tier. In a recession, companies downgraded to junk (“fallen angels”) face forced selling from investment-grade-only funds, potentially flooding the high-yield market.

## High-Yield (Junk) Bonds

Below investment grade, the high-yield market serves:

- **Leveraged buyout targets:** PE-owned companies with debt loads that preclude investment-grade ratings
- **Growth companies:** Firms with strong prospects but unproven track records
- **Fallen angels:** Former investment-grade issuers that have deteriorated
- **Distressed issuers:** Companies in financial difficulty

High-yield issuers pay significantly more—spreads of 300-500 basis points over Treasuries in normal times, widening to 1,000+ in stress periods.

## Investment Banking and Deal-Making

### The M&A Market

Mergers and acquisitions represent the highest-profile activity in corporate finance. The U.S. M&A market totaled roughly \$2 trillion in announced deals in 2024, representing about 54% of global activity.

#### Deal Activity by Type:

Category	Share of Value	Characteristics
Strategic (corporate)	55%	Synergy-driven, stock or cash
Private equity buyouts	30%	Leverage, operational improvement
Financial sponsors (other)	10%	Infrastructure, real assets
SPAC/de-SPAC	5%	Down from 20%+ in 2021

#### The Largest Deals (Recent History):

Deal	Value	Year
Microsoft-Activision	\$69 billion	2023
Broadcom-VMware	\$61 billion	2023
Exxon-Pioneer	\$60 billion	2024
Chevron-Hess	\$53 billion	2024
Capital One-Discover	\$35 billion	2024

### The Advisory Business

Investment banks advise on M&A transactions, typically earning fees of 0.5-1% of deal value for large transactions (higher percentages for smaller deals).

#### Top M&A Advisors by Deal Value (2024):

## **U.S. Mergers and Acquisitions (M&A) Volume**

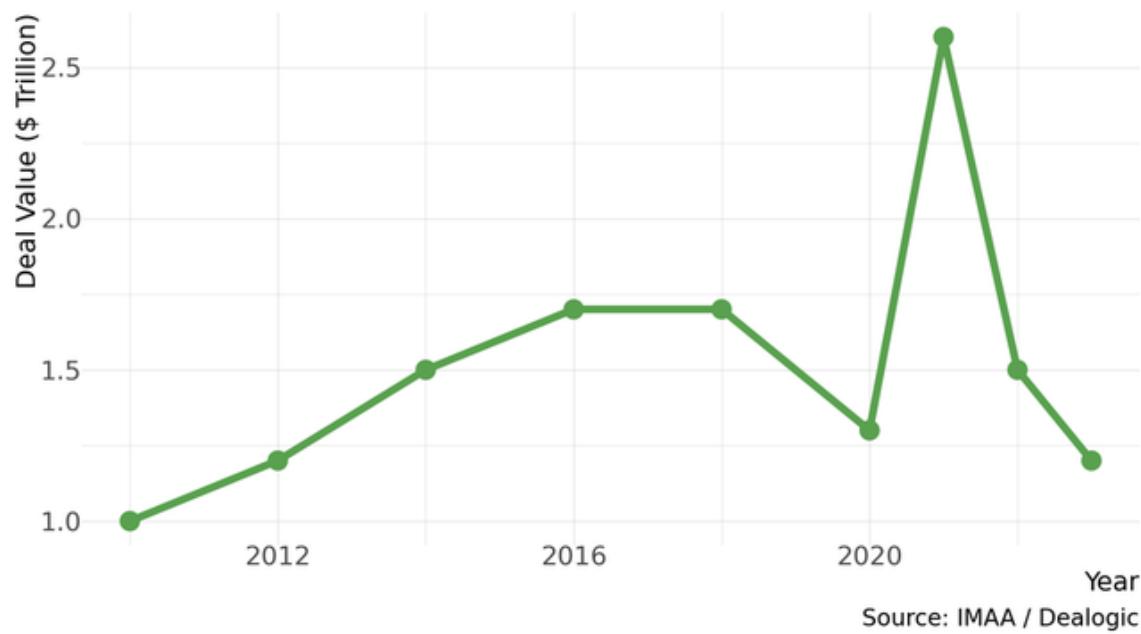


Figure 72: Figure 20.2: U.S. M&A activity has been cyclical, with peaks in 2000, 2007, and 2021 corresponding to bull markets and cheap financing. Source: Refinitiv

Bank	Market Position	Specialty
Goldman Sachs	#1 large-cap	Marquee deals, hostile defense
Morgan Stanley	#2 large-cap	Tech, healthcare
JPMorgan	#3 large-cap	Cross-border, financing
Centerview Partners	Top boutique	Complex situations
Lazard	Top boutique	Restructuring, activism defense

### Mid-Market Specialists:

Bank	Position	Focus
Houlihan Lokey	#1 by volume	Middle market, restructuring
Jefferies	#2 by volume	Healthcare, tech
William Blair	Regional leader	Private companies
Harris Williams	PE specialist	PE portfolio exits

The boutique advisory firms (Centerview, Evercore, Lazard, Moelis, PJT Partners) have gained share from bulge-bracket banks by offering senior banker attention and avoiding conflicts of interest.

### The Legal Architecture

Law firms are essential to deal execution, handling due diligence, contract negotiation, regulatory filings, and litigation risk.

### Top M&A Law Firms:

Firm	Specialty	Notable
Kirkland & Ellis	PE, private M&A	Largest by revenue
Wachtell, Lipton	Public company M&A	Invented poison pill
Skadden, Arps	Public M&A	Global reach
Simpson Thacher	PE, financing	Leveraged buyouts
Paul, Weiss	PE, complex deals	High-stakes litigation

Wachtell, Lipton, Rosen & Katz occupies a unique position: a small partnership (roughly 250 lawyers) that handles the most complex and contentious public company transactions, charging premium rates and generating the highest revenue per partner in the industry.

### Private Equity's Role

Private equity firms have become central actors in corporate America. (See also Chapter 19 for PE as an investment category.)

## How PE Changes Corporate Finance

PE ownership transforms corporate finance in several ways:

**Higher leverage:** PE-owned companies typically carry 5-7x EBITDA in debt, versus 2-3x for public companies. This amplifies returns but increases bankruptcy risk.

**Governance intensity:** PE boards meet monthly rather than quarterly, with partners deeply involved in operations.

**Short investment horizon:** PE firms aim to exit within 3-7 years, creating pressure for rapid improvement.

**Management incentives:** Executives receive significant equity stakes, aligning their interests with owners.

**Table 20.3: Public vs. PE-Owned Capital Structure**

Metric	Public Company	PE-Owned
Debt/EBITDA	2-3x	5-7x
Equity cushion	50-70%	20-40%
Board meetings	Quarterly	Monthly
CEO equity stake	0.1-0.5%	3-10%

Source: Federal Reserve Z.1 Financial Accounts, 2024

## Dividend Recapitalizations

A controversial PE practice: after improving a company's performance (or simply waiting for conditions to improve), PE firms sometimes have the company issue debt specifically to pay a dividend to owners. This extracts value before exit, but also increases leverage and risk for remaining stakeholders.

Critics argue dividend recaps transfer risk to employees and creditors while PE extracts cash. Defenders note the practice is legal, and PE firms maintain ownership stakes so their interests remain aligned with company performance.

## Corporate Governance

### Board Composition and Function

American corporate boards have evolved significantly in recent decades.

#### Size and Structure:

Characteristic	2000	2024
Average board size (S&P 500)	12	11
Independent directors	65%	85%
CEO also chairman	75%	45%

Characteristic	2000	2024
Women directors	12%	34%
Racial/ethnic minority directors	10%	26%

### Key Committees:

- **Audit Committee:** Financial oversight, internal controls, external auditor relationship (must be all independent)
- **Compensation Committee:** Executive pay, performance metrics, equity grants
- **Nominating/Governance Committee:** Board composition, succession planning
- **Risk Committee:** Enterprise risk management (common at financial firms)

### Executive Compensation

CEO pay has grown dramatically relative to average worker compensation.

**Table 20.4: CEO-to-Worker Pay Ratio (S&P 500)**

Year	Ratio	Average CEO Pay
1990	71:1	\$3.5 million
2000	293:1	\$14.2 million
2010	221:1	\$10.1 million
2020	264:1	\$13.9 million
2024	285:1	\$18.9 million

Source: Economic Policy Institute, CEO Compensation Analysis, 2024

### Compensation Structure:

Modern CEO pay consists primarily of equity-linked compensation:

Component	Share	Form
Base salary	8-12%	Cash
Annual bonus	15-20%	Cash, tied to annual targets
Performance shares	40-50%	Stock vesting over 3 years, tied to TSR/EPS
Stock options	15-25%	Right to buy stock at fixed price
Perquisites	2-5%	Jet, security, etc.

**Total Shareholder Return (TSR)** has become the dominant performance metric—stock price appreciation plus dividends, often measured relative to peers. This ties CEO wealth directly to stock performance, for better or worse.

**Say on Pay:** Since 2011, public companies must hold non-binding shareholder votes on executive compensation. Companies failing to receive majority support face pressure to revise pay packages, but failures are rare (less than 3% of companies annually).

## Activist Investors

Activist investors acquire stakes in public companies and push for changes—board seats, strategic shifts, operational improvements, or capital returns.

### Major Activists:

Firm	Founder	Style	2024 Campaigns
Elliott Management	Paul Singer	Operational, aggressive	14
Starboard Value	Jeff Smith	Margin improvement	8
Trian Partners	Nelson Peltz	Strategic, board seats	5
Icahn Enterprises	Carl Icahn	Confrontational	3
Third Point	Dan Loeb	Media-savvy	4

### Notable 2024 Campaigns:

- **Southwest Airlines:** Elliott won six board seats after attacking operational failures and demanding management change
- **Starbucks:** Elliott and Starboard pressure contributed to CEO change, with Brian Niccol hired from Chipotle
- **Disney:** Trian lost the proxy fight but forced focus on succession planning and cost discipline

### Activist Tactics:

1. **Accumulate stake:** Build position (often using derivatives to avoid disclosure until 5% threshold)
2. **Engage privately:** Present analysis and demands to management
3. **Go public:** If private engagement fails, release letter and presentation
4. **Proxy fight:** Nominate alternative directors for shareholder vote
5. **Settlement:** Often results in board seats, strategic review, or buybacks

## ESG and Stakeholder Capitalism

Environmental, Social, and Governance (ESG) factors rose to prominence in the late 2010s, with major investors incorporating ESG metrics into investment decisions.

### The Backlash:

ESG has become politically contested. Republican-led states have restricted state pension fund investments with ESG-focused managers. “Anti-ESG” funds have launched (though with minimal assets). Companies increasingly practice “**green-hushing**

### The Practical Reality:

Despite political controversy, most large companies continue ESG-related activities:

- Climate risk disclosure (required by SEC, EU regulations, California law)
- Diversity reporting (investor and customer pressure)

- Supply chain auditing (reputational risk management)
- Board oversight of sustainability (governance best practice)

The terminology is shifting from “ESG” to “sustainability” or simply “risk management,” but the underlying work continues.

## Capital Allocation Decisions

### The CFO's Perspective

Chief Financial Officers face a constant capital allocation question: what to do with cash generated by operations?

#### The Decision Tree:

1. **Maintain liquidity buffer:** Keep 1-3 months of operating expenses in cash
2. **Fund organic investment:** Capital expenditures, R&D, working capital
3. **Pursue M&A:** Acquisitions for growth or synergies
4. **Return capital:** Buybacks, dividends, or debt paydown

**Table 20.5: S&P 500 Capital Allocation (2023)**

Use of Funds	Amount	Share
Capital expenditures	\$850 billion	35%
R&D spending	\$400 billion	17%
Dividends	\$590 billion	24%
Share buybacks	\$795 billion	33%
M&A (net)	Variable	—
Debt paydown	Variable	—

Note: Percentages exceed 100% as some uses are funded by debt issuance.

Source: Federal Reserve Z.1 Financial Accounts, 2024

### Buybacks vs. Dividends

Why do companies prefer buybacks over dividends?

**Tax efficiency:** Shareholders who don't sell pay no tax on buybacks. Dividends are taxed when paid.

**Flexibility:** Markets punish dividend cuts severely. Buybacks can be reduced or suspended without stigma.

**EPS management:** Reducing share count boosts earnings per share mechanically, even without earnings growth.

**Offsetting dilution:** Stock-based compensation continuously issues new shares; buybacks offset this dilution.

**Signal strength:** A dividend signals confidence in stable future earnings. A buyback signals belief that shares are undervalued.

Critics argue buybacks represent short-termism—returning cash rather than investing in growth. The 2022 Inflation Reduction Act imposed a 1% excise tax on buybacks, the first U.S. tax specifically targeting repurchases. Early evidence suggests minimal impact on buyback volumes.

## The Geography of Corporate Finance

### Corporate Headquarters Concentration

Fortune 500 headquarters cluster in a few metropolitan areas:

**Table 20.6: Fortune 500 Headquarters by Metro (2024)**

Metro Area	Fortune 500 HQs	Major Companies
New York	45	JPMorgan, Verizon, Pfizer
Houston	24	Exxon, ConocoPhillips, Sysco
Chicago	22	Boeing (moving), McDonald's, Abbott
Dallas-Fort Worth	21	ExxonMobil (Irving), AT&T, Southwest
San Francisco Bay	20	Apple, Alphabet, Chevron
Atlanta	17	Home Depot, UPS, Coca-Cola
Minneapolis	16	Target, UnitedHealth, 3M

### Recent Shifts:

Several companies relocated headquarters in the 2020s, typically from high-tax coastal states to Texas and Florida:

- **Tesla:** Palo Alto → Austin
- **Oracle:** Redwood City → Austin
- **Caterpillar:** Chicago → Dallas area
- **Boeing:** Chicago → Arlington, VA
- **Citadel:** Chicago → Miami

Tax considerations, executive preferences, and workforce availability drive relocation decisions.

### Financial Centers

Corporate finance advisory work concentrates in New York, with secondary hubs:

- **New York:** Investment banks, law firms, PE headquarters
- **San Francisco:** Tech-focused banking, VC
- **Boston:** Asset management, biotech deals
- **Chicago:** Derivatives, Midwest corporate clients
- **Houston:** Energy finance
- **Los Angeles:** Entertainment finance

## Recent Trends

### The Rise of Private Credit

Traditional bank lending to corporations has declined as a share of financing, replaced by direct lending from non-bank investors—insurance companies, pension funds, and specialized credit funds. This shift accelerated after 2008 as tighter banking regulations (Basel III capital requirements, and the proposed “Basel III Endgame” rules) made holding corporate loans more expensive for traditional banks, clearing the path for private lenders.

Private credit assets under management have grown from roughly \$500 billion in 2015 to over \$1.7 trillion in 2024. Major players include:

Firm	Private Credit AUM	Parent/Affiliate
Ares Management	\$240 billion	Standalone
Apollo	\$400+ billion	Alternative manager
Blackstone Credit	\$300+ billion	Blackstone
Blue Owl	\$150 billion	Standalone
KKR Credit	\$100+ billion	KKR

Private credit offers borrowers flexibility (looser covenants, faster execution) and lenders higher yields than public markets. But the rapid growth raises concerns about credit quality in untested conditions.

### The Resilience of Conglomerates

Conventional wisdom holds that conglomerates—diversified corporations operating in multiple unrelated businesses—are outdated. The “conglomerate discount” (market values diversified firms below the sum of their parts) has been documented since the 1990s.

Yet some conglomerates persist and thrive:

**Berkshire Hathaway:** Warren Buffett’s holding company owns insurance (GEICO, Gen Re), railroads (BNSF), utilities (Berkshire Hathaway Energy), manufacturing (Precision Castparts), and retail (See’s Candies), plus massive equity portfolios.

**Danaher:** A diversified industrial company that has created enormous value through disciplined M&A and the “Danaher Business System” of operational improvement.

**3M:** The classic diversified manufacturer (though struggling in recent years with litigation and portfolio questions).

The surviving conglomerates typically share characteristics: disciplined capital allocation, decentralized operations, and a culture of continuous improvement.

## **Corporate Simplification**

The opposite trend is also underway: corporations spinning off divisions to create “pure-play” companies.

### **Recent Breakups:**

Parent	Spinoff	Year	Rationale
Johnson & Johnson	Kenvue (consumer)	2023	Separate pharma/consumer valuations
GE	Vernova, Aerospace	2023-24	End of conglomerate model
3M	Solventum (healthcare)	2024	Focus remaining business
Kellanova	WK Kellogg (cereal)	2023	Snacks vs. cereal strategies

The theory: focused companies can be valued more precisely, managed more effectively, and compensated more appropriately. The sum of the parts exceeds the whole.

## **AI and Corporate Finance**

Artificial intelligence is beginning to transform corporate finance functions:

- **FP&A:** AI-driven forecasting and scenario analysis
- **Due diligence:** Automated document review in M&A
- **Credit analysis:** Machine learning credit scoring
- **Fraud detection:** Pattern recognition in transactions
- **Investor relations:** AI analysis of earnings call sentiment

CFOs are also grappling with AI’s impact on their businesses more broadly—both the opportunity (productivity gains) and threat (disruption risk).

## **Firm Profiles**

### **Goldman Sachs**

**Quick Facts - Headquarters:** New York, NY - **Revenue:** \$46 billion (2024)  
- **Employees:** 46,000 - **Market Cap:** \$180 billion

Goldman Sachs is Wall Street’s most storied investment bank, synonymous with both financial elite status and the revolving door between finance and government. The firm consistently ranks #1 in M&A advisory and equity underwriting globally, handling the most complex and highest-profile transactions.

Founded in 1869 by Marcus Goldman, the partnership remained private until its 1999 IPO—one of the last major Wall Street firms to go public. That delayed IPO

created enormous wealth for partners and preserved a partnership culture that emphasizes collective success over individual stardom. Goldman partners historically rotated through functions, building broad expertise; many became Treasury Secretaries (Robert Rubin, Hank Paulson), central bankers (Mario Draghi), and corporate CEOs.

Goldman's business spans investment banking (M&A advisory, securities underwriting), trading (market-making in equities, bonds, currencies, commodities), asset management, and consumer banking (the Marcus platform, since scaled back). The firm's trading operations generated controversy during the 2008 crisis—Goldman both sold mortgage securities to clients and bet against them—leading to a \$550 million SEC settlement. Since then, Goldman has emphasized advisory businesses over proprietary risk-taking, though trading remains highly profitable. Under CEO David Solomon, the firm attempted and then retreated from consumer banking, refocusing on its core strengths serving corporations, institutions, and the ultra-wealthy.

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## Apollo Global Management

**Quick Facts - Headquarters:** New York, NY - **Assets Under Management:** \$700 billion (2024) - **Founded:** 1990 - **Employees:** 3,000+

Apollo exemplifies the evolution of private equity from leveraged buyouts into a diversified alternative asset manager. The firm manages more credit assets than equity—a strategic choice that has made it one of the largest non-bank lenders in America.

Leon Black, Marc Rowan, and Josh Harris founded Apollo in 1990 after the collapse of Drexel Burnham Lambert, where they had worked in Michael Milken's high-yield bond operation. That heritage informed Apollo's approach: the firm specializes in complex, contrarian investments that others avoid. Apollo's PE deals often involve distressed situations, corporate carve-outs, and heavily leveraged transactions where the firm's credit expertise provides an edge.

Apollo's integration of private equity and private credit distinguishes it from competitors. The firm raises credit funds that lend to its own PE portfolio companies and to third parties, generating multiple fee streams from related activities. The 2022 acquisition of Athene, a retirement services company with \$250 billion in assets, gave Apollo a permanent capital base and positioned it at the center of the insurance industry's shift toward alternative investments. Critics note potential conflicts—Apollo lending to Apollo-owned companies—while defenders argue the integration creates unique deal-sourcing advantages. Under CEO Marc Rowan (who succeeded Leon Black in 2021 following the Epstein association scandal), Apollo has emphasized its transformation from a PE shop to a "retirement services company" with PE capabilities.

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## Berkshire Hathaway

Berkshire Hathaway, led by Warren Buffett since 1965, represents a unique model of corporate finance: a holding company that allocates capital across wholly-owned businesses, public equity investments, and fixed income.

Buffett's approach inverts conventional corporate finance:

- **No dividends:** Berkshire has never paid a dividend, preferring to retain and reinvest earnings
- **Minimal debt:** Operating companies may carry debt, but the holding company maintains massive liquidity
- **Decentralized operations:** Subsidiary CEOs run their businesses with minimal headquarters interference
- **Long-term ownership:** Berkshire rarely sells businesses, creating loyalty and reducing transaction friction

The company's insurance operations (GEICO, General Re, Berkshire Hathaway Reinsurance) generate "float"—premiums collected before claims are paid—that Buffett invests. This essentially creates low-cost or negative-cost leverage.

At 94 (in 2024), Buffett remains active, though succession planning has advanced with Greg Abel designated as heir apparent.

**Key Statistics (2024):** - Market capitalization: \$900+ billion - Cash and equivalents: \$325 billion - Major equity holdings: Apple (\$180B), Bank of America, Coca-Cola, American Express - Employees (subsidiaries): 400,000+ - Operating earnings: \$40+ billion

## Elliott Management

Elliott Management, founded by Paul Singer in 1977, has become the world's most active and feared activist investor. The firm manages roughly \$65 billion and pursues both corporate activism and distressed debt investing.

Elliott's approach is distinctive:

- **Deep research:** Campaigns built on extensive operational analysis, not just financial engineering
- **Patient capital:** Willing to pursue multi-year campaigns
- **Aggressive tactics:** Litigation, media campaigns, regulatory complaints
- **Global reach:** Active in U.S., Europe, Asia, and emerging markets

The firm's sovereign debt battles—notably against Argentina, holding out for full payment while other creditors settled—demonstrated willingness to pursue extreme positions.

Recent corporate campaigns have targeted operational underperformance: Southwest Airlines (won six board seats), Salesforce (board seats, cost cuts), and AT&T (strategic refocus).

**Key Statistics:** - AUM: \$65 billion - Founded: 1977 - Campaigns (2024): 14 - Average holding period: 2-3 years - Headquarters: West Palm Beach (relocated from NYC)

## **Johnson & Johnson**

Johnson & Johnson exemplifies the evolution of large-company corporate finance. One of only two remaining AAA-rated companies, J&J maintains the most conservative balance sheet among major corporations—a strategic choice that comes with trade-offs.

The company's 2023 decision to spin off its consumer health business (Kenvue, maker of Tylenol, Band-Aid, and Listerine) reflected the ongoing trend toward corporate simplification. The remaining J&J focuses on pharmaceuticals and medical devices.

J&J has also deployed a controversial corporate finance technique: the “Texas Two-Step.” Facing billions in talc powder litigation, J&J created a subsidiary, transferred the liabilities to it, and placed that subsidiary into bankruptcy. Courts have scrutinized but not definitively resolved the legality of this approach.

**Key Statistics (2024):** - Market capitalization: \$380 billion - Credit rating: AAA - Revenue: \$85 billion - R&D spending: \$15 billion - Dividend: \$4.96/share (62 consecutive years of increases) - Employees: 130,000

## **Conclusion**

Corporate finance in America is less about raising capital than about allocating it. Large corporations generate far more cash than they invest, returning the surplus to shareholders through buybacks and dividends. The equity market, rather than funding corporate expansion, extracts capital from the corporate sector.

This pattern reflects several forces: mature companies with limited growth opportunities, shareholder pressure for returns, tax incentives favoring buybacks, and executive compensation tied to stock prices. Whether it represents efficient capital allocation or short-term value extraction remains contested.

The infrastructure of corporate finance—investment banks, law firms, PE firms, activist investors—has developed to facilitate transactions rather than capital formation. M&A advisory, activist campaigns, and leveraged buyouts all generate fees for intermediaries and returns for sophisticated investors, but their contribution to economic growth is less clear.

For the American economy, corporate finance practices shape investment patterns, employment decisions, and wealth distribution. The shift toward financial optimization and shareholder primacy—celebrated by some as disciplined capital allocation, criticized by others as extractive short-termism—is one of the defining features of contemporary American capitalism.

## **Data Sources and Further Reading**

### **Data Sources**

- **Federal Reserve Z.1:** Financial Accounts (corporate financing flows)
- **SEC EDGAR:** Corporate filings, proxy statements, executive compensation

- **S&P Global:** Capital IQ for M&A data
- **Refinitiv:** Deal data, league tables
- **Equilar/ISS:** Executive compensation and governance data
- **Company filings:** 10-K, 8-K, proxy statements

## Further Reading

- **Jensen, Michael.** “Agency Costs of Free Cash Flow” (1986)—foundational on buybacks and leverage
  - **Shleifer & Vishny.** “A Survey of Corporate Governance” (1997)—comprehensive overview
  - **Kaplan, Steven.** “The Effects of Management Buyouts on Operating Performance and Value” (1989)—PE’s impact
  - **Gutierrez & Philippon.** “Investment-less Growth” (2017)—the corporate investment puzzle
  - **Admati & Hellwig.** The Bankers’ New Clothes (2013)—critique of leverage
  - **Appelbaum & Batt.** Private Equity at Work (2014)—critical examination
- 

## Exercises

### Review Questions

1. The chapter shows that in 2023, internal funds (retained earnings plus depreciation) provided 76% of corporate funding, net debt issuance provided 24%, and net equity issuance was negative at -\$0.8 trillion. Explain why this pattern confirms the pecking order theory of corporate finance. Why would a company with ample internal funds ever issue debt at all? (Hint: consider Apple’s strategy of issuing bonds to fund buybacks rather than repatriating overseas cash before the 2017 tax reform.)
2. The chapter identifies the “BBB cliff” as a systemic risk: the largest segment of investment-grade bonds is now rated BBB, the lowest investment-grade tier. Explain the mechanism by which a recession could trigger a cascade: companies get downgraded to junk (“fallen angels”), investment-grade-only funds face forced selling, and the high-yield market gets flooded with supply. How did this scenario partially play out in March 2020, and what Fed intervention prevented it from spiraling?
3. The chapter reports that PE-owned companies typically carry 5-7x EBITDA in debt, versus 2-3x for public companies. Explain how this higher leverage amplifies equity returns in good times (use a numerical example with, say, \$100 million EBITDA and compare returns at 3x versus 6x leverage). Then explain why the same leverage amplifies losses in a downturn. What is the role of dividend recapitalizations in extracting value before exit, and why do critics view this practice as transferring risk to employees and creditors?
4. The chapter documents that the CEO-to-worker pay ratio at S&P 500 companies

rose from 71:1 in 1990 to 285:1 in 2024, with equity-linked compensation (performance shares, stock options) comprising 55-75% of CEO pay. Explain how tying CEO compensation to Total Shareholder Return (TSR) creates incentives that may favor buybacks over long-term capital investment. How does the “say on pay” provision work, and why have failures been rare (less than 3% of companies annually) despite public concern about executive pay levels?

5. Elliott Management won six board seats at Southwest Airlines in 2024 after attacking operational failures. The chapter describes the typical activist playbook: accumulate a stake (often using derivatives to avoid early disclosure), engage privately, go public if engagement fails, launch a proxy fight, and settle for board seats or strategic changes. Explain why activists often use equity swaps or other derivatives to build positions before crossing the 5% disclosure threshold. What informational advantage does this create, and what regulatory reforms might address the asymmetry?
6. The chapter describes corporate simplification—GE splitting into three companies, Johnson & Johnson spinning off Kenvue, 3M spinning off Solventum—as the reverse of the 1960s-1980s conglomerate era. Explain why the “conglomerate discount” exists (markets value diversified firms below the sum of their parts). Then explain why Berkshire Hathaway and Danaher have avoided this discount. What specific characteristics—Buffett’s capital allocation discipline, insurance float as negative-cost leverage, decentralized operations—allow some conglomerates to thrive while others destroy value?
7. Private credit has grown from roughly \$500 billion in 2015 to over \$1.7 trillion in 2024, as firms like Ares, Apollo, and Blackstone Credit replace traditional bank lending to middle-market companies. The chapter notes this shift was driven by Basel III capital requirements making corporate loans more expensive for banks. Explain how this regulatory arbitrage works: what specific capital charges make bank lending less attractive, and why don’t the same constraints apply to private credit funds? What risks arise from moving corporate lending outside the regulated banking system, particularly in a credit downturn?

## Data Exercises

1. **Corporate Capital Allocation over Time.** Using the Federal Reserve’s Z.1 Financial Accounts (<https://www.federalreserve.gov/releases/z1/>), download the “Nonfinancial Corporate Business” table (Table F.103 or its successor). Track four series over the past 25 years: (a) internal funds (retained earnings + capital consumption allowances), (b) net equity issuance, (c) net bond issuance, and (d) capital expenditures. FRED series to use include BOGZ1FA106300085Q (corporate internal funds) and BOGZ1FA103164103Q (net equity issuance). Plot these on a single chart. In which years did net equity issuance turn negative? How does capital expenditure track relative to internal funds? Calculate the ratio of buybacks-plus-dividends to capital expenditures for the most recent year and compare it to the 1990s average.
2. **The BBB Cliff in Real Time.** Using FRED, pull the ICE BofA BBB US Corporate Index Option-Adjusted Spread (series BAMLC0A4CBBB) and the ICE

BofA US High Yield Option-Adjusted Spread (series BAMLH0A0HYM2). Plot both over the past 15 years. Identify the March 2020 spike and the subsequent compression after Fed intervention. Then visit SIFMA's statistics page (<https://www.sifma.org/resources/research/us-corporate-bonds-statistics/>) and find the current breakdown of investment-grade bonds by rating tier (AAA, AA, A, BBB). What percentage of the investment-grade market is now rated BBB? Compare this to the BBB share in 2005.

3. **Executive Compensation at a Specific Firm.** Choose one of the firm profiles from this chapter (Goldman Sachs, Berkshire Hathaway, Johnson & Johnson, or Apollo Global Management). Access the company's most recent proxy statement (DEF 14A) on SEC EDGAR (<https://www.sec.gov/cgi-bin/browse-edgar>). Find the Summary Compensation Table for the top five named executive officers. Break down the CEO's total compensation into base salary, bonus, stock awards, option awards, and other compensation. What percentage is equity-linked? Compare the CEO-to-median-employee pay ratio (required since 2018 under the Dodd-Frank Act) to the S&P 500 average of 285:1 reported in this chapter. Does the company's ratio seem high or low relative to its industry?

## Deeper Investigation

**Buybacks, Investment, and Growth.** The chapter documents that S&P 500 companies spent \$795 billion on buybacks and \$590 billion on dividends in 2023, while capital expenditures totaled \$850 billion and R&D \$400 billion. Critics like William Lazonick ("Profits Without Prosperity," Harvard Business Review, 2014) argue that buybacks represent a massive diversion of corporate resources from productive investment to financial engineering. Defenders like Jesse Fried and Charles Wang ("Short-Termism and Capital Flows," 2019) counter that firms return capital they cannot productively invest, and shareholders redeploy it more efficiently. Write a research paper evaluating this debate. Use the Z.1 Financial Accounts to trace the historical relationship between buybacks and investment for the nonfinancial corporate sector. Examine whether the 2017 Tax Cuts and Jobs Act (which proponents said would boost investment) primarily funded buybacks instead. Analyze the 2022 Inflation Reduction Act's 1% buyback excise tax—has it affected behavior? Draw on the academic literature (Jensen's 1986 "free cash flow" theory, Gutierrez and Philippon's 2017 "investment-less growth" findings) to evaluate whether American corporations are underinvesting relative to their profit levels, and whether policy interventions (higher buyback taxes, R&D subsidies, changes to executive compensation rules) could shift capital allocation toward productive investment.

## **Part IV: Trade and Global Linkages**

# Chapter 21: America's Trading Relationships

In 1994, the United States championed NAFTA and pushed China toward WTO membership, betting that free trade would spread prosperity and anchor geopolitical stability. Thirty years later, American tariffs on Chinese goods average 19%—higher than the Smoot-Hawley rates of the 1930s that economics textbooks cite as a cautionary tale. The United States now actively discourages semiconductor investment in China, restricts technology exports, and subsidizes domestic manufacturing. The country that built the postwar trading system is now busily dismantling parts of it.

This chapter examines what remains: \$5 trillion in annual goods trade, relationships with 200 trading partners, an institutional architecture of treaties and enforcement mechanisms, and the policy shifts reshaping all of it.

## The Scale of American Trade

### □ Info:

#### The Trade Deficit Paradox

America's persistent trade deficit—importing \$1.2 trillion more than it exports—reflects its role as global consumer of last resort. The deficit is financed by foreign purchases of American assets: Treasury bonds, stocks, and real estate. In effect, the world lends to America so America can buy from the world. The dollar's reserve currency status makes this sustainable.

The United States trades roughly \$5 trillion in goods annually—more than any other nation.

**Table 21.1: U.S. Goods Trade (2024)**

Measure	Value
Total exports	\$2.1 trillion
Total imports	\$3.3 trillion
Trade deficit	\$1.2 trillion
Total trade volume	\$5.4 trillion

Source: Census Bureau, USA Trade Online, 2024

The persistent trade deficit—America imports far more than it exports—reflects the economy's role as global consumer of last resort and the dollar's status as reserve currency. The deficit is financed by foreign purchases of American assets: Treasury bonds, corporate securities, and real estate.

## Top Trading Partners

America's largest trading relationships have shifted significantly, with North American neighbors gaining share as China's position has declined.

**Table 21.2: Top U.S. Trading Partners (Goods, 2024)**

Rank	Partner	Total Trade	Trade Balance
1	European Union	\$980 billion	-\$236 billion
2	Mexico	\$840 billion	-\$172 billion
3	Canada	\$762 billion	-\$68 billion
4	China	\$582 billion	-\$295 billion
5	Japan	\$228 billion	-\$62 billion
6	South Korea	\$185 billion	-\$44 billion
7	United Kingdom	\$147 billion	+\$12 billion
8	Germany	\$185 billion	-\$85 billion
9	Vietnam	\$165 billion	-\$124 billion
10	Taiwan	\$128 billion	-\$48 billion

Source: Census Bureau, Foreign Trade Statistics, 2024

Mexico surpassed China as America's largest single-country trading partner in 2023—a milestone reflecting both the “nearshoring” trend and the cumulative effect of tariffs on Chinese goods. Vietnam has emerged as a major beneficiary of supply chain diversification, its trade with the U.S. growing from \$50 billion in 2015 to \$165 billion in 2024.

## Services Trade: The Surplus

While goods trade shows a persistent deficit, services trade runs a surplus. The United States exports more services—financial, professional, intellectual property, travel—than it imports.

**Table 21.3: U.S. Services Trade (2024)**

Category	Exports	Imports	Balance
Financial services	\$150 billion	\$45 billion	+\$105 billion
Intellectual property	\$130 billion	\$55 billion	+\$75 billion
Travel	\$195 billion	\$180 billion	+\$15 billion
Transport	\$105 billion	\$145 billion	-\$40 billion

Category	Exports	Imports	Balance
Business services	\$220 billion	\$140 billion	+\$80 billion
<b>Total services</b>	<b>\$920 billion</b>	<b>\$680 billion</b>	<b>+\$240 billion</b>

Source: Bureau of Economic Analysis, International Services, 2024

The services surplus partially offsets the goods deficit. American dominance in finance, technology, entertainment, and professional services generates enormous foreign earnings—though these are invisible in the shipping containers that dominate trade imagery.

## What America Trades

### Major Exports

The shale revolution transformed America's export profile. Energy products—crude oil, refined petroleum, natural gas—have become the largest export category.

**Table 21.4: Top U.S. Exports (2024)**

Category	Value	Key Products
Mineral fuels	\$320 billion	Crude oil, LNG, refined products
Machinery	\$252 billion	Industrial equipment, turbines
Electrical equipment	\$214 billion	Semiconductors, power equipment
Vehicles	\$144 billion	Cars, trucks, parts
Aircraft	\$134 billion	Commercial jets, engines
Pharmaceuticals	\$98 billion	Medicines, vaccines
Medical instruments	\$65 billion	Diagnostic equipment
Plastics	\$72 billion	Polymers, articles
Organic chemicals	\$58 billion	Petrochemicals
Cereals	\$42 billion	Corn, wheat, soybeans

Source: Census Bureau, USA Trade Online, 2024

America exports capital goods (machines that make things), transportation equipment, and commodities (energy, agricultural products). The country runs surpluses in aerospace, agriculture, and energy.

### Major Imports

Consumer goods dominate imports, reflecting America's role as the world's largest consumer market.

**Table 21.5: Top U.S. Imports (2024)**

## Top U.S. Trading Partners, 2023

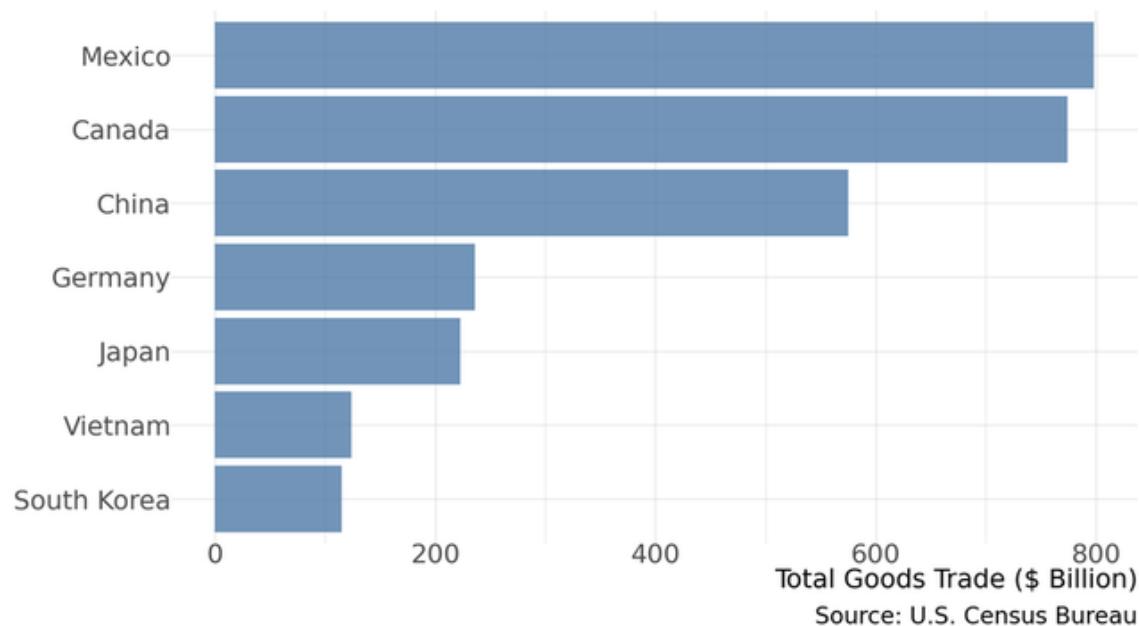


Figure 73: Figure 21.1: Top U.S. trading partners. Mexico surpassed China as America's largest trading partner in 2023, reflecting nearshoring trends and tariff effects. Source: Census Bureau

## **U.S. Trade Balance (Goods and Services)**

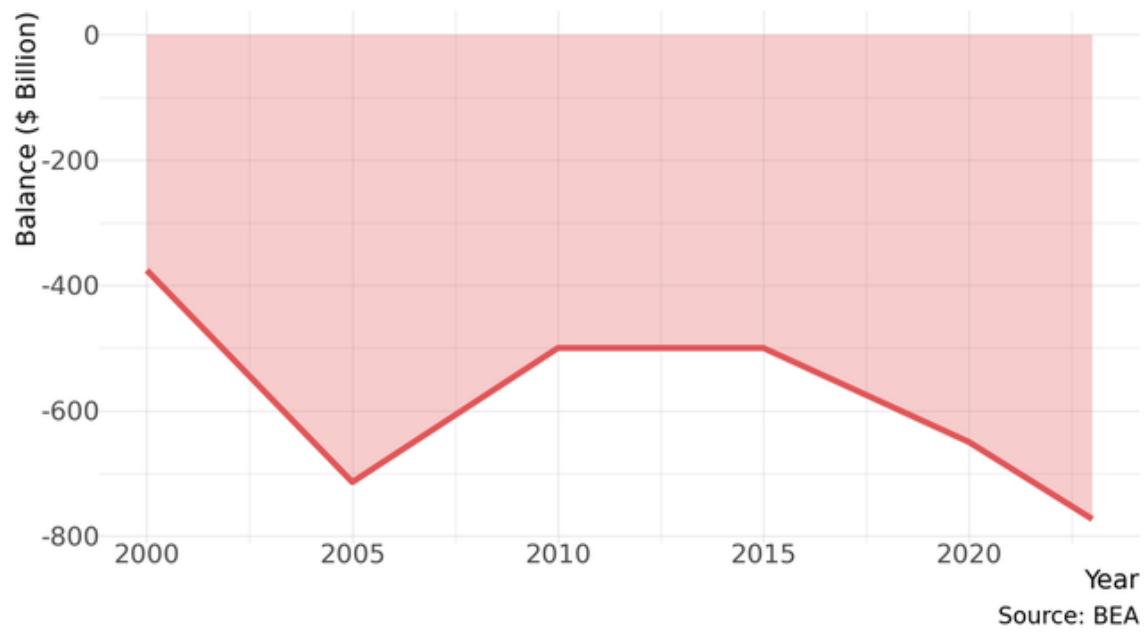


Figure 74: Figure 21.2: U.S. trade balance. The persistent goods deficit (imports > exports) is partially offset by a services surplus. Source: BEA

Category	Value	Key Products
Machinery & computers	\$531 billion	Laptops, servers, equipment
Electrical equipment	\$486 billion	Phones, chips, batteries
Vehicles	\$391 billion	Cars, trucks, parts
Mineral fuels	\$251 billion	Crude oil (heavy grades)
Pharmaceuticals	\$213 billion	Medicines, API
Furniture	\$85 billion	Household items
Apparel	\$92 billion	Clothing, textiles
Toys & games	\$48 billion	Consumer products
Footwear	\$32 billion	Shoes
Iron & steel	\$42 billion	Metal products

Source: Census Bureau, USA Trade Online, 2024

The import profile reveals America's manufacturing gaps. Consumer electronics, apparel, and furniture are overwhelmingly imported. Even in vehicles, where domestic production is substantial, America imports roughly \$400 billion worth—a category dominated by parts moving back and forth across the USMCA borders.

## Trade Agreements

### The Multilateral System

The United States was the architect of the post-World War II trading system: the General Agreement on Tariffs and Trades (GATT), the World Trade Organization (WTO), and successive rounds of tariff reductions that brought global average tariffs from 40%+ to single digits.

That system has frayed. The WTO's Doha Round (launched 2001) never concluded. The Appellate Body—the WTO's court of appeals—has been non-functional since 2019 because the United States blocked new judge appointments, citing concerns about judicial overreach. The U.S. hasn't withdrawn from the WTO but has rendered key dispute settlement mechanisms inoperative.

### Regional Agreements

#### USMCA (United States-Mexico-Canada Agreement)

USMCA replaced NAFTA in 2020. Key provisions:

- **Automotive rules of origin:** 75% of vehicle content must be North American (up from 62.5% under NAFTA)
- **Labor value content:** 40-45% of vehicles must be produced by workers earning at least \$16/hour
- **Rapid Response Mechanism:** Allows investigations of specific factories for labor rights violations
- **Sunset clause:** Agreement must be reviewed every six years, expires after 16 years unless renewed

- **Digital trade:** New chapter on cross-border data flows, prohibition of data localization

The tightened automotive rules were designed to reshore production from Mexico to the United States and raise Mexican wages. Early evidence suggests mixed results: Mexican auto employment has remained strong, while some production has returned to the U.S.

### Bilateral and Strategic Frameworks

The United States has free trade agreements with 20 countries, including Australia, South Korea, Singapore, and several Latin American nations. But the trend has shifted from comprehensive FTAs toward narrower frameworks:

- **Indo-Pacific Economic Framework (IPEF):** Not a traditional market-access agreement—no tariff reductions—but a framework for supply chain coordination, digital trade standards, and anti-corruption measures among 14 Asia-Pacific nations
- **Critical minerals agreements:** Targeted deals allowing partner countries (Japan, EU, UK) to qualify for Inflation Reduction Act EV tax credit requirements without full FTAs
- **U.S.-UK Trade Agreement (2025):** Post-Brexit deal focusing on services, digital trade, and regulatory recognition

### The Tariff Turn

From the late 1940s through 2016, American trade policy moved consistently toward lower tariffs and greater openness. That trajectory reversed sharply.

**Table 21.6: Average U.S. Tariff Rates**

Period	Trade-Weighted Average	Note
1930 (Smoot-Hawley)	45%+	Historic high
1950	13%	Post-GATT reduction
1980	5.6%	Tokyo Round complete
2000	4.0%	Uruguay Round
2017	1.5%	Pre-tariff war
2025	3-5%	Section 301/232 on targeted goods

Source: USITC, Tariff Database; World Bank WITS, 2024

Note: The overall average remains low because most imports face no special tariffs. However, tariffs on Chinese goods average 19%, and specific categories (EVs, steel) face rates of 25-100%.

### Section 301 Tariffs (China)

The Trade Act of 1974's Section 301 authorizes the president to impose tariffs in response to unfair trade practices. Beginning in 2018, the U.S. imposed escalating tariffs on Chinese goods, eventually covering over \$350 billion in imports.

Key tariff rates (as of 2025): - Electric vehicles: 100% - Semiconductors: 50% - Solar cells/modules: 50% - Steel and aluminum products: 25% - Batteries: 25% - Many consumer goods: 7.5-25%

The Biden administration maintained and in some cases increased Trump-era tariffs, particularly on strategic goods. The policy rationale shifted from deficit reduction to industrial policy and national security.

### **Section 232 Tariffs (National Security)**

Section 232 of the Trade Expansion Act of 1962 authorizes tariffs on national security grounds. The U.S. imposed 25% tariffs on steel and 10% on aluminum in 2018, subsequently raising steel tariffs to 50% for some sources.

These tariffs apply globally, including to allies. Europe, Canada, and other partners received temporary exemptions, then quotas, in ongoing negotiations that have never fully resolved.

### **De Minimis Closure (2025)**

Until 2025, packages valued under \$800 entered the U.S. duty-free under the “de minimis” exemption. E-commerce platforms—particularly Shein and Temu, shipping directly from Chinese factories—exploited this rule to avoid tariffs entirely. In August 2025, the exemption was terminated, bringing direct-from-China e-commerce under the tariff regime.

## **Trade Enforcement Agencies**

American trade policy is administered by multiple agencies with overlapping and sometimes conflicting mandates.

### **Office of the U.S. Trade Representative (USTR)**

USTR is the president’s principal trade advisor and negotiator. Located in the Executive Office of the President, USTR negotiates trade agreements, represents the U.S. in WTO disputes, and develops trade policy.

Recent USTR priorities have shifted from “market opening” toward “worker-centric trade policy”—emphasizing labor standards, domestic manufacturing, and skepticism of agreements that primarily benefit corporations.

### **Department of Commerce**

**Bureau of Industry and Security (BIS)** administers export controls—arguably the most powerful trade tool of the 2020s. BIS maintains the Entity List (companies prohibited from receiving U.S. technology), controls semiconductor equipment exports, and enforces technology transfer restrictions. In practice, BIS now determines which foreign companies can access American technology.

**International Trade Administration (ITA)** investigates dumping (selling below cost) and foreign subsidies. When combined with injury findings from the ITC, these investigations lead to antidumping and countervailing duties on specific products.

## **U.S. International Trade Commission (USITC)**

An independent, quasi-judicial agency, the USITC conducts injury determinations in trade remedy cases and produces analytical studies on trade impacts. Its investigations determine whether domestic industries are harmed by imports—the prerequisite for imposing antidumping duties.

## **Customs and Border Protection (CBP)**

CBP enforces trade laws at the border: collecting duties, inspecting cargo, and enforcing product standards. Since 2022, CBP has also enforced the **Uyghur Forced Labor Prevention Act (UFLPA)**, detaining shipments suspected of involving forced labor in Xinjiang. This has become a significant trade barrier for goods with any connection to Chinese cotton, polysilicon, or other Xinjiang-linked supply chains.

# **The New Trade Policy**

## **From Free Trade to Managed Trade**

The intellectual framework for American trade policy has shifted fundamentally. The old consensus held that:

- Trade is positive-sum: all parties benefit from specialization
- Market outcomes are presumptively efficient
- Government should reduce barriers and let comparative advantage determine production

The new framework emphasizes:

- Trade has distributional consequences that markets don't correct
- Some production (semiconductors, pharmaceuticals, defense) is "strategic" and shouldn't be offshored
- Geopolitical rivals (China) shouldn't control critical supply chains
- "Efficiency" must be balanced against "resilience"

## **Economic Statecraft**

Trade policy has fused with foreign policy. Export controls on semiconductors and manufacturing equipment aim to slow China's technological development. Tariffs serve as bargaining leverage. Investment screening (CFIUS) blocks foreign acquisitions of sensitive companies.

The Treasury Department's Office of Foreign Assets Control (OFAC) administers sanctions that function as trade barriers. Russian entities, Chinese technology companies, and Iranian oil exporters face financial exclusion that effectively blocks trade.

## **Industrial Policy Linkages**

Domestic industrial policy now explicitly discriminates based on supply chain geography. The Inflation Reduction Act's EV tax credits require:

- Battery components manufactured in North America
- Critical minerals sourced from the U.S. or FTA partners
- No components from "Foreign Entities of Concern" (primarily Chinese companies)

The CHIPS Act similarly restricts recipients from expanding advanced manufacturing in China. Trade compliance has become a prerequisite for domestic subsidies.

### **□ Info:**

#### **Deep Dive: How U.S. Economic Institutions Compare to Trading Partners**

Trade debates often focus on tariffs and exchange rates, but the deeper structural differences between the U.S. and its trading partners lie in labor law, corporate taxation, and social insurance. These institutional differences shape production costs, firm behavior, and the political feasibility of trade liberalization. A workforce with universal healthcare and generous unemployment benefits can absorb trade shocks that would devastate workers dependent on employer-provided coverage and minimal safety nets.

### **Labor Laws**

The United States is the only advanced economy that maintains "at-will" employment as the default rule—employers can terminate workers for any non-discriminatory reason, with no notice period and no statutory severance. Germany requires 1-7 months of notice depending on tenure, plus works council consultation. Japan's courts have developed a "doctrine of abusive dismissal" that makes layoffs of regular employees extremely difficult in practice. The U.K. mandates 1-12 weeks of statutory notice and provides redundancy pay after two years of service.

Union density reinforces these differences. Roughly 10% of American workers belong to unions (6% in the private sector). In Germany, collective bargaining agreements cover about 52% of workers through sectoral agreements, even at non-union firms. Japan's enterprise unions cover roughly 16% of workers but exert influence through the "spring offensive" (shunto) wage negotiations. The U.K. sits at about 23% union density, down from its postwar peak but still double the U.S. rate.

On minimum wages, the U.S. federal floor of \$7.25/hour has not increased since 2009—the longest stretch without adjustment in the minimum wage's history. Most states set higher floors, but significant regional variation persists. Germany introduced a national minimum wage only in 2015 (now €12.82/hour). Japan sets prefectural minimums averaging roughly ¥1,050/hour (~\$7.50). The U.K.'s National Living Wage stands at £12.21/hour (~\$15.50).

## **Corporate Tax Structures**

The Tax Cuts and Jobs Act (TCJA) of 2017 cut the U.S. federal corporate rate from 35% to 21%, dropping America from the highest statutory rate in the OECD to slightly below average. Combined with state taxes (averaging 4–5%), the effective U.S. rate is roughly 25–26%. Germany's combined federal/trade tax rate is about 30%. Japan's effective rate is approximately 30%. The U.K. raised its rate to 25% in 2023 after years at 19%.

The TCJA also shifted the U.S. to a modified territorial system for overseas profits, exempting most foreign earnings from domestic tax—aligning with the approach long used by the U.K. and Japan. Germany operates a similar participation exemption. However, the U.S. introduced GILTI (Global Intangible Low-Taxed Income), a minimum tax on foreign earnings designed to discourage profit shifting to tax havens. The OECD's Pillar Two framework (15% global minimum tax), agreed in 2021 and being implemented unevenly, partially converges these regimes.

On R&D incentives, the U.S. offers a federal research tax credit (roughly 6–8% of qualifying expenses), but it ranks below many peers in generosity. The U.K.'s R&D tax relief provides up to 27% for qualifying SME expenditures. Japan and Germany offer direct R&D tax credits alongside government co-investment in applied research through institutions like Fraunhofer and AIST.

## **Social Insurance**

The most consequential institutional difference is healthcare. The U.S. is the only OECD nation where health insurance is primarily employer-provided, adding \$10,000–\$25,000 per employee in annual costs depending on plan generosity. Germany, Japan, and the U.K. all provide universal coverage funded through taxes or social insurance contributions—costs that fall on the general budget rather than individual employers' balance sheets. This difference directly affects labor mobility, firm formation, and the ability of workers to weather job transitions caused by trade displacement.

Unemployment insurance in the U.S. typically replaces 30–40% of prior wages for a maximum of 26 weeks (varying by state). Germany's Arbeitslosengeld replaces 60–67% for up to 12 months, with longer durations for older workers. Japan provides 50–80% replacement for 3–11 months. The U.K.'s Universal Credit is less generous in replacement rate but has no fixed duration. The gap matters for trade adjustment: German workers displaced by Chinese competition had a stronger safety net than their American counterparts in the Rust Belt.

Retirement systems diverge similarly. The U.S. relies heavily on employer-sponsored 401(k) plans (defined contribution), shifting investment risk to workers. Germany's three-pillar system includes a pay-as-you-go state pension replacing roughly 48% of earnings. Japan combines a flat-rate National Pension with an earnings-related Employees' Pension. The U.K. blends a

state pension with auto-enrolled workplace pensions. In each peer country, the state pension provides a higher baseline than Social Security's roughly 40% replacement rate for median earners.

**Table: Institutional Comparison—U.S. vs. Key Trading Partners**

Dimension	United States	Germany	Japan	United Kingdom
<b>Employment protection</b>	At-will (minimal)	Strong; 1-7 months notice, works councils	Very strong; abusive dismissal doctrine	Moderate; 1-12 weeks notice, redundancy pay
<b>Union density</b>	10% (6% private)	16% (52% covered by bargaining)	16%	23%
<b>Minimum wage</b>	\$7.25 federal (varies by state)	€12.82/hr (~\$14.25)	~¥1,050/hr (~\$7.50)	£12.21/hr (~\$15.50)
<b>Corporate tax rate (combined)</b>	~25-26% (21% federal + state)	~30%	~30%	25%
<b>Overseas profit treatment</b>	Territorial + GILTI minimum	Participation exemption	Territorial exemption	Territorial exemption
<b>R&amp;D tax incentive</b>	6-8% credit	Direct grants + tax allowance	Tax credit + co-investment	Up to 27% relief (SMEs)
<b>Healthcare</b>	Employer-provided (no universal system)	Universal (statutory insurance)	Universal (social insurance)	Universal (NHS, tax-funded)
<b>Unemployment replacement</b>	30-40%, up to 26 weeks	60-67%, up to 12 months	50-80%, 3-11 months	Lower rate, no fixed duration
<b>Retirement system</b>	Social Security + 401(k)	State pension (~48%) + occupational	National + Employees' Pension	State pension + auto-enroll workplace

Sources: OECD Employment Outlook 2024; OECD Tax Database; OECD Social Expenditure Database; national statistical agencies

These institutional gaps explain why trade adjustment is harder in the United States than in peer economies. An American autoworker displaced by imports may simultaneously lose wages, health insurance, and retirement contributions. A German autoworker in the same situation retains healthcare, receives more generous unemployment benefits for a longer

period, and keeps accruing state pension credits. The political backlash against trade in the U.S. is partly a backlash against the absence of institutional buffers that other advanced economies take for granted.

## The Political Economy of Trade

### Regional Interests

Trade politics vary dramatically by region:

- **Farm Belt:** Agricultural exports (soybeans, corn, pork) depend on foreign markets, particularly China. Farm states have mixed feelings about tariffs that invite retaliation.
- **Rust Belt:** Manufacturing communities support tariffs on steel, aluminum, and Chinese goods. Union members are skeptical of trade agreements.
- **Port cities:** Import-dependent regions (Los Angeles, Seattle, Houston) have economies tied to trade flows.
- **Border regions:** Communities along the Mexican border depend on cross-border commerce.

### Interest Groups

Trade policy attracts intense lobbying from competing interests:

**Pro-liberalization:** - U.S. Chamber of Commerce: Generally opposes broad tariffs, supports “rules-based” trade - Business Roundtable: Major corporations prefer stable, open markets - National Retail Federation: Retailers oppose tariffs (import costs) and supported de minimis - Agriculture groups: Farm exports require open markets

**Pro-protection:** - AFL-CIO and industrial unions: Support tariffs, strict labor standards - United Steelworkers: Strong backers of Section 232 - National Association of Manufacturers: Mixed; supports anti-dumping enforcement - Semiconductor Industry Association: Supports domestic subsidies but worries about export controls cutting off China market

### The Partisan Realignment

Trade policy has scrambled traditional partisan alignments. Republicans, historically the free-trade party, have become more protectionist under populist influence. Democrats, historically skeptical of trade agreements, now include both union-aligned protectionists and cosmopolitan free-traders.

The bipartisan consensus: skepticism of China. Both parties support tariffs on Chinese goods, export controls on technology, and restrictions on Chinese investment. The disagreement is over how far to extend those policies and whether allies should face similar treatment.

## Firm Profiles

### Port of Los Angeles and Long Beach

**Quick Facts - Location:** San Pedro Bay, California - **Combined Annual Volume:** 17+ million TEUs - **U.S. Import Share:** 30-40% of containerized imports - **Economic Impact:** \$450+ billion in trade value annually

The twin ports of Los Angeles and Long Beach—collectively the San Pedro Bay Complex—form America’s primary gateway to Asia and the largest container port complex in the Western Hemisphere. Together they handle more cargo than all other West Coast ports combined and serve as the entry point for goods from China, Vietnam, Japan, South Korea, and Taiwan.

The ports operate as separate entities—Los Angeles is a city department, Long Beach a city enterprise—but function as a single integrated complex sharing the same bay, similar infrastructure, and common challenges. The Port of Los Angeles handles slightly more volume (roughly 9.5 million TEUs annually), while Long Beach operates the most automated terminals. Major terminal operators include APM Terminals (Maersk), SSA Marine, and Yang Ming.

The 2021-22 supply chain crisis exposed the complex’s vulnerabilities. At the peak, over 100 container ships anchored offshore waiting weeks to berth. The ports lacked surge capacity, chassis were in short supply, warehouses were full, and trucker availability was limited. The backlog took months to clear. Since then, both ports have invested in automation, extended operating hours, and coordinated with railroads to improve throughput. But fundamental constraints remain: the ports are surrounded by dense urban development, and expansion faces environmental and community opposition. The Panama Canal expansion has shifted some cargo to Gulf and East Coast ports, beginning a long-term diversification of American trade infrastructure away from total dependence on San Pedro Bay.

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### Office of the U.S. Trade Representative (USTR)

**Quick Facts - Headquarters:** Washington, DC (Executive Office of the President) - **Agency Type:** Cabinet-level Executive Office - **Staff:** ~250 employees - **Role:** Principal trade negotiator and policy advisor

The Office of the U.S. Trade Representative is the federal agency responsible for developing and coordinating American trade policy. The U.S. Trade Representative—a Cabinet-level position—serves as the president’s principal advisor on trade and as the chief U.S. negotiator for international trade agreements.

Created in 1962 and elevated to Cabinet status in 1974, USTR emerged from Congressional frustration with the State Department’s handling of trade negotiations, which lawmakers felt prioritized diplomatic relationships over American commercial interests. USTR’s location in the Executive Office of the President (rather than as an independent department) gives it direct access to presidential decision-making while maintaining arms-length separation from agencies with competing interests.

USTR's small staff punches far above its weight. The agency negotiates bilateral and multilateral trade agreements, represents the United States in World Trade Organization disputes, administers Section 301 (unfair trade practices) investigations, and coordinates the interagency trade policy process. Recent USTR priorities have shifted from traditional "market opening" toward what the agency calls "worker-centered trade policy"—emphasizing labor standards, environmental provisions, and skepticism of agreements that benefit corporations without delivering gains to workers. Under both Trump and Biden administrations, USTR maintained tariffs on Chinese goods and pursued aggressive use of Section 301 authority. The agency's pivot from free-trade orthodoxy to managed trade reflects the broader transformation of American trade policy.

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## **Walmart**

Walmart is America's largest importer, bringing in roughly \$400 billion in merchandise annually—more than most countries' total imports. The company's supply chain extends to thousands of factories in China, Vietnam, Bangladesh, and Mexico.

Walmart pioneered the model of using purchasing power to drive down supplier costs, passing savings to consumers. The company's logistics innovations—cross-docking, satellite-linked inventory management, "everyday low prices" enabled by everyday low costs—reshaped American retail.

Trade policy directly affects Walmart's business model. Section 301 tariffs increased costs on Chinese-sourced goods, forcing supplier shifts and some price increases. The company has invested heavily in supply chain diversification, expanding sourcing from India, Vietnam, and Central America.

**Key Statistics (2024):** - U.S. revenue: \$430 billion - Imports: roughly \$400 billion - Suppliers: 100,000+ globally - U.S. stores: 4,700+ - Employees: 1.6 million (U.S.)

## **Boeing**

Boeing exemplifies American aerospace's global reach. The company exports roughly \$70 billion annually—more than any other U.S. manufacturer—making it the country's largest exporter by company.

But Boeing also depends on a global supply chain. Major components come from Japan (fuselage sections), France (aircraft systems), and dozens of other countries. The 787 Dreamliner's "global sourcing" strategy—originally designed to reduce costs and spread risk—backfired during production, creating coordination problems that delayed deliveries for years.

Trade policy affects Boeing through export financing (Ex-Im Bank support), technology transfer restrictions (limits on selling to China), and tariff retaliation (European tariffs in the Airbus-Boeing subsidy dispute).

**Key Statistics (2024):** - Revenue: \$78 billion - Exports: roughly \$70 billion - Commercial aircraft delivered: 528 - Defense revenue: \$25 billion - Employees: 170,000

## TSMC Arizona

Taiwan Semiconductor Manufacturing Company—the world’s most advanced chipmaker—is building America’s largest semiconductor manufacturing complex in Phoenix, Arizona. The project illustrates both the promise and challenges of reshoring strategic manufacturing.

TSMC announced the Arizona investment in 2020, with a \$12 billion first phase producing 5-nanometer chips. Subsequent expansions have pushed total investment to \$65 billion across three fabs, including cutting-edge 2-nanometer production planned for 2028.

The project has faced substantial challenges:

- **Labor:** Taiwan’s semiconductor workforce culture (long hours, technical expertise) differs from American norms. TSMC initially brought Taiwanese workers for training, creating friction with local unions.
- **Cost:** Building in Arizona costs 4-5x more than Taiwan due to labor, materials, and infrastructure
- **Subsidies:** The project received \$6.6 billion in CHIPS Act grants plus substantial tax incentives
- **Timeline:** Production start has slipped multiple times

TSMC Arizona represents the most ambitious attempt to reshore advanced semiconductor manufacturing—a test case for whether America can rebuild manufacturing capacity in strategic industries.

**Key Statistics:** - Total investment: \$65 billion - CHIPS Act grants: \$6.6 billion - Jobs (projected): 6,000 direct, 20,000+ indirect - First production: 2025 (Phase 1) - Technology: 4nm, 3nm, 2nm (phased)

## Conclusion

American trade policy has entered a new era. The half-century movement toward lower barriers and greater openness has reversed. Tariffs have risen to levels not seen since the 1930s. Export controls restrict technology flows to rivals. Industrial policy openly discriminates based on supply chain geography.

The new framework prioritizes resilience over efficiency, security over cost minimization, and domestic production over global optimization. Whether this represents wise adaptation to geopolitical realities or costly retreat from the gains of trade remains fiercely contested.

What’s clear is that trade is no longer just economics. It has become a tool of statecraft, an instrument of industrial policy, and a fault line in domestic politics. For businesses, navigating this landscape requires attention to policy as much as markets—and the assumption that rules will continue changing.

# Data Sources and Further Reading

## Data Sources

- **Census Bureau:** Trade statistics (USA Trade Online)
- **Bureau of Economic Analysis:** Services trade, balance of payments
- **USTR:** Trade agreement texts, annual reports
- **USITC:** Trade remedy investigations, data tools
- **WTO:** Tariff profiles, trade statistics

## Further Reading

- **Irwin, Douglas.** *Clashing over Commerce* (2017)—comprehensive U.S. trade policy history
- **Autor, Dorn & Hanson.** “The China Shock” (2016)—trade’s impact on American manufacturing
- **Bown, Chad.** Trade policy analysis at Peterson Institute
- **Baldwin, Richard.** *The Great Convergence* (2016)—how global value chains changed trade
- **Klein, Matthew & Pettis, Michael.** *Trade Wars Are Class Wars* (2020)—macroeconomic view of imbalances

## Exercises

### Review Questions

1. The United States runs a persistent goods trade deficit of roughly \$1.2 trillion per year, yet this deficit is described as “financed by foreign purchases of American assets.” Explain the mechanism by which the trade deficit and capital inflows are connected. Why does the dollar’s reserve currency status make this arrangement sustainable in ways it would not be for most other countries?
2. Mexico surpassed China as America’s largest single-country trading partner in 2023. Identify at least three factors discussed in this chapter that contributed to this shift. How do Section 301 tariffs, USMCA provisions, and the nearshoring trend each play a role?
3. While the United States runs a large goods trade deficit, it runs a \$240 billion surplus in services trade. Using Table 21.3, identify the two largest categories contributing to this surplus. Why are services exports less visible in public debate about trade than goods exports, and what does this imbalance in attention mean for trade policy design?
4. USMCA raised the regional value content requirement for automobiles from 62.5% to 75% and introduced a labor value content requirement of \$16 per hour. Explain the economic logic behind each provision. Who benefits and who bears the costs of these stricter rules of origin?
5. The chapter describes a shift from “free trade” to “managed trade” as the dominant intellectual framework for American trade policy. Compare the two frame-

works across three dimensions: how each views the distributional consequences of trade, the role of “strategic” industries, and the appropriate balance between efficiency and resilience.

6. Section 301, Section 232, and the de minimis exemption closure represent three distinct trade policy instruments. For each, identify the legal authority, the stated policy rationale, and at least one specific sector or product category affected. How do these instruments differ in scope and purpose?
7. The chapter profiles four firms or institutions with very different relationships to trade: the Port of Los Angeles/Long Beach, USTR, Walmart, and Boeing. For any two of these, explain how a 25% across-the-board tariff on all imports would affect their operations, revenues, and strategic decisions differently.

## Data Exercises

1. Using the USTR’s National Trade Estimate Report (available at <https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications>) and the Census Bureau’s USA Trade Online database (<https://usatrade.census.gov/>), construct a profile of U.S. trade with Vietnam for the most recent available year. Report total exports, total imports, the bilateral trade balance, and the top three product categories in each direction. Compare the current figures to the \$50 billion total trade figure cited for 2015 in this chapter. What does the growth trajectory suggest about Vietnam’s role in the “China Plus One” strategy?
2. Using the FRED database, retrieve the series “BOPGSTB” (U.S. Trade Balance on Goods and Services) for the period 2000 to present. Plot the quarterly data and identify the periods of widening and narrowing deficits. Annotate your chart with at least three major policy or economic events discussed in this chapter (e.g., China’s WTO accession effects, the 2018 tariff escalation, the 2021-22 supply chain crisis). How do these events correlate with movements in the trade balance?
3. The USITC maintains a Tariff Database and the DataWeb tool (<https://dataweb.usitc.gov/>) that allows users to look up applied tariff rates by product. Select three product categories mentioned in this chapter’s discussion of Section 301 tariffs—electric vehicles (HTS 8703.80), semiconductors (HTS 8541/8542), and steel (HTS 7206-7229)—and find the current applied tariff rates for imports from China versus imports from a U.S. FTA partner (e.g., South Korea). Summarize the tariff differential and discuss what incentives this creates for supply chain decisions.

## Deeper Investigation

1. The chapter describes a “partisan realignment” on trade, in which Republicans have become more protectionist and Democrats are internally divided. Select one specific trade policy action taken since 2017—such as the Section 301 tariffs on China, the USMCA renegotiation, or the de minimis closure—and trace its political history across administrations. Which interest groups supported and opposed it? How did the policy’s stated rationale shift between administrations even as the policy itself persisted? What does this continuity suggest

about whether the “new trade policy” represents a durable structural shift or a temporary political alignment?

# Chapter 22: Global Supply Chains

Global supply chains are the circulatory system of the modern American economy. While trade statistics focus on finished products crossing borders, the reality of 21st-century commerce is more complex: products cross borders multiple times at different stages of production. A smartphone designed in California contains chips fabricated in Taiwan from equipment made in the Netherlands, assembled in China with batteries from South Korea, and shipped through logistics networks spanning multiple continents.

This chapter examines how American companies organize international production: the physical infrastructure of global trade, the architecture of specific supply chains, the vulnerabilities exposed by recent crises, and the ongoing reorganization toward resilience.

## The Structure of Modern Trade

### Intermediate Goods and Value Chains

Most trade today involves intermediate goods—components used to make other products—rather than finished consumer items.

**Table 22.1: Composition of U.S. Goods Imports (2024)**

Category	Share	Examples
Intermediate goods	45%	Components, parts, materials
Capital goods	25%	Machinery, equipment
Consumer goods	22%	Finished products
Automotive	8%	Vehicles and parts

A semiconductor is an intermediate good when it goes into a smartphone, a capital good when it goes into factory equipment, and a consumer good when it's sold as a replacement chip. These categories overlap and blur.

## Intra-Firm Trade

A defining feature of globalization is that much trade happens within single corporations. In 2023, **related-party trade**—transactions between a U.S. company and its foreign affiliates or parent—accounted for 43% of U.S. goods trade (\$2.2 trillion).

This means nearly half of “international trade” is companies shipping goods to themselves across borders. When Ford moves engines from a Mexican plant to a Michigan assembly line, it shows up as a U.S. import from Mexico—but it’s internal logistics, not arm’s-length commerce.

Intra-firm trade has several implications:

- **Transfer pricing:** Multinational corporations can allocate profits to low-tax jurisdictions by adjusting internal prices
- **Supply chain control:** Companies can coordinate production across borders more tightly than with external suppliers
- **Trade policy sensitivity:** Tariffs on intra-firm trade are effectively taxes on companies’ own operations

## The Geography of Production

Production has fragmented across borders following a pattern economists call “global value chains” or “trade in tasks.” Different stages of production locate where conditions are most favorable:

Stage	Location Drivers	Typical Geography
R&D and design	Talent, IP protection	U.S., Europe, Japan
High-value manufacturing	Capital, precision	Germany, Japan, U.S.
Component fabrication	Scale, infrastructure	Taiwan, Korea, China
Assembly	Labor cost, logistics	China, Vietnam, Mexico
Distribution	Market access	Regional hubs

This fragmentation created efficiency gains—each stage locates optimally—but also vulnerabilities. Disruption at any link ripples through the entire chain.

## Major Trade Corridors

The physical movement of goods relies on specific high-volume corridors connecting the U.S. to global production networks.

### The Transpacific Corridor

**Gateway:** The San Pedro Bay Complex (Ports of Los Angeles and Long Beach) handles 30-40% of all U.S. containerized imports. These twin ports process over 17 million TEUs (twenty-foot equivalent units) annually, dominated by trade with Asia.

**Inland Distribution:** Goods move east via the Alameda Corridor rail link to massive intermodal yards and warehouses in the Inland Empire (Ontario, Riverside, San Bernardino). From there, Union Pacific and BNSF rail lines carry containers to Chicago, Dallas, and Memphis for further distribution.

The LA/Long Beach complex is vulnerable to congestion, labor disputes, and natural disasters—all of which have caused significant disruptions.

## The USMCA Corridor

**Gateway:** Laredo, Texas, is the busiest land port in the Western Hemisphere. Roughly 16,000 trucks cross the World Trade Bridge daily, carrying auto parts, produce, and manufactured goods between Mexico and the U.S.

**The I-35 Corridor:** Often called the “NAFTA Superhighway,” I-35 connects Laredo northward through San Antonio, Austin, and Dallas, continuing to Kansas City, Minneapolis, and ultimately Duluth. This corridor carries much of North American automotive supply chain traffic.

Other major land crossings include El Paso-Juarez (second largest), Detroit-Windsor (automotive), and Buffalo-Niagara (general cargo to Canada).

## The Transatlantic Corridor

**Gateway:** The Port of New York and New Jersey is the largest on the East Coast, handling European trade plus Asian cargo routed through the Suez Canal. The port complex spans multiple terminals across Newark, Elizabeth, and Staten Island.

**The I-95 Corridor:** The densely populated Northeast Corridor receives European imports plus transshipped Asian goods. Savannah has grown rapidly as an alternative East Coast gateway, with direct rail connections to Atlanta and the Southeast.

## Domestic Logistics Hubs

**Chicago:** The only city where all six Class I railroads converge, Chicago functions as America’s primary freight sorting center. Intermodal yards in suburban Chicago (Joliet, Rochelle) transfer containers between rail and truck for final delivery.

**Memphis:** Home to the FedEx SuperHub, Memphis International Airport is North America’s busiest cargo airport. FedEx processes 180+ aircraft nightly, sorting packages for next-day delivery nationwide.

**Louisville:** UPS Worldport, the largest automated package handling facility in the world, processes 2 million packages daily.

## Semiconductor Supply Chains

No industry better illustrates the complexity and vulnerability of global supply chains than semiconductors.

## Simplified iPhone Global Supply Chain



Figure 75: Figure 22.1: The iPhone supply chain spans dozens of countries. Components designed in the U.S. are manufactured across Asia, assembled in China, and shipped worldwide. Source: Author compilation from company data

## The Geographic Fragmentation

Semiconductor production has fragmented by function:

**Table 22.2: Semiconductor Value Chain Geography**

Stage	U.S. Share	Dominant Players
Design (EDA tools)	85%	Synopsys, Cadence, Mentor
Design (chips)	50%	NVIDIA, Qualcomm, AMD, Apple
Equipment	40%	Applied Materials, Lam, ASML (NL)
Fabrication (leading edge)	0%	TSMC (Taiwan), Samsung (Korea)
Fabrication (mature)	12%	GlobalFoundries, Intel, TI
Assembly/test/packaging	3%	ASE, Amkor (mostly in Asia)

Source: Semiconductor Industry Association; BCG Analysis, 2024

The United States dominates chip design and manufacturing equipment but has almost no leading-edge fabrication capacity. The most advanced chips—powering AI systems, smartphones, and advanced computing—come from a single company (TSMC) in a single location (Taiwan).

**The Semiconductor Supply Chain: Geographic Concentration Risk**

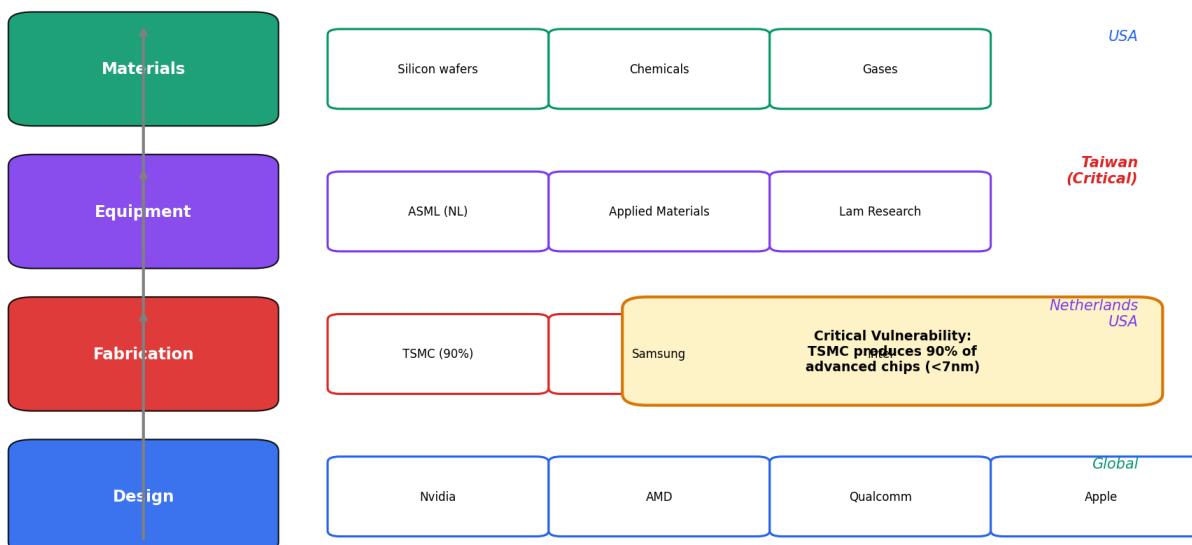


Figure 76: Figure 22.1: The semiconductor supply chain's geographic concentration risk. TSMC in Taiwan produces 90% of the world's most advanced chips. ASML in the Netherlands is the sole supplier of critical EUV lithography equipment. Source: Author analysis

## The Chokepoints

**ASML and EUV Lithography:** The most advanced chips require Extreme Ultraviolet (EUV) lithography machines, manufactured exclusively by ASML in the Netherlands.

These \$200 million machines, containing 100,000+ components from hundreds of suppliers, are the most complex manufacturing equipment ever built. No EUV machine, no leading-edge chips.

**TSMC:** Taiwan Semiconductor Manufacturing Company fabricates over 90% of the world's most advanced logic chips. Apple, NVIDIA, AMD, Qualcomm, and most other leading chip designers depend on TSMC. The concentration creates geopolitical risk—Taiwan sits 100 miles from mainland China—and business risk (a single earthquake or pandemic could halt global electronics production).

**Neon and Specialty Gases:** Semiconductor manufacturing requires ultra-pure specialty gases. Ukraine supplied roughly half of the world's semiconductor-grade neon before Russia's 2022 invasion disrupted production.

## The CHIPS Act Response

The CHIPS and Science Act (2022) committed \$52 billion to rebuild domestic semiconductor manufacturing:

- **TSMC Arizona:** \$65 billion investment across three fabs, producing down to 2nm chips
- **Intel Ohio:** \$20 billion "Silicon Heartland" campus near Columbus
- **Samsung Taylor:** \$17 billion fab in Texas
- **Micron New York:** \$100 billion memory fab investment over 20 years

Whether these investments can restore U.S. competitiveness remains uncertain. Building costs are 4-5x higher than Asia. The workforce barely exists. And the subsidies, while large, are small relative to what Asian governments have provided for decades.

## Automotive Supply Chains

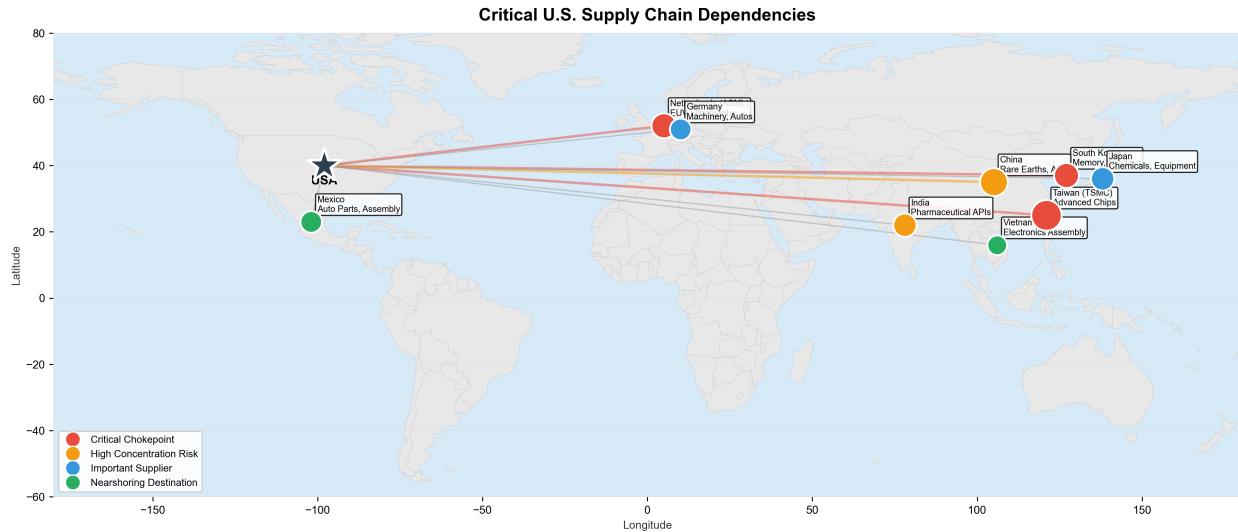
The North American automotive industry functions as a single integrated production network, with components crossing borders multiple times before a vehicle is completed.

## The USMCA Rules

The United States-Mexico-Canada Agreement tightened regional content requirements:

**Table 22.3: USMCA Automotive Content Requirements**

Requirement	Level	Purpose
Regional value content	75%	Must be North American
Labor value content	40-45%	Must be produced at \$16+/hour
Core parts	75%	Engines, transmissions, etc.
Steel/aluminum	70%	Must be "melted and poured" in region



Source: Commerce Department Supply Chain Review (2024). Schematic representation.

Figure 77: Figure 22.2: Critical U.S. supply chain dependencies. Red markers indicate single-point-of-failure chokepoints (TSMC, ASML); orange indicates high concentration risk (China for rare earths and pharmaceutical precursors); green indicates nearshoring destinations (Mexico, Vietnam). Source: Commerce Department Supply Chain Review (2024)

These rules aim to prevent vehicles from qualifying for duty-free treatment based on minimal regional processing. The labor value content requirement specifically targets the wage gap between Mexico and the U.S./Canada, incentivizing either higher Mexican wages or more U.S. production.

## The EV Transition

Electric vehicles are reorganizing automotive supply chains. The key battleground is batteries.

### Battery Supply Chain Control:

Stage	China Share	Alternative Sources
Lithium refining	65%	Chile, Australia
Cobalt refining	75%	DRC (mining), Finland
Cathode production	70%	Korea, Japan
Anode production	85%	Japan, limited
Cell manufacturing	75%	Korea, U.S. (growing)

Source: International Energy Agency, Global EV Outlook, 2024

China dominates battery supply chains more thoroughly than any other country dominates any other critical technology. The Inflation Reduction Act attempts to break

this dominance through sourcing requirements for EV tax credits:

- By 2027: 80% of critical minerals from U.S. or FTA partners
- By 2029: 100% of battery components manufactured in North America
- No components from “Foreign Entities of Concern” (Chinese companies)

These requirements are forcing automakers to build North American battery supply chains rapidly—or forfeit billions in tax credits.

### The “Battery Belt”

A corridor of battery and EV manufacturing investment stretches from Michigan through Ohio, Kentucky, Tennessee, and Georgia:

Project	Location	Investment
Ford BlueOval City	Tennessee	\$5.6 billion
Ford BlueOval SK	Kentucky	\$5.8 billion
GM-LG Ultium	Ohio, Tennessee	\$7 billion
Toyota	North Carolina	\$13.9 billion
Hyundai	Georgia	\$7.6 billion
BMW	South Carolina	\$1.7 billion
Rivian	Georgia	\$5 billion

This “Battery Belt” represents the largest manufacturing investment wave in decades, driven by IRA subsidies and proximity to existing automotive assembly plants.

## Pharmaceutical Supply Chains

Pharmaceutical manufacturing has concentrated in ways that create national security vulnerabilities.

### The Dependency

**Table 22.4: Pharmaceutical Supply Chain Geography**

Category	China/India Share	Risk Level
Generic drugs	70-80%	High
Active pharmaceutical ingredients	70%+	Critical
Antibiotics (inputs)	90%+	Critical
Key starting materials	80%+	High

Source: FDA; Commerce Department Supply Chain Review, 2024

The United States imports the vast majority of its generic medicines from India. But India itself imports 70%+ of its active pharmaceutical ingredients (APIs) from China. The ultimate dependency is on Chinese chemical manufacturing.

## Critical Vulnerabilities:

- **Antibiotics:** China manufactures nearly 90% of global inputs for penicillin and related antibiotics
- **Blood pressure medications:** Most APIs from China/India
- **Diabetes drugs:** Concentrated sourcing
- **Chemotherapy drugs:** Periodic shortages from supply disruptions

## Quality and Security Concerns

The concentration creates multiple risks:

**Quality control:** FDA inspects only a fraction of foreign manufacturing facilities. Several scandals—contaminated heparin (2008), carcinogenic impurities in blood pressure drugs (2018-2019)—revealed quality problems at overseas plants.

**Geopolitical leverage:** China has not weaponized pharmaceutical supply chains, but the capability exists. During COVID-19, export restrictions on PPE and medical supplies demonstrated willingness to use supply chain position strategically.

**Pandemic vulnerability:** COVID-19 created severe shortages of medications, PPE, and medical equipment as global supply chains buckled under simultaneous demand spikes.

## Reshoring Efforts

The federal government has initiated pharmaceutical supply chain diversification:

- **Essential Medicines List:** Identification of drugs requiring domestic or allied sourcing
- **API manufacturing incentives:** Subsidies for domestic ingredient production
- **Strategic reserves:** Stockpiling critical medications
- **Advanced manufacturing:** Supporting continuous manufacturing technology that could make U.S. production competitive

Progress has been slow. Pharmaceutical manufacturing is capital-intensive, heavily regulated, and subject to fierce price competition. Without sustained policy support, economics favor continued offshoring.

## The 2021-22 Supply Chain Crisis

The COVID-19 pandemic exposed fragilities across global supply chains, creating disruptions that took years to resolve.

## The Demand Shock

The pandemic fundamentally altered consumption patterns. As services spending (travel, dining, entertainment) collapsed, goods spending exploded. Americans bought home office equipment, exercise bikes, home improvement materials, and consumer electronics at unprecedented rates.

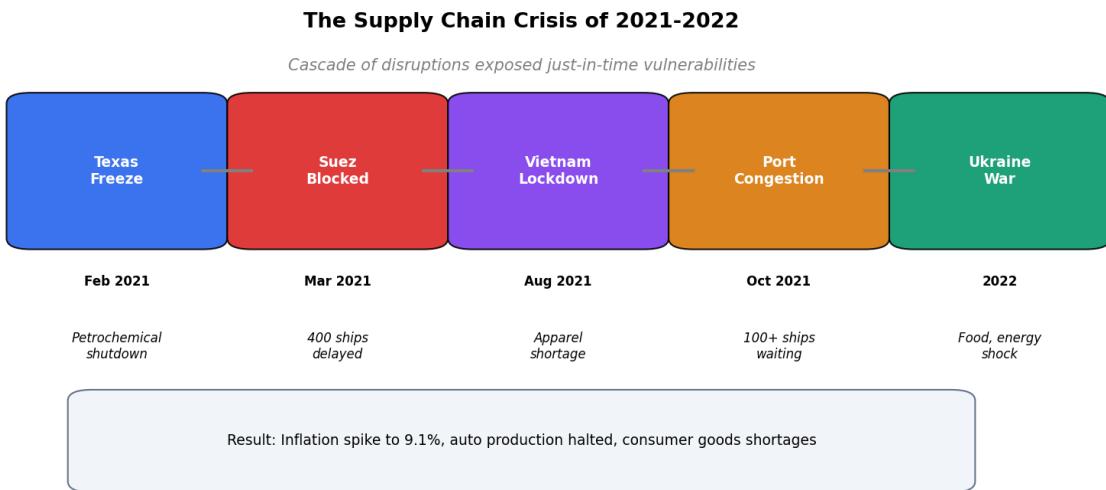


Figure 78: Figure 22.2: The cascade of supply chain disruptions in 2021-22. Sequential shocks—the Texas freeze, Suez blockage, Vietnam lockdowns, port congestion, and Ukraine war—created compounding disruptions that drove inflation to 9.1%. Source: Author analysis

This demand surge hit supply chains configured for normal patterns. Factories, shipping networks, and distribution systems couldn't adapt quickly.

## The Bottlenecks

**Port Congestion:** At the crisis peak in late 2021, over 100 container ships anchored off Los Angeles/Long Beach, waiting weeks to berth. The ports operated 24/7 but couldn't clear the backlog. Chassis (the trailers that carry containers) were in short supply. Warehouses were full. Truck drivers were unavailable.

**Shipping Costs:** Container shipping rates from China to the U.S. West Coast rose from roughly \$2,000 pre-pandemic to over \$20,000 at the peak—a 10x increase that rippled through the prices of everything from furniture to toys.

**Semiconductor Shortage:** Multiple factors converged: - A drought in Taiwan reduced water supply for chip fabs - A Texas freeze shut down chemical plants and chip factories - Fire at a Japanese auto chip plant removed capacity - Crypto mining absorbed chip production - Auto demand recovered faster than expected

The result: automakers parked tens of thousands of unfinished vehicles, waiting for chips. Ford, GM, Toyota, and others lost billions in production.

**Table 22.5: Supply Chain Crisis Metrics**

Metric	Pre-Crisis	Peak Crisis	Resolution
LA/LB ship queue	0-5	109 (Jan 2022)	0 (late 2022)
Shanghai-LA container rate	\$2,000	\$20,586	\$2,000 (2023)

Metric	Pre-Crisis	Peak Crisis	Resolution
Auto production lost	—	10+ million units	Recovered 2023
Inflation impact	—	1-2 pp	Faded 2023

## Lessons and Responses

The crisis forced corporate reevaluation of supply chain strategy:

**From efficiency to resilience:** The “just-in-time” model that minimized inventory and maximized efficiency proved fragile. Companies are rebuilding buffer stocks and diversifying suppliers.

**From optimization to optionality:** Rather than single-source lowest-cost suppliers, companies are building redundancy—multiple suppliers in multiple regions.

**From offshore to nearshore:** Geographic concentration (especially in China) creates risk. Mexico, Southeast Asia, and even domestic production are receiving increased investment.

## Reshoring and Nearshoring

### The Mexico Boom

Mexico surpassed China as America’s largest goods supplier in 2023. This reflects:

**Nearshoring advantages:** - Shorter shipping times (days vs. weeks) - Time zone alignment for coordination - USMCA duty-free access - Lower tariff and geopolitical risk - Growing infrastructure and workforce

**Investment surge:** Foreign direct investment in Mexico reached record levels as companies diversified from China. Nuevo León (Monterrey) and Bajío region have become manufacturing hubs for electronics, appliances, and automotive.

**Limitations:** Mexico has infrastructure constraints (energy, water, ports), security concerns in some regions, and workforce availability challenges. It cannot simply absorb all production leaving China.

### The Manufacturing Construction Boom

U.S. manufacturing construction spending has doubled since 2021, reaching \$225 billion annually—the largest investment wave since World War II.

**Key drivers:** - CHIPS Act semiconductor subsidies - IRA electric vehicle and battery incentives - Supply chain security concerns - Reshoring of strategic production

**Major projects:** - Semiconductor fabs (Arizona, Ohio, Texas, New York) - Battery plants (Tennessee, Kentucky, Georgia, North Carolina) - EV assembly (multiple states) - Pharmaceutical manufacturing (various)

## “China Plus One”

Most companies are not abandoning China entirely. The market is too large (1.4 billion consumers), the supply base too developed, and existing investments too substantial.

Instead, the dominant strategy is “China Plus One”: maintaining China operations while adding capacity elsewhere. Vietnam, India, Indonesia, and Mexico are primary beneficiaries.

**Table 22.6: Alternative Manufacturing Destinations**

Country	Strengths	Limitations
Vietnam	Low cost, proximity to China	Infrastructure, scale
India	Scale, English, democracy	Bureaucracy, infrastructure
Indonesia	Scale, resources	Infrastructure, logistics
Mexico	Proximity, USMCA	Security, capacity
Thailand	Quality, infrastructure	Cost rising

## Firm Profiles

### Taiwan Semiconductor Manufacturing Company (TSMC)

**Quick Facts - Headquarters:** Hsinchu, Taiwan - **Revenue:** \$69 billion (2023) - **Global Foundry Market Share:** 60%+ (90%+ at leading edge) - **Employees:** 73,000

TSMC is the most important company most Americans have never heard of. The Taiwanese semiconductor foundry manufactures over 90% of the world's most advanced logic chips—the processors powering iPhones, NVIDIA AI systems, AMD computers, and Qualcomm devices. No other company can fabricate chips at the cutting edge (below 7 nanometers), making TSMC an irreplaceable node in global technology supply chains.

Morris Chang founded TSMC in 1987 with a revolutionary business model: pure-play foundry manufacturing. Rather than designing and selling its own chips (like Intel), TSMC would manufacture chips designed by others. This allowed “fabless” companies—firms without factories—to compete in semiconductors. NVIDIA, Qualcomm, AMD, and eventually Apple built their businesses on TSMC’s manufacturing capability.

TSMC’s dominance stems from relentless process improvement. The company invests \$30+ billion annually in capital expenditure, staying ahead of Samsung (its only potential competitor at advanced nodes) in yield, reliability, and capacity. The firm’s workforce culture—demanding hours, precision engineering, deep process expertise—is difficult to replicate elsewhere, as the Arizona fab construction has demonstrated. TSMC’s Taiwan location creates geopolitical risk that policymakers increasingly view as unacceptable: the company sits 100 miles from mainland China, and a Taiwan conflict would devastate global electronics production. The CHIPS Act subsidies for U.S.

fabs aim partly to reduce this concentration, though TSMC's Arizona operations will produce a small fraction of its Taiwan output.

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## **Flexport**

Flexport represents a new model of freight forwarding, combining digital technology with physical logistics to provide end-to-end supply chain visibility.

Founded in 2013 by Ryan Petersen, Flexport built a software platform tracking shipments across ocean, air, truck, and rail—providing the kind of real-time visibility that previously required manual tracking across dozens of systems.

The company gained prominence during the 2021-22 supply chain crisis when Petersen's Twitter threads explaining port congestion went viral. Flexport's data showed shippers what was actually happening in ways traditional freight forwarders couldn't.

Flexport has expanded beyond software into physical operations: chartering aircraft, operating warehouses, and managing end-to-end logistics. The company raised over \$2 billion in venture capital before the 2022 downturn forced significant layoffs.

**Key Statistics:** - Revenue: \$4+ billion (2022 peak) - Freight under management: \$19 billion - Employees: 4,000+ (post-layoffs) - Customers: 10,000+ shippers - Technology: 700+ engineers

## **Maersk**

A.P. Moller-Maersk, the Danish shipping conglomerate, operates the world's largest container shipping fleet and has transformed into an integrated logistics company.

Maersk ships carry roughly 17% of global container trade. The company's vessels—including the world's largest container ships, carrying 24,000+ TEUs—form the backbone of transpacific and transatlantic trade.

Post-2016, Maersk pursued vertical integration, acquiring logistics companies to offer end-to-end supply chain services rather than just ocean shipping. The strategy aims to capture more value and reduce cyclical.

The 2021-22 boom generated record profits (\$31 billion in 2022) as shipping rates soared. The subsequent normalization has pressured margins, though Maersk remains dominant.

**Key Statistics (2023):** - Revenue: \$51 billion - Container fleet: 700+ vessels - TEU capacity: 4.3 million - Employees: 100,000+ - Ports/terminals: 65+

## **Apple Supply Chain**

Apple operates perhaps the world's most sophisticated consumer electronics supply chain, coordinating thousands of suppliers across dozens of countries to produce hundreds of millions of devices annually.

**The Network:** - 200+ major suppliers - Facilities in 50+ countries - Roughly 2 million workers in supplier facilities - Annual procurement: \$75+ billion

**Geographic Distribution:** - Design: Cupertino, California - Chips: TSMC (Taiwan), Samsung (Korea) - Displays: Samsung, LG (Korea), BOE (China) - Assembly: Foxconn, Pegatron, Luxshare (China, India, Vietnam) - Final logistics: Global distribution centers

Apple's supply chain strategy emphasizes control, quality, and secrecy. The company often finances supplier factories, maintains engineers on-site, and enforces strict production standards. Supplier relationships are long-term but demanding.

**Diversification Efforts:** Since 2020, Apple has aggressively diversified from China:  
- India: iPhone assembly (10%+ of production) - Vietnam: AirPods, MacBooks - U.S.: Mac Pro assembly (Texas)

The diversification is real but limited. Most iPhone production remains in China, and critical components still flow through Chinese suppliers.

**Key Statistics (Supply Chain, 2024):** - Products shipped: 500+ million units - Supply chain workers: 2+ million - Countries with suppliers: 50+ - India iPhone production: 14% and growing - R&D spending: \$30 billion

## Conclusion

Global supply chains represent both American economic strength and vulnerability. The efficiency gains from global specialization—each stage of production in its optimal location—created wealth and lowered prices for consumers. But that same fragmentation created fragilities that became apparent when pandemic, geopolitics, and climate disrupted flows.

The response has been partial decoupling. Semiconductors, batteries, pharmaceuticals, and other strategic sectors are being reshored or nearshored, backed by unprecedented government subsidies. Mexico and Southeast Asia are gaining share at China's expense. Companies are trading efficiency for resilience.

Yet complete decoupling is neither possible nor desirable. Global supply chains remain the most efficient way to produce complex products. American consumers benefit from lower prices; American companies benefit from global markets. The challenge is finding the right balance—maintaining the benefits of integration while reducing the risks of excessive dependence on any single country or chokepoint.

The supply chain of the future will be more regional, more redundant, and more expensive than the pre-2020 model. Whether it will also be more resilient remains to be tested.

## Data Sources and Further Reading

### Data Sources

- **Census Bureau:** Trade statistics, related-party trade

- **Bureau of Transportation Statistics:** Freight data, port statistics
- **Semiconductor Industry Association:** Chip industry data
- **International Trade Administration:** Supply chain reports
- **Federal Reserve:** Industrial production, capacity data

## Further Reading

- **Baldwin, Richard.** *The Great Convergence* (2016)—how supply chains changed globalization
- **Shih, Willy.** Harvard Business Review articles on manufacturing and supply chains
- **Miller, Chris.** *Chip War* (2022)—semiconductor supply chain history
- **Levinson, Marc.** *The Box* (2006)—containerization revolution
- **Dingel, Jonathan.** International trade course materials (econ35101)

## Exercises

### Review Questions

1. The chapter states that 43% of U.S. goods trade (\$2.2 trillion) consists of related-party transactions—companies shipping goods to themselves across borders. Explain why intra-firm trade complicates the conventional understanding of trade deficits. When Ford ships engines from a Mexican plant to a Michigan assembly line, how should policymakers think about this “import” differently from an arm’s-length purchase of a finished consumer good from an unrelated foreign supplier?
2. The semiconductor supply chain exhibits extreme geographic fragmentation: the United States controls 85% of EDA design tools and 50% of chip design, yet holds 0% of leading-edge fabrication capacity. Using the Semiconductor Value Chain Geography table, explain why each stage of the supply chain has concentrated in different locations. What does TSMC’s dominance in fabrication imply about the vulnerability of American technology companies that depend on its output?
3. ASML’s EUV lithography machines are described as a critical chokepoint—\$200 million machines with 100,000+ components from hundreds of suppliers, manufactured exclusively in the Netherlands. Explain how a single company can become an irreplaceable node in a global supply chain. What conditions created this monopoly, and why hasn’t a competitor emerged?
4. The Inflation Reduction Act requires that by 2029, 100% of battery components for EV tax credits must be manufactured in North America, with no components from “Foreign Entities of Concern.” Given China’s dominance in battery supply chains (65-85% control across key stages from lithium refining to cell manufacturing), evaluate whether this timeline is realistic. What are the costs and benefits of attempting to build an entirely non-Chinese battery supply chain?
5. The 2021-22 supply chain crisis saw container shipping rates from China to the U.S. West Coast rise from \$2,000 to over \$20,000—a tenfold increase. Trace

the cascade of disruptions described in this chapter, from the pandemic demand shock through port congestion, semiconductor shortages, and the Texas freeze. Why did “just-in-time” inventory management amplify rather than dampen these shocks?

6. The chapter describes a strategic shift from “efficiency to resilience” and from “offshore to nearshore.” Using the Mexico nearshoring example, explain why proximity offers advantages beyond lower shipping costs—consider time zone alignment, USMCA access, and geopolitical risk reduction. What limitations does the chapter identify that prevent Mexico from simply absorbing all production leaving China?
7. Compare the supply chain strategies of Apple and Walmart as described in the firm profiles. Both companies source extensively from China, and both face Section 301 tariffs. How do their diversification strategies differ? Why might Apple’s approach (moving 14% of iPhone production to India) be harder to replicate than Walmart’s supplier shifts?

## Data Exercises

1. The Bureau of Transportation Statistics publishes freight data through its Freight Analysis Framework (<https://www.bts.gov/faf>). Using the FAF data or the Port of Los Angeles monthly container statistics (<https://www.portoflosangeles.org/business/statistics>), chart monthly TEU volumes at the Port of Los Angeles from January 2019 through the most recent available month. Identify the pre-pandemic baseline, the 2021-22 crisis peak, and the post-crisis normalization. How does the current volume compare to the pre-pandemic trend line? What does this suggest about whether trade patterns have permanently shifted?
2. The FRED database maintains several series relevant to supply chain conditions. Retrieve the Global Supply Chain Pressure Index from the New York Fed (FRED series “GSCPI”) and the ISM Manufacturing PMI Supplier Deliveries Index for 2019 to present. Plot them on a common timeline. Identify the period of maximum supply chain stress and the timeline for normalization. How long did it take for conditions to return to pre-pandemic levels?
3. Using the Semiconductor Industry Association’s annual Factbook (<https://www.semiconductors.org>) and the CHIPS Act project tracker maintained by the Commerce Department, compile a table of all major CHIPS Act-funded manufacturing projects announced to date, including TSMC Arizona, Intel Ohio, Samsung Taylor, and Micron New York. For each, record the company, location, investment amount, federal subsidy, projected direct jobs, and expected production start date. Calculate the total federal subsidy per projected direct job. Is the CHIPS Act primarily a jobs program or a national security program?

## Deeper Investigation

1. The chapter identifies pharmaceutical supply chains as a critical national security vulnerability, with China and India controlling 70-80% of generic drug

production and 90%+ of antibiotic inputs. Yet reshoring progress has been described as “slow,” with economics favoring continued offshoring. Investigate the specific case of one essential medicine category—antibiotics, blood pressure medications, or chemotherapy drugs. Map the current supply chain from raw materials to the finished product reaching an American pharmacy, identifying points of geographic concentration. Assess the policy interventions attempted so far (Essential Medicines List, API manufacturing incentives, strategic reserves) using FDA facility inspection data (<https://www.fda.gov/drugs>) and Commerce Department supply chain review reports. Can the United States realistically reduce its pharmaceutical dependency on China within a decade, and at what cost to drug prices for consumers?

# **Part V: Regional Economies**

# 23. The Northeast Corridor

The Acela train leaves Penn Station in New York at 6:00 AM, and by 8:30 it has deposited passengers at Union Station in Washington. In between, the train passes through Newark, Philadelphia, Wilmington, and Baltimore—a continuous metropolitan fabric housing 50 million people generating over \$4 trillion in annual output. If the Northeast Corridor were a country, it would rank among the world's five largest economies.

## A Unified Economic Region

The Northeast Corridor—stretching from Boston to Washington—functions less as a collection of separate cities than as a single economic mega-region. Economists increasingly view it through the lens of agglomeration: four major metros so tightly integrated by rail, road, and digital infrastructure that they operate as a unified labor market for elite professional services.

The corridor's economic dominance reflects centuries of path dependence. Colonial-era port cities became industrial centers, which became financial capitals, which became knowledge hubs. Each transition built on existing infrastructure, institutions, and human capital. The result is an economic density that would be nearly impossible to replicate elsewhere—a fact that explains both the corridor's resilience and its persistent cost disadvantages.

The six states that comprise the corridor's core—Massachusetts, Connecticut, New York, New Jersey, Pennsylvania, and Maryland—plus the District of Columbia together generated \$4.8 trillion in GDP in 2023, roughly 18% of the national total. Per capita income across these states averaged \$77,000, well above the national figure of \$70,000. But these averages mask enormous variation: Connecticut and Massachusetts lead at roughly \$90,000 per capita, while Pennsylvania trails at \$68,000.

### Combined Regional Statistics (2024)

Metro Area	GDP	Population	Economic Identity
New York-Newark	\$2.16 trillion	19.5 million	Global finance and media capital
Washington, D.C.	\$715 billion	6.3 million	Federal government and defense

Metro Area	GDP	Population	Economic Identity
Boston-Cambridge	\$641 billion	4.9 million	Biotech and higher education
Philadelphia	\$558 billion	6.2 million	Healthcare, logistics, pharma

Source: Bureau of Economic Analysis, Regional GDP; Bureau of Labor Statistics, 2024

Together, the corridor accounts for roughly 17% of U.S. GDP on less than 2% of its land area. This concentration of economic output in such a small geographic footprint is unmatched anywhere in the world outside of city-states like Singapore. The density creates both extraordinary productivity and extraordinary vulnerability: the corridor's economic output depends on infrastructure that was largely built a century ago.

## The Four Pillars

Each major corridor city has developed a distinct economic specialization, creating complementarity rather than pure competition.

### Boston: The Knowledge Refinery

Boston's economy runs on ideas. The city's concentration of elite research universities—Harvard, MIT, Boston University, Tufts, Northeastern—generates a continuous stream of basic research that nearby firms commercialize. This is the “knowledge refinery” model: universities produce science, venture capital provides fuel, and startups convert discoveries into products.

The epicenter is Kendall Square in Cambridge, arguably the world's densest cluster of innovation. Within a few blocks of MIT sit the research headquarters of Novartis, Pfizer, Sanofi, and Takeda, alongside hundreds of biotechnology startups. When Moderna developed its COVID-19 vaccine using mRNA technology, the entire value chain—from basic research to manufacturing—drew on this ecosystem.

The numbers reflect this concentration: Massachusetts received \$4.2 billion in NIH funding in 2023, second only to California despite having one-fifth the population. The state's 1,200+ life sciences companies employ roughly 100,000 workers directly, with average wages exceeding \$130,000—among the highest of any industry cluster in the country.

Boston's economy has also diversified beyond biotech. The city has emerged as a robotics hub, with companies like Boston Dynamics (now owned by Hyundai) and iRobot headquartered in the region. Financial services remain substantial: Fidelity Investments manages \$4.5 trillion in assets from its headquarters in Boston, while State Street provides custody services for \$40 trillion in assets globally.

The University of Massachusetts system, with campuses in Boston, Amherst, and elsewhere, provides a second tier of research and workforce development that comple-

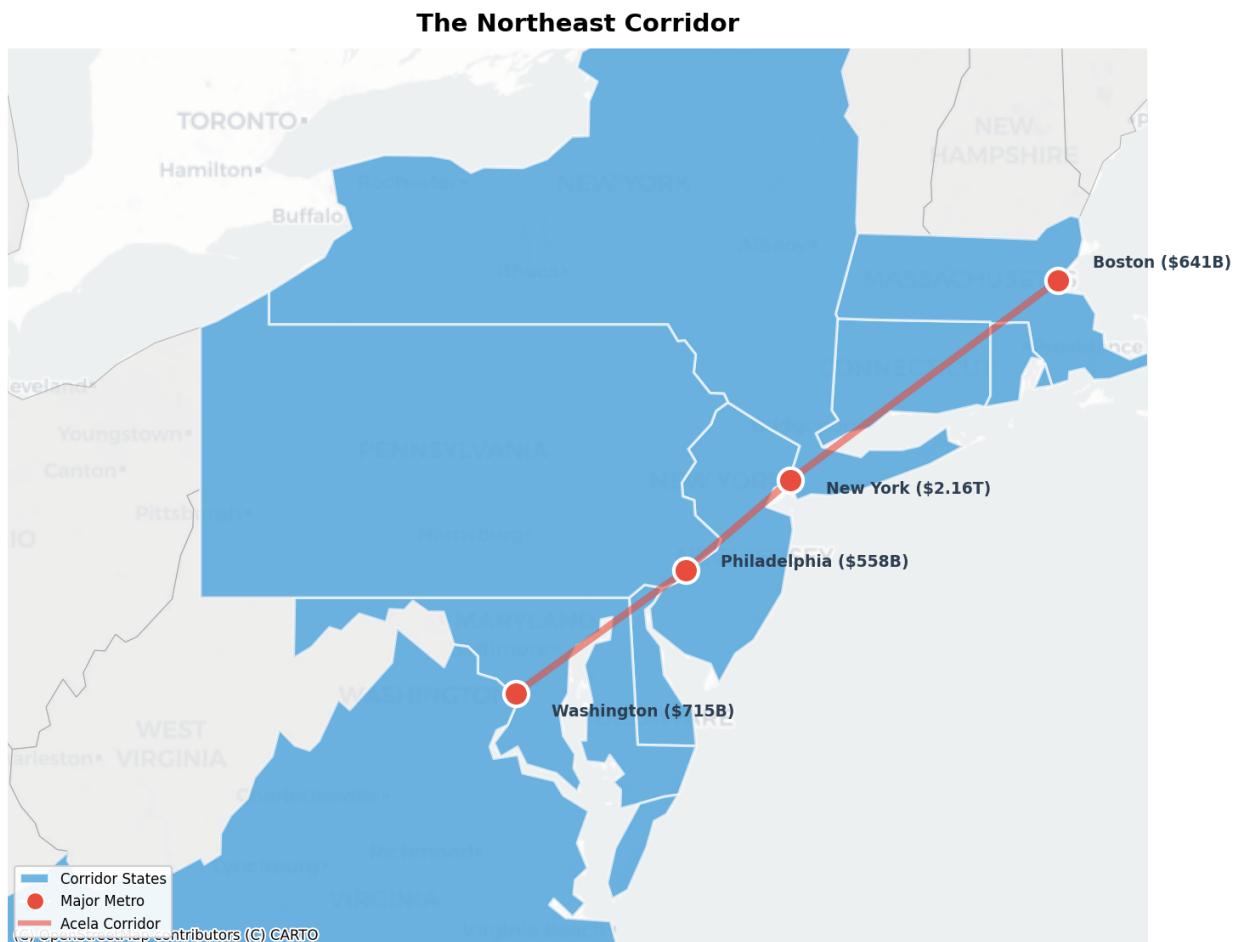


Figure 79: Figure 23.0: The Northeast Corridor mega-region. Four major metros—Boston, New York, Philadelphia, and Washington—form a continuous economic zone generating over \$4 trillion annually linked by the Acela rail corridor. Source: Author analysis

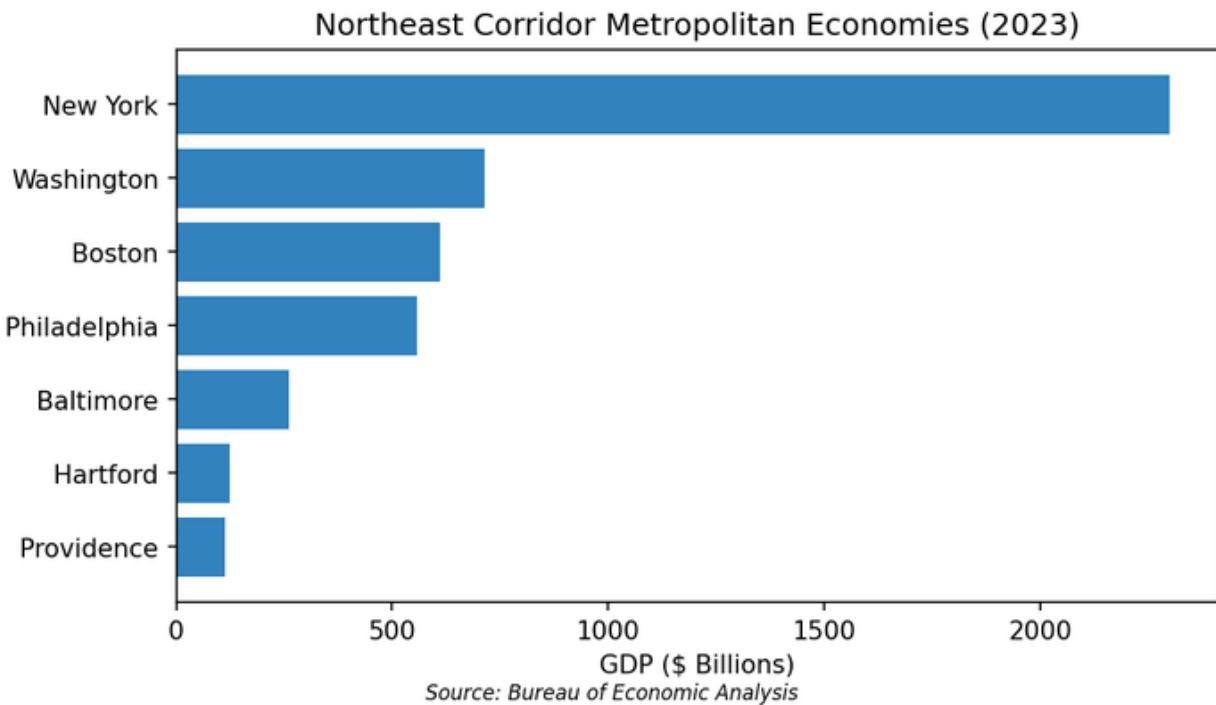


Figure 80: Figure 23.1: GDP of Northeast Corridor metros (2023). New York dominates at \$2.3 trillion, but the combined corridor economy exceeds \$4 trillion. View interactive map of top 20 metros. Source: BEA

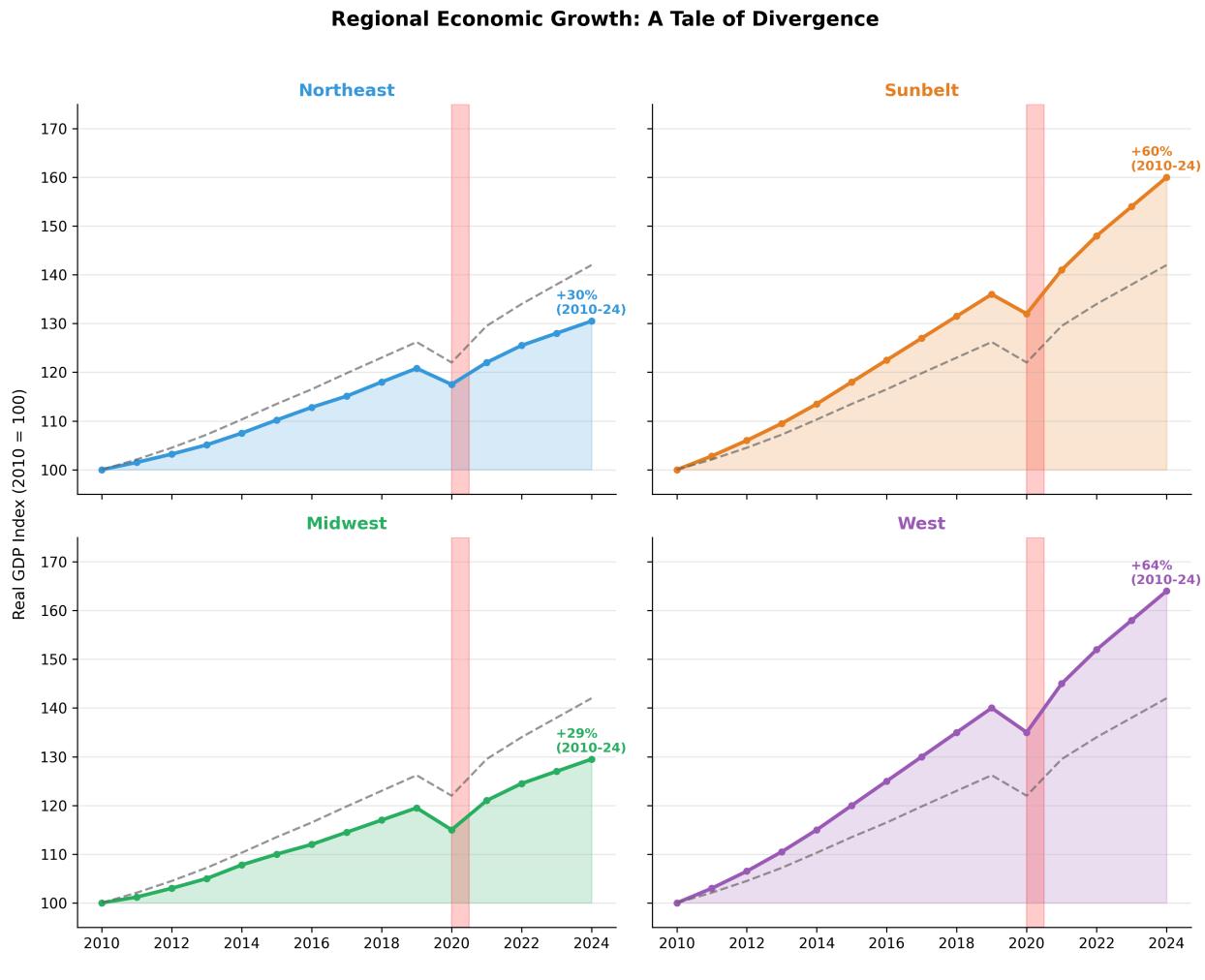


Figure 81: Figure 23.2: Regional economic growth trajectories (indexed to 2010). The Sunbelt and West have grown faster than the Northeast and Midwest over the past decade, though the COVID recession hit all regions. The dashed line shows the national average. Source: BEA Regional GDP

ments the elite private institutions. This layered educational infrastructure produces graduates at multiple skill levels, feeding both the research labs and the broader economy.

**Key Industries:** - Biotechnology and life sciences - Higher education - Asset management (Fidelity, State Street) - Robotics and hardware

**Major Employers:** Mass General Brigham (healthcare system), Harvard University, Fidelity Investments, Vertex Pharmaceuticals, Biogen

## New York: The Capital Allocator

New York is where the world's capital gets allocated. Wall Street remains the center of global finance: the equity markets, the bond markets, the commodity markets, the foreign exchange markets. JPMorgan Chase, Goldman Sachs, Morgan Stanley, and Citigroup all call the city home, as do thousands of hedge funds, private equity firms, and asset managers.

The scale is staggering. The New York Stock Exchange and NASDAQ together list companies worth over \$50 trillion. The municipal bond market—largely headquartered in New York—handles \$4 trillion in outstanding debt. The city's banks hold roughly \$3 trillion in deposits. BlackRock, the world's largest asset manager with \$10 trillion under management, operates from midtown Manhattan.

But New York has become much more than finance. The city's technology sector grew 64% between 2014 and 2024, outpacing even financial services. This isn't the generic tech of Silicon Valley—it's tech applied to New York's traditional strengths. Fintech dominates: Square's Cash App, Bloomberg, Stripe's East Coast operations. Media and advertising technology cluster around Madison Avenue's legacy. E-commerce logistics serves the region's dense consumer population.

The healthcare sector has grown to rival finance in employment. Mount Sinai, NYU Langone, NewYork-Presbyterian, and Northwell Health together employ over 200,000 workers in the metropolitan area. These systems have also become research powerhouses, attracting billions in NIH funding and spinning off biomedical startups.

New York's creative industries remain globally dominant. The city produces roughly 40% of American advertising revenue, despite the shift to digital. Film and television production has boomed since the state implemented generous tax credits—the Steiner Studios complex in Brooklyn is now the largest studio facility outside Hollywood. Publishing houses still cluster in Manhattan, even as the industry consolidates.

The metropolitan area's GDP of \$2.16 trillion in 2023 makes it larger than the national economies of Brazil, Italy, or Canada. If the New York metro area were a country, it would rank among the world's ten largest economies.

**Key Industries:** - Financial services (capital markets, asset management) - Media and entertainment - Professional services (law, accounting, consulting) - Technology (particularly fintech and ad-tech)

**Major Employers:** JPMorgan Chase, Citigroup, Verizon, Northwell Health, Mount Sinai Health System, NBCUniversal, Pfizer

## **Philadelphia: The Specialized Producer**

Philadelphia has found success by developing deep expertise in specific niches. The city's universities—Penn, Temple, Drexel, Jefferson—provide research talent, while lower costs than Boston or New York attract firms seeking value. Philadelphia's median rent of roughly \$1,900 per month is nearly half Boston's, making it increasingly attractive for mid-career professionals and cost-conscious companies.

The standout is cell and gene therapy. The University of Pennsylvania's pioneering work on CAR-T cancer treatments sparked an industry cluster that now hosts roughly 10% of the world's companies in this niche. Nearby, Chester County has emerged as a pharmaceutical manufacturing hub, while the broader region's logistics infrastructure supports distribution along the entire corridor.

The pharmaceutical connection runs deep. The Philadelphia region was once the center of American drug manufacturing—SmithKline Beecham, Wyeth, and Merck all had major operations here. Consolidation has reduced the big pharma presence, but contract manufacturing and specialized production remain strong. The region produces roughly 15% of all prescription drugs manufactured in the United States.

Comcast's headquarters in Philadelphia anchors the city's media presence. The company's \$200 billion market cap makes it one of the largest media conglomerates globally. Vanguard, headquartered in nearby Malvern, manages over \$8 trillion in assets, making the Philadelphia suburbs a quiet giant in asset management.

The port of Philadelphia and South Jersey handle substantial cargo, though dwarfed by New York-Newark. More importantly, the region's location midway along the corridor makes it a natural logistics hub. Amazon, UPS, and FedEx all maintain major distribution facilities serving the dense northeastern consumer market.

**Key Industries:** - Healthcare and “eds-and-meds” - Pharmaceutical manufacturing  
- Cell and gene therapy - Logistics and distribution - Telecommunications (Comcast headquarters)

**Major Employers:** Penn Medicine, Children's Hospital of Philadelphia (CHOP), Comcast, Vanguard, Independence Blue Cross

## **Washington: The Regulator and Contractor**

Washington's economy is built on a peculiar foundation: the federal government consumes roughly 30% of the region's GDP directly, and much of the remainder exists to serve, influence, or extract value from government activity. Defense contractors, lobbying firms, think tanks, government relations practices, and federal-adjacent consultancies create an economy that is remarkably recession-proof but structurally dependent on political decisions.

The privatization of government has been the dominant trend for four decades. The “Beltway Bandits”—defense and IT contractors headquartered in suburban Virginia and Maryland—now rival the federal workforce in size. Lockheed Martin, General Dynamics, Booz Allen Hamilton, and Leidos employ hundreds of thousands across the region.

The geography of federal contracting has created distinct clusters. Tysons Corner and Reston in Virginia host defense and IT contractors. Bethesda has become the biomedical research capital, anchored by the NIH campus and its \$45 billion annual budget. The “Data Center Alley” in Loudoun County, Virginia, houses roughly 70% of the world’s internet traffic, drawn initially by proximity to federal agencies and now sustained by its own network effects.

Amazon’s decision to locate its second headquarters in Arlington, Virginia—just across the Potomac from D.C.—validated the region’s emergence as a tech hub. The company has committed to 25,000 jobs at average salaries exceeding \$150,000. The HQ2 campus, centered on the revitalized National Landing neighborhood, has attracted complementary tech employers.

The region’s knowledge economy also includes one of the nation’s densest concentrations of think tanks and policy research organizations. The Brookings Institution, American Enterprise Institute, Center for Strategic and International Studies, and dozens of others employ thousands of researchers producing analysis that shapes policy. The lobbying industry—roughly \$4 billion annually in registered lobbying alone—represents another dimension of the influence economy.

Washington’s resilience during recessions reflects its federal foundation. The metropolitan area barely felt the 2008-2009 financial crisis and recovered faster than any major market. Even COVID-19’s impact was muted by the shift to remote work among the region’s heavily white-collar workforce.

**Key Industries:** - Federal government - Defense contracting - Lobbying and public affairs - Cybersecurity - Healthcare (major hospital systems)

**Major Employers:** Federal government (largest by far), Lockheed Martin, General Dynamics, Booz Allen Hamilton, Capital One, Marriott International, Amazon (HQ2 in Arlington)

## The Acela Economy

The physical infrastructure that unites the corridor creates economic possibilities unavailable in more dispersed regions. The corridor handles 2,200 trains per day—Amtrak intercity services, commuter rail from New Jersey Transit, SEPTA, MARC, and Metro-North, plus freight—making it the most intensively used rail corridor in North America.

## Labor Market Integration

The corridor’s rail and shuttle connections allow a “super-thick” labor market to function across metropolitan boundaries. A lawyer living in Philadelphia can litigate cases in New York. A consultant based in Washington can service clients in Boston. A Boston-based venture capitalist can attend board meetings in New York and be home for dinner.

This integration is asymmetric: New York serves as the hub, drawing workers from all directions. The 6:00 AM Acela from Washington and the 6:15 AM from Boston are

filled with professionals commuting to New York for client meetings, depositions, and deal closings. The evening trains reverse the flow.

Amtrak's Northeast Corridor carried 12.5 million passengers in 2023, roughly half the railroad's total ridership despite representing just one of its many routes. The Acela premium service—which cuts the New York-Washington trip to under three hours—competes directly with airline shuttles and often wins on reliability and door-to-door time.

The labor market integration extends beyond the trains. The regional airlines—American's shuttle, Delta's shuttle, JetBlue—connect the corridor's airports with hourly frequency. For same-day business trips, professionals can board a 6:00 AM flight in Boston, conduct meetings in Washington, and be home by dinner. This connectivity enables firms to maintain clients across the entire corridor without establishing multiple offices.

## **Knowledge Spillovers**

The corridor links the highest concentration of elite universities in the world: Harvard, MIT, Yale, Columbia, Princeton, Penn, Georgetown, Johns Hopkins, NYU, Boston University. These institutions produce research that flows across the region, train students who populate its firms, and provide consulting expertise to its industries.

Faculty at MIT collaborate with colleagues at Columbia. Penn Medical School works with Boston's research hospitals. Princeton's economists advise Washington policy-makers. The density of these connections—enabled by geographic proximity—creates knowledge spillovers unavailable in more dispersed university systems.

## **Infrastructure Vulnerability**

The corridor's dependence on its infrastructure spine creates acute vulnerability. Estimates suggest that a shutdown of the Northeast Corridor rail line would cost the economy roughly \$100 million per day in lost productivity. When Amtrak closes for maintenance or severe weather disrupts service, the effects ripple through the professional services economy.

The infrastructure itself shows its age. Penn Station in New York operates far beyond designed capacity—650,000 daily passengers through a station designed for 200,000. The tunnels under the Hudson River, built in 1910, are deteriorating; Hurricane Sandy flooded them with saltwater in 2012, accelerating corrosion. A single-track failure in these tunnels can cascade into delays affecting the entire corridor.

The Gateway Project—a \$16 billion initiative to add new tunnels and rebuild Penn Station—secured full federal funding in 2024 after more than a decade of political disputes, with major construction now underway. The project will add two new tubes under the Hudson, allowing the original tunnels to be rehabilitated. Completion is expected in the early 2030s, though mega-project delays are common.

The corridor's bridges present similar challenges. The 113-year-old Portal Bridge over the Hackensack River in New Jersey is a notorious chokepoint; it swings open for marine traffic and frequently gets stuck. A replacement bridge, also part of the

Gateway program, is under construction. The Susquehanna River Bridge near Baltimore, built in 1906, limits speeds to 30 mph on a critical stretch.

Even the airports face capacity constraints. LaGuardia Airport finally completed a multibillion-dollar reconstruction in 2024, but runway limitations cap throughput. Newark, JFK, and Reagan National all operate at or near capacity during peak hours. The region's airspace is among the most congested in the world, with delays at New York-area airports rippling through the national aviation system.

## Housing and Talent Competition

The corridor's success has created its greatest challenge: housing costs that increasingly threaten its economic model. The fundamental problem is simple: the corridor's economy has grown far faster than its housing stock. Between 2010 and 2023, the four major metros added roughly 1.5 million jobs but only 800,000 housing units.

### The Affordability Crisis

All four corridor metros rank among the nation's most expensive housing markets. Strict zoning, limited new construction, and intense demand from high-wage workers have pushed prices to levels that exclude middle-class families. The crisis is most acute in Boston and New York, where median rents exceed \$3,400 per month—requiring an income of roughly \$140,000 just to meet standard affordability guidelines.

#### Housing Cost Comparison (2024)

Metro	Median Rent	Median Home Price
Boston	\$3,495/month	\$720,000
New York	\$3,489/month	\$680,000
Washington, D.C.	\$2,195/month	\$575,000
Philadelphia	\$1,895/month	\$365,000

Source: Bureau of Economic Analysis, Regional GDP; Bureau of Labor Statistics, 2024

The Boston-New York convergence is particularly striking. Historically, Boston offered a modest cost advantage—enough to attract firms and workers priced out of New York. With that differential eliminated, Boston risks losing mid-career talent to lower-cost alternatives.

### The Missing Middle

The corridor's housing market increasingly resembles an hourglass: luxury apartments for the wealthy, subsidized housing for the poor, and almost nothing for the middle class. Teachers, nurses, police officers, and junior professionals face impossible choices between hour-long commutes and unsustainable housing costs.

The result is demographic distortion. The corridor's cities attract young graduates willing to crowd into small apartments and wealthy professionals who can afford premium housing. But when families form and children arrive, middle-class households flee to the exurbs or leave the region entirely.

Population data tells the story. New York State's population peaked in 2020 at 20.1 million and has since declined to 19.9 million, despite continued international immigration. The state lost domestic migrants to Florida, Texas, and the Carolinas throughout the early 2020s. Massachusetts grew modestly—from 6.9 million in 2019 to 7.1 million in 2024—but this growth came almost entirely from international immigration, masking substantial domestic out-migration.

## **The Zoning Problem**

The corridor's housing shortage stems largely from local land-use policies that make new construction difficult or impossible. Boston's suburbs—Cambridge, Brookline, Newton—have barely added housing in decades despite skyrocketing demand. New York City builds more than its suburbs but still falls far short of demand. Philadelphia and Washington have somewhat more elastic housing supplies, which helps explain their lower prices.

Recent reform efforts show mixed results. Massachusetts passed a zoning reform law in 2021 requiring communities near transit to allow multifamily housing, but implementation has been slow. New York's attempts at statewide zoning reform have repeatedly failed in the legislature. The political economy is brutal: existing homeowners benefit from scarcity and use their political power to maintain it.

## **Recent Trends**

### **The Office Bifurcation**

The post-pandemic office market has split into two tracks. Premium "Class A" space in new buildings—One Vanderbilt in New York, Seaport developments in Boston—commands record rents above \$200 per square foot. Older "Class B" buildings face vacancy crises, particularly in Washington where federal workers have been slower to return to offices than private sector employees.

### **Biotech Real Estate Cycle**

After a hyper-growth phase fueled by COVID vaccine success and SPAC-funded startups, Boston's laboratory real estate market has experienced a sharp correction. Vacancy rates in life sciences space surpassed 25% by late 2024, creating a "tenant's market" for the first time in a generation. This may paradoxically strengthen the ecosystem by making space available to early-stage startups previously priced out of Kendall Square.

## **The Tech-Finance Convergence**

The distinction between New York's technology and financial sectors has blurred nearly to the point of meaninglessness. JPMorgan Chase employs 60,000 technologists globally; Goldman Sachs describes itself as a technology company. The growth of fintech, crypto-finance, and AI-applied-to-trading has merged the industries physically and organizationally. New York increasingly competes directly with San Francisco for technical talent.

The AI boom has accelerated this trend. New York's AI startups raised \$8 billion in venture funding in 2023, second only to the Bay Area. The city's strength lies in applied AI—using machine learning for trading strategies, risk management, legal document review, advertising optimization—rather than foundational model development. This fits the corridor's broader pattern: adapting frontier technologies to established industries rather than creating entirely new ones.

## **The Remote Work Adjustment**

The pandemic's shift to remote work initially threatened the corridor's economic model, which depends on face-to-face interaction in dense urban environments. Office vacancy rates spiked to historic highs—20% in Manhattan, 22% in Washington—as employers adopted hybrid policies.

By 2024, the adjustment had partially stabilized. Most professional services firms settled on hybrid arrangements requiring two to three days in the office. This preserved the corridor's role in spontaneous collaboration and client entertainment while reducing the premium on daily commuting. The trains are fuller on Tuesdays, Wednesdays, and Thursdays; Mondays and Fridays remain quiet.

The long-term implications remain unclear. Some firms have used hybrid work to reduce their footprint and costs. Others have used it to hire talent from outside the corridor who commute only occasionally. The net effect appears to be a modest reduction in the corridor's magnetic pull rather than a fundamental disruption.

## **Regional Profiles**

### **Mass General Brigham**

**Quick Facts** - Headquarters: Boston, MA - Type: Integrated academic healthcare system - Revenue: \$18 billion (2023) - Employees: 85,000

Mass General Brigham—formed from the merger of Massachusetts General Hospital and Brigham and Women's Hospital—is the largest private employer in New England and the research engine driving Boston's life sciences economy. Its affiliated hospitals conduct more NIH-funded research than any healthcare system in the country.

The system's scale creates a virtuous cycle. Research grants attract top scientists. Scientists generate discoveries. Discoveries spawn spinoff companies. Companies recruit talent from the hospitals. The talent generates more research. This cycle has made the Boston area the global center of biotechnology—a position that would

have been impossible to predict when the Kendall Square cluster began forming in the 1970s.

## JPMorgan Chase

**Quick Facts** - Headquarters: New York, NY - Revenue: \$158 billion (2024)  
- Employees: 313,000 worldwide; roughly 60,000 in NYC metro - Market cap: \$700 billion

JPMorgan Chase is not just the largest bank in the United States—it is increasingly the dominant player across multiple segments of American finance. Under CEO Jamie Dimon, the bank has grown its market share in investment banking, commercial lending, asset management, and consumer banking while most competitors have retrenched.

The bank's New York presence anchors the city's financial district. Its headquarters occupies a full block of Park Avenue; a new 60-story tower is under construction at 270 Park Avenue. But JPMorgan also exemplifies the corridor's integration: substantial operations in Delaware (credit cards), New Jersey (operations centers), and a major presence in Washington (government relations and treasury services).

## The Washington Metro

**Quick Facts** - Type: Regional transit system - Ridership: 600,000 daily (2024) - Stations: 98 - System length: 128 miles

Unlike New York or Boston, Washington was designed for the automobile. But the Metro system, opened in 1976, has reshaped the region's economic geography. The corridor's major employers—from the Pentagon to the NIH campus in Bethesda to Amazon's HQ2 in Arlington—cluster around Metro stations.

The system's challenges mirror the corridor's infrastructure woes: aging equipment, deferred maintenance, and funding disputes between jurisdictions (D.C., Maryland, and Virginia). A 2015 safety crisis led to system-wide shutdowns for repairs. But the Metro remains essential: the region's traffic congestion without transit would cripple its economy.

## Comcast

**Quick Facts** - Headquarters: Philadelphia, PA - Revenue: \$121 billion (2023) - Employees: 186,000 - Market cap: \$160 billion

Comcast is Philadelphia's largest private employer and one of the corridor's most important corporate anchors. The company operates the nation's largest cable television provider (Xfinity), NBCUniversal's entertainment empire, and a growing theme park division.

The company's Philadelphia presence includes two signature towers that dominate the city skyline. But Comcast's footprint extends across the corridor: NBCUniversal operates from 30 Rockefeller Center in New York, and the company's broadband network serves customers from Maine to Virginia.

Comcast exemplifies the corridor's pattern of consolidation. Through decades of acquisitions—AT&T Broadband in 2002, NBCUniversal in 2011, Sky in 2018—the company has assembled a vertically integrated media and telecommunications giant. The combination of content creation, distribution, and direct customer relationships gives Comcast leverage across the entire value chain.

## Data Sources and Further Reading

### Key Data Sources

- **BEA Regional Accounts:** GDP by metropolitan area
- **BLS Quarterly Census of Employment and Wages:** Employment by metro
- **Amtrak:** Corridor ridership and economic impact studies
- **Regional Federal Reserve Banks:** Economic surveys (New York Fed, Boston Fed, Philadelphia Fed)

### Further Reading

- Glaeser, Edward. *Triumph of the City* (2011) - Agglomeration and urban economies
- Goldsmith, Stephen and Susan Crawford. *The Responsive City* (2014) - Urban technology and governance
- Regional Plan Association reports on Northeast megaregion
- CBRE and JLL real estate market reports

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**Word count:** roughly 4,300 words

Note: This chapter focuses on economic structure and geography. For treatment of specific industries (financial services, healthcare, technology), see the relevant sector chapters in Part II.

## Exercises

### Review Questions

1. The chapter argues that the Northeast Corridor functions “less as a collection of separate cities than as a single economic mega-region.” What evidence supports this claim? Discuss at least three mechanisms—labor market integration, knowledge spillovers, and infrastructure connectivity—that bind the four major metros into a unified economic zone. Where does this integration break down?
2. Each of the corridor’s four major metros has developed a distinct economic specialization: Boston as the “knowledge refinery,” New York as the “capital allocator,” Philadelphia as the “specialized producer,” and Washington as the “regulator and contractor.” For any two of these, explain how their specializations create complementarity rather than direct competition. What would each city lose if the other did not exist nearby?

3. The chapter describes Boston's Kendall Square as "arguably the world's densest cluster of innovation." Trace the virtuous cycle that sustains this cluster: how do NIH funding (\$4.2 billion to Massachusetts in 2023), university research, venture capital, and the presence of pharmaceutical giants like Novartis and Pfizer reinforce each other? What role did Moderna's COVID-19 vaccine development play in demonstrating this ecosystem's capabilities?
4. The corridor faces a severe housing affordability crisis, with Boston and New York median rents exceeding \$3,400 per month. The chapter identifies a "missing middle" in the housing market. Explain this concept and its consequences for the corridor's demographic composition, workforce pipeline, and long-term economic competitiveness. Why have zoning reform efforts in Massachusetts and New York yielded only "mixed results"?
5. The Gateway Project—a \$16 billion initiative to add new Hudson River tunnels and rebuild Penn Station—is described as critical infrastructure for the corridor's economy. Explain why a shutdown of the Northeast Corridor rail line would cost "roughly \$100 million per day in lost productivity." What does this vulnerability reveal about the relationship between infrastructure investment and economic output in dense urban regions?
6. Washington's economy is described as "remarkably recession-proof but structurally dependent on political decisions." Using examples from the chapter—including the "Beltway Bandits," Data Center Alley in Loudoun County, and Amazon's HQ2—explain how federal spending creates private-sector economic activity. What are the risks of this dependency model?
7. The post-pandemic office market has "split into two tracks," with premium Class A space commanding record rents while older buildings face vacancy crises. How has hybrid work (two to three office days per week) changed the economic geography of the corridor? Why are Tuesdays through Thursdays busier than Mondays and Fridays, and what does this pattern imply for transit planning, commercial real estate, and urban fiscal health?

## Data Exercises

1. Using the BEA Regional Economic Accounts (<https://www.bea.gov/data/gdp/gdp-metropolitan-area>), download GDP data for the four major Northeast Corridor metros—New York-Newark, Washington D.C., Boston-Cambridge, and Philadelphia—for 2010 through the most recent available year. Calculate each metro's share of national GDP and plot the trend over time. Has the corridor's combined share of U.S. GDP grown, shrunk, or remained stable? Compare the corridor's growth trajectory to the national average and to a Sunbelt metro of your choice (Houston, Dallas, or Atlanta).
2. The BLS Quarterly Census of Employment and Wages (<https://www.bls.gov/cew/>) provides employment and wage data by metro and industry. For the Boston-Cambridge metro area, download employment data for NAICS 3254 (Pharmaceutical and Medicine Manufacturing) and NAICS 5417 (Scientific Research and Development Services) for 2015 through the most recent year. How have em-

ployment and average wages in these sectors changed? Do the data support the chapter’s characterization of Boston’s life sciences cluster as a high-wage growth engine?

3. Using Census Bureau population estimates and the American Community Survey (<https://data.census.gov/>), compare net domestic migration for New York State and Massachusetts from 2018 to the most recent available year. Break down the flows by age cohort if possible. Does the pattern confirm the chapter’s claim that the corridor attracts young graduates but loses middle-class families? Which age groups are arriving, and which are leaving?

## **Deeper Investigation**

1. The chapter describes the corridor’s biotech real estate market as having experienced a “sharp correction,” with life sciences vacancy rates in Boston surpassing 25% by late 2024—paradoxically suggesting this might “strengthen the ecosystem by making space available to early-stage startups previously priced out of Kendall Square.” Investigate the relationship between real estate costs and innovation ecosystem health in one corridor city. How do rising rents affect the mix of firms in a cluster (favoring large incumbents over startups)? Has the correction actually led to increased startup formation? Use data from commercial real estate brokerages (CBRE, JLL quarterly reports), PitchBook or Crunchbase venture funding data, and Massachusetts Biotechnology Council reports. Consider whether the corridor’s innovation advantage is self-sustaining or whether cost pressures could eventually cause the cluster to disperse.

# 24. The Sunbelt

In 2024, Chevron announced it was moving its corporate headquarters from the San Francisco Bay Area to Houston. The company joins an exodus: Toyota to Texas, Caterpillar to Texas, Boeing to Virginia, Oracle to Texas, Tesla to Texas, Citadel to Miami. Something fundamental is shifting in American economic geography, and the beneficiary has a name: the Sunbelt.

## The Great Shift

The Sunbelt—stretching from the Carolinas through Georgia, Florida, Texas, Arizona, and Nevada—has captured the lion's share of American growth for two decades. This is not simply population movement; it represents a structural reallocation of economic activity from the Northeast and Midwest to the South and Southwest.

The shift accelerated after 2020. Remote work untethered millions of knowledge workers from expensive coastal metros; lower taxes and warmer weather suddenly became accessible without career sacrifice. Corporate relocations followed, drawn by the same cost arbitrage plus the desire to locate near migrating talent. The Sunbelt absorbed the resulting influx with a mixture of triumphalism and infrastructure strain.

The numbers are stark. Between 2019 and 2024, Texas added 2.3 million residents—growing from 29 million to 31.3 million. Florida added 1.9 million, growing from 21.5 million to 23.4 million. Together, these two states absorbed more population than the bottom 30 states combined. Meanwhile, New York lost 250,000 residents, Illinois lost 270,000, and California essentially flatlined despite substantial international immigration.

### Growth Differentials (2023-2024)

Region	Population Growth	GDP Growth
Sunbelt states	1.1% annually	3.2%
Non-Sunbelt	0.1% annually	1.8%

Source: Census Bureau, Population Estimates; Bureau of Economic Analysis, Regional GDP, 2024

The South alone accounted for 87% of U.S. population growth in 2023. Texas and Florida added nearly 800,000 residents between them in a single year—equivalent to

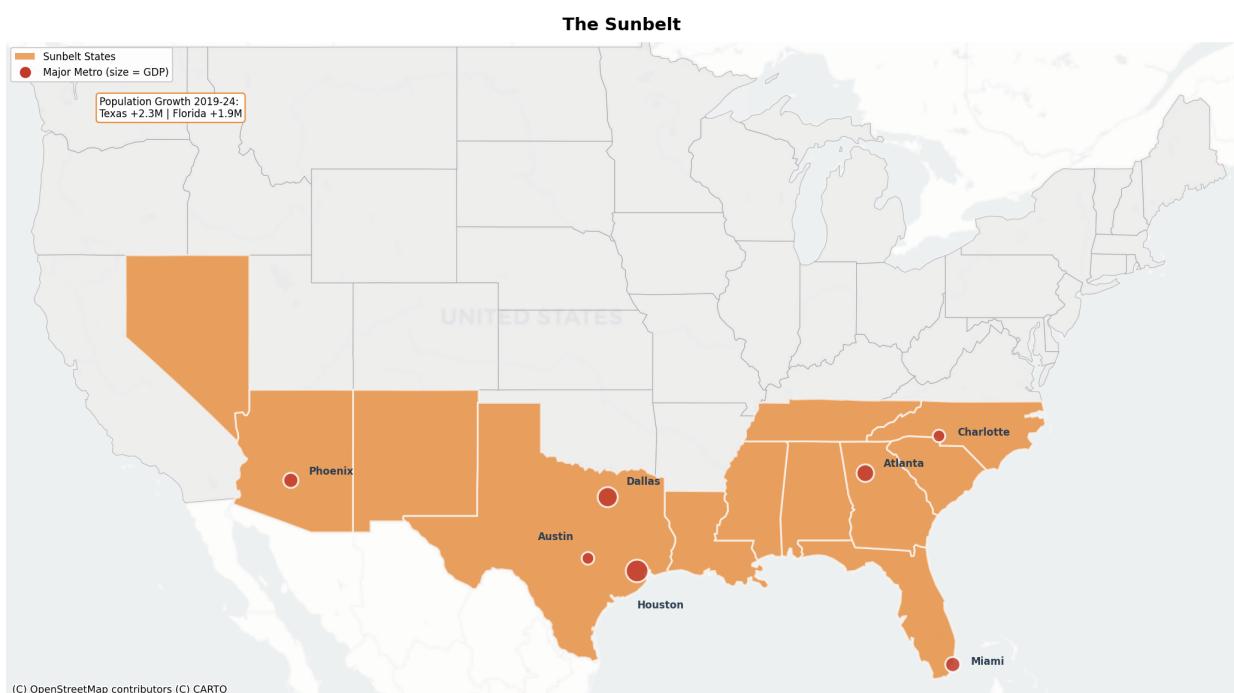


Figure 82: Figure 24.1: The Sunbelt region. Major metros in Texas, Florida, Georgia, Arizona, and the Carolinas have captured the majority of U.S. population and economic growth since 2019. Circle size indicates metro GDP. Source: BEA, Census Bureau

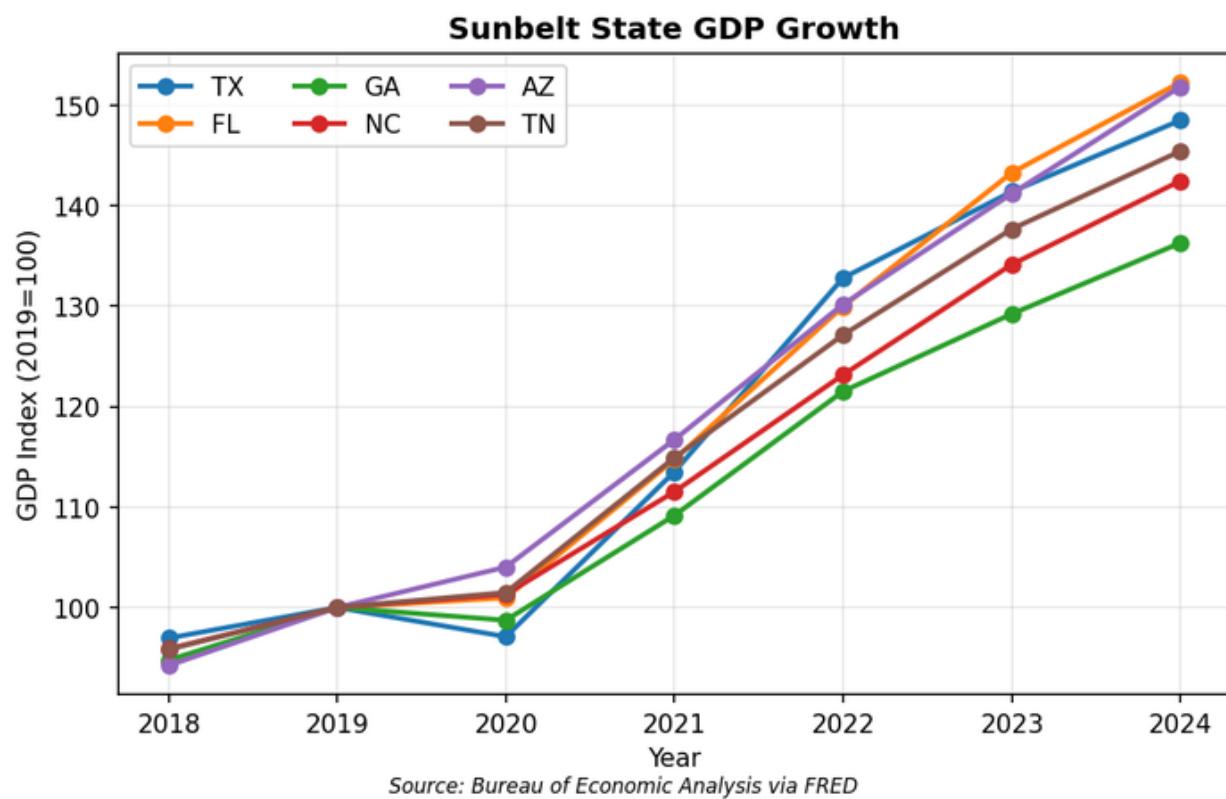


Figure 83: Figure 24.2: Sunbelt state GDP growth since 2019, indexed to 100. All Sunbelt states have outpaced national growth, with Texas and Florida leading. Source: BEA

adding a city the size of Seattle.

The Sunbelt's projected growth over the next decade exceeds 7%, adding roughly 11 million people. The rest of the country is projected to grow by 0.3%.

## **The Economic Composition**

The Sunbelt economy is more diverse than stereotypes suggest. Texas alone had a GDP of \$2.3 trillion in 2023—larger than Italy's national economy. Florida's \$1.4 trillion economy would rank as the world's 15th largest if it were a separate country. Georgia's \$781 billion economy exceeds that of Switzerland.

Energy remains central to Texas—the state produces 43% of U.S. crude oil and 25% of natural gas—but healthcare, technology, manufacturing, and professional services have grown to match it. Florida's economy tilts toward tourism, real estate, and financial services, but aerospace and biomedical manufacturing have gained ground. Georgia's economy balances logistics, media production, and a growing technology sector.

The Sunbelt's per capita income tells a different story than total output. Texas (\$67,500), Florida (\$70,000), Georgia (\$60,000), and Arizona (\$63,000) all trail the national average of \$70,000. The region's economic growth has been extensive—more people, more jobs—rather than intensive growth in productivity per worker. This creates a different economic character than the high-productivity coastal metros.

## **Key Metropolitan Economies**

The Sunbelt's growth concentrates in a handful of metropolitan areas, each developing distinct economic specializations.

### **Houston: The Energy Capital**

Houston is to global energy what New York is to global finance: the command center. The city hosts the headquarters of most major oil and gas companies operating in the Western Hemisphere, along with the engineering firms, oilfield service companies, and legal practices that serve them.

**Key Statistics:** - Metropolitan GDP: \$700 billion (2023) - Fortune 500 headquarters: 22 - Employment in energy sector: 230,000 direct

When Chevron relocated its headquarters in 2024, Houston completed a decades-long consolidation. Every major integrated oil company with significant U.S. operations—ExxonMobil, Chevron, Phillips 66, ConocoPhillips, Occidental—is now headquartered in the Houston metropolitan area.

But Houston is also diversifying. The Texas Medical Center, the world's largest medical complex, employs 120,000 people across 60 institutions. The city has become a center for energy transition technologies: hydrogen production, carbon capture, and

renewable project development. The same engineering talent that managed offshore drilling platforms now designs wind farms and solar installations.

Houston's port complex—the nation's largest by foreign tonnage—handles 45% of U.S. petrochemical exports and serves as the gateway for goods bound for Mexico. The ship channel's ongoing widening project, when completed in 2026, will allow post-Panamax vessels to access the port directly, reducing transshipment costs.

The city's sprawl is legendary—the metropolitan area covers 10,000 square miles, larger than New Jersey—but this sprawl enables affordable housing that coastal metros cannot match. A median home price of \$340,000 in 2024, while substantially higher than pre-pandemic levels, remains far below comparable coastal markets.

## **Dallas-Fort Worth: The Boardroom of the South**

If Houston is the energy capital, Dallas is the corporate capital. The metropolitan area hosts more than 20 Fortune 500 headquarters, ranging from AT&T and American Airlines to Texas Instruments and Kimberly-Clark.

**Key Statistics:** - Metropolitan GDP: \$745 billion (2023) - Fortune 500 headquarters: 23 - Population: 7.8 million (4th largest U.S. metro)

Dallas has positioned itself as the low-regulation, low-tax alternative to New York for corporate headquarters. When Charles Schwab moved from San Francisco, when Caterpillar left Illinois, when Toyota relocated from California—they chose Dallas. The city offers executive-friendly costs, a central time zone, and the nation's most connected hub airport (DFW).

The financial services sector has grown particularly rapidly. Schwab, Fidelity, and multiple regional banks have expanded Texas operations, creating a secondary financial hub that competes with Charlotte.

Dallas's logistics infrastructure supports its corporate economy. DFW Airport handles more domestic passengers than any hub except Atlanta; American Airlines' fortress hub enables same-day business travel to nearly anywhere in the country. The extensive freight rail network—including the massive Alliance Global Logistics Hub in north Fort Worth—makes Dallas a natural distribution center for goods flowing from Pacific ports to eastern markets.

The metroplex's corporate tax base creates a different fiscal dynamic than most Texas metros. Property taxes fund schools and local governments, but the concentration of corporate headquarters generates substantial franchise taxes at the state level. The result is relatively well-funded infrastructure and education by Texas standards.

## **Austin: Silicon Hills Under Strain**

Austin's emergence as a technology center represents one of the most successful economic development stories in American history. A college town with a state government and a guitar scene has become a major technology hub, home to Dell, Apple's largest office outside California, Tesla's headquarters, Oracle's headquarters, and thousands of startups.

**Key Statistics:** - Metropolitan GDP: \$180 billion - Tech employment: 200,000+ - Population growth 2010-2024: 45%

But Austin also illustrates the limits of growth without infrastructure investment. Traffic congestion has worsened dramatically; housing costs have quintupled since 2010; the city's electric grid strains under extreme temperatures. The creative culture that attracted early tech workers has been transformed by corporate density.

The question facing Austin is whether it can mature into a genuine first-tier technology center or whether infrastructure constraints will cap its potential.

The University of Texas at Austin provides a continuous pipeline of engineering talent; Samsung's Austin semiconductor fab and Applied Materials' major presence reflect the region's strength in hardware. But Austin lacks the deep venture capital ecosystem of the Bay Area and Boston—most Austin startups ultimately raise money from coastal investors.

The music and creative culture that made Austin famous increasingly feels like a residual brand rather than a living reality. Rising rents have displaced the small venues that incubated musicians; tech workers have priced out artists. The "Live Music Capital of the World" slogan rings hollow to many longtime residents watching the transformation.

## **Miami: Wall Street South**

Miami's reinvention as a financial center has been remarkably rapid. When Citadel, the hedge fund managing \$60 billion in assets, relocated from Chicago to Miami in 2022, it signaled that the city had arrived as a serious destination for elite finance.

**Key Statistics:** - Metropolitan GDP: \$400 billion - International banking assets: \$260 billion - Daily international flights: 200+

Miami has always been the gateway to Latin America—half of U.S. trade with South America flows through its ports and airport. But the pandemic-era migration of wealthy New Yorkers and financial professionals has created something new: a concentration of hedge funds, family offices, and wealth management firms that rivals Greenwich, Connecticut.

The city's lack of state income tax, combined with its climate and cultural amenities, has made it particularly attractive to high-net-worth individuals. Critics argue that Miami is building a "wealth management economy" rather than a diversified metropolitan base—but for now, the formula is working.

Miami also faces unique climate vulnerabilities. Sea level rise threatens low-lying neighborhoods; hurricane risk requires expensive insurance; saltwater intrusion endangers the aquifer that supplies drinking water. The real estate boom has proceeded despite these risks, but climate insurance costs are rising rapidly, and some areas may become effectively uninsurable.

The city's role as the gateway to Latin America continues to drive trade and banking. Miami International Airport handles more international freight than any U.S. airport

except JFK; Brightline's high-speed rail connection to Orlando (completed in 2023) has enhanced intercity connectivity within Florida.

## **Atlanta: The Logistics and Media Hub**

Atlanta's economy rests on two pillars: moving things and making things (where "things" increasingly means content).

**Key Statistics:** - Metropolitan GDP: \$450 billion - Hartsfield-Jackson airport: World's busiest by passenger traffic - Fortune 500 headquarters: 16

As a logistics hub, Atlanta is unmatched in the Southeast. Hartsfield-Jackson handles 93 million passengers annually; UPS operates one of its primary hubs nearby; the interstate highway system converges on the city. Any company serving the southeastern United States needs Atlanta presence.

The media transformation has been equally striking. Georgia's generous film tax credits have made Atlanta the "Hollywood of the South." Major studios operate production facilities; the Marvel Cinematic Universe films largely in and around the city. This has created an ecosystem of production services, talent development, and creative industries that reinforces itself.

Georgia Tech's "Tech Square" innovation district is attempting to replicate what MIT's Kendall Square did for Boston: create a dense cluster of research, startups, and corporate R&D that generates knowledge spillovers.

Atlanta's large Black middle class distinguishes it demographically from other Sunbelt metros. Historically Black colleges and universities—Morehouse, Spelman, Clark Atlanta—anchor a distinctive educational ecosystem. Corporate headquarters like Coca-Cola, Home Depot, and Delta Air Lines have made diversity commitments that shape hiring patterns. The result is a metropolitan economy that looks different from Houston or Phoenix in racial composition and economic opportunity distribution.

The region's rapid suburban growth has created governance challenges. The 10-county metropolitan area spans multiple school districts, transit authorities, and municipal governments with competing priorities. MARTA, the regional transit system, operates primarily within Fulton and DeKalb counties; suburban counties have resisted expansion, limiting connectivity.

## **Phoenix: Silicon Desert**

Phoenix has emerged as the epicenter of America's semiconductor reshoring effort. TSMC's Arizona fabs represent \$65 billion in investment—the largest foreign direct investment in American history. Intel is expanding its facilities. The CHIPS Act has directed billions more toward Arizona projects.

**Key Statistics:** - Metropolitan GDP: \$280 billion - Semiconductor investment announced: \$100 billion+ - Population growth 2010-2024: 25%

Phoenix also serves as a massive retirement and healthcare destination. The population skews older than other Sunbelt metros; healthcare systems are among the largest employers.

The city's water constraints present an existential challenge. The Colorado River, which supplies Phoenix, is in crisis. Groundwater depletion in suburban developments has led to construction moratoriums. The long-term viability of continued growth depends on solving the water problem.

The semiconductor investments create both opportunity and risk. TSMC's fabs require enormous quantities of ultra-pure water—roughly 10 million gallons per day per fab. Arizona has worked to secure water rights and recycling infrastructure, but the fundamental tension between industrial water demand and a drought-stressed region remains unresolved.

Phoenix's housing market experienced one of the most extreme boom-bust-recovery cycles of the 2020s. Home prices roughly doubled between 2019 and 2022, then declined 15% as rising interest rates cooled demand. By 2024, prices had stabilized but remained unaffordable for many workers at the new semiconductor facilities.

## **Charlotte: Banking Center**

Charlotte's improbable rise as America's second-largest banking center—after New York—reflects the consolidation of regional banking over four decades. NationsBank's merger with Bank of America, First Union's evolution into Wachovia and then Wells Fargo's acquisition, Truist's formation from BB&T and SunTrust: Charlotte captured the headquarters each time.

**Key Statistics:** - Metropolitan GDP: \$230 billion - Bank of America employees in region: 15,000 - Financial services employment: 100,000+

The concentration of banking headquarters has created a broader financial services ecosystem: fintech startups, corporate law practices, consulting firms. Honeywell's relocation of its headquarters from New Jersey in 2019 signaled that Charlotte could attract major non-financial corporations as well.

## **Cost Advantages and Their Limits**

For decades, the Sunbelt offered a distinctive arbitrage: coastal-quality wages with heartland costs. That advantage is eroding.

## **The Housing Surge**

Between 2020 and 2024, home prices in Austin increased 60%. Phoenix, Tampa, and Dallas saw increases of 40-50%. The “affordability advantage” that drew middle-class families from California and New York has diminished significantly.

### **Housing Price Growth 2020-2024**

Metro	Price Increase
Austin	60%
Phoenix	48%
Tampa	45%

Metro	Price Increase
Dallas	40%
National average	30%

Source: Census Bureau; Federal Housing Finance Agency, House Price Index, 2024

Rents tell a similar story. Sunbelt rents increased 24% from 2020 to 2024, compared to just 7% in coastal markets. The convergence isn't complete—Texas and Florida remain cheaper than California and New York—but the gap has narrowed dramatically.

## The Tax Wedge

The “zero income tax” advantage remains the primary attractor for high-earning households. Texas, Florida, Tennessee, and Nevada impose no state income tax; for a household earning \$500,000, relocating from California or New York effectively provides a 10-13% raise.

This wedge explains the particular concentration of wealth management and hedge funds in Miami and the corporate headquarters in Texas. High-income individuals and capital-gains-dependent executives benefit most from tax arbitrage.

## Business Environment

Beyond taxes, Sunbelt states offer lighter regulation, faster permitting, and “right-to-work” labor laws that limit union power. Land costs remain far below coastal metros. For manufacturing and logistics operations requiring large facilities, these factors create genuine cost advantages.

## Infrastructure Challenges

The Sunbelt’s growth has outpaced its infrastructure investment, creating vulnerabilities that threaten the growth model. The region’s low-tax philosophy generates less revenue per capita for infrastructure; the rapid growth strains existing systems; and the car-dependent development pattern requires expensive highway expansion rather than more efficient transit alternatives.

## Climate and Extreme Weather

Climate change creates asymmetric risks across the Sunbelt. Texas faces both freezing events (like February 2021) and intensifying heat waves. Florida confronts accelerating sea level rise, hurricane intensification, and flooding that already affects inland communities. Arizona and Nevada experience extreme heat that makes outdoor work dangerous and strains electrical systems during peak demand.

Insurance markets have begun to price these risks. Florida’s property insurance market has entered crisis: major carriers have withdrawn, Citizens (the state insurer of last resort) has grown to 1.3 million policies, and premiums have tripled in five

years. Similar dynamics are emerging in coastal Texas and Louisiana. The long-term growth model assumes continued migration, but climate costs may eventually discourage it.

## Water Scarcity

The Colorado River system serves 40 million people across the Southwest—including Phoenix, Las Vegas, and Southern California. The system is in crisis. Lake Mead, the largest reservoir in the United States, has dropped to levels not seen since it was first filled in the 1930s.

Arizona and Nevada face mandatory water cutbacks under “Level 1 Shortage” conditions. Agricultural users have lost much of their allocation; urban restrictions are tightening. The long-term math is unforgiving: the region is using more water than nature provides.

Phoenix has responded with water recycling and efficiency measures, but these provide marginal improvements to a structural deficit. Construction moratoriums in suburban developments reflect the underlying constraint: at some point, the water runs out.

## Power Grid Instability

The Texas electricity grid, ERCOT, operates in isolation from the rest of the country—a deliberate regulatory choice that avoids federal oversight but also prevents the grid from importing power during emergencies.

The February 2021 freeze exposed this vulnerability catastrophically: hundreds of Texans died as the grid collapsed. Extreme heat events strain the system in summer. AI data centers and cryptocurrency miners, attracted by cheap Texas power, consume gigawatts that compete with residential growth.

The grid is improving—new generation is being added, weatherization requirements have tightened—but the fundamental isolation remains. When the Texas grid fails, there’s no backstop.

## Traffic Without Transit

Sunbelt cities were built for automobiles. Austin and Nashville grew into major metros with small-town road networks and virtually no mass transit. The result is congestion that rivals or exceeds coastal cities, without the transit alternatives that allow workers to bypass highways.

Houston and Dallas have invested in light rail systems, but these serve a fraction of travel needs. The Sunbelt’s suburban form makes transit inherently difficult: low density means few riders per station, making service economically marginal.

Florida’s Brightline represents an exception: privately financed intercity passenger rail connecting Miami, Fort Lauderdale, West Palm Beach, and (since 2023) Orlando. The service has exceeded ridership expectations, suggesting demand for alternatives

to highway travel. Extensions to Tampa and potentially Jacksonville are under consideration.

## **Labor and Workforce**

The Sunbelt's rapid growth creates persistent labor shortages across multiple sectors. Construction workers, healthcare professionals, and skilled tradespeople command premium wages. The 2024 unemployment rates—3.5% in Texas, 3.1% in Florida, 3.3% in Georgia—indicate tight labor markets despite substantial in-migration.

### **The Education Pipeline**

Sunbelt states vary dramatically in educational attainment. Texas has invested heavily in its flagship universities (UT-Austin, Texas A&M) and community college system, producing engineering and technical graduates at scale. Florida's state university system, led by the University of Florida and Florida State, has grown substantially. Georgia Tech ranks among the nation's top engineering schools.

But K-12 education presents challenges. Teacher pay in Texas, Florida, and Georgia lags national averages; public school funding in low-tax states constrains resources. The result is a workforce pipeline that produces adequate quantities but sometimes struggles with quality. Companies relocating to the Sunbelt often import management talent from higher-cost regions while hiring operational staff locally.

### **Immigration**

The Sunbelt economy depends heavily on immigrant labor. Texas employs roughly 2 million unauthorized workers; Florida employs over 800,000. These workers concentrate in construction, agriculture, hospitality, and food processing—precisely the sectors where labor shortages are most acute.

The political tension is obvious: state governments pursue restrictive immigration policies while their economies depend on immigrant labor. The construction boom funding new semiconductor plants and battery factories requires workers that domestic labor markets cannot fully supply.

## **The Battery Belt**

The most significant structural development in the Sunbelt economy is the emergence of a “Battery Belt”—a corridor of advanced manufacturing stretching from Michigan through Ohio, Kentucky, Tennessee, Georgia, and Texas.

**Major Projects:** - Ford BlueOval City (Tennessee): \$5.6 billion EV and battery complex - Hyundai Metaplant (Georgia): \$7.6 billion EV facility - TSMC (Arizona): \$65 billion semiconductor fabs - Samsung (Texas): \$40 billion semiconductor fab - Texas Instruments (Texas): \$30 billion chip plants

The CHIPS Act, Inflation Reduction Act, and other industrial policy measures have directed tens of billions in subsidies toward these projects. Combined with state incentives, the result is a manufacturing boom unprecedented since World War II.

This represents true reshoring: manufacturing capacity returning from Asia to North America. The Sunbelt is capturing the majority of this investment, combining lower costs with proximity to final consumers.

## Political Economy

The Sunbelt's economic model intersects with distinctive political dynamics that create tensions at the state and metropolitan level.

### Red States, Blue Cities

The Sunbelt's economic engines—Austin, Atlanta, Miami, Charlotte—are politically distinct from the state legislatures that govern them. This creates conflicts over zoning, housing policy, social issues, and local control.

Texas has preempted Austin's attempts to regulate short-term rentals, mandate paid sick leave, and establish local minimum wages. Georgia has intervened in Atlanta's governance. Florida has overridden Miami-Dade's COVID policies. The pattern repeats across the region: metropolitan areas that vote Democratic governed by state capitals that vote Republican.

### Business and Politics

States like Florida and Texas have waded into cultural politics in ways that complicate business recruitment. Disney's conflict with Florida over "Don't Say Gay" legislation, and subsequent retaliation affecting the company's special tax district, demonstrated the risks. Tech companies recruiting diverse workforces navigate carefully around restrictive abortion laws.

Laws restricting state pension funds from ESG (Environmental, Social, Governance) investing create tension with Wall Street firms that the same states are courting. The political economy is complex: business-friendly tax and regulatory policy combined with social legislation that some businesses view as hindering talent recruitment.

## Regional Profiles

### Tesla

**Quick Facts** - Headquarters: Austin, TX (relocated from Palo Alto in 2021)  
- Revenue: \$97 billion (2024) - Employees: 140,000 worldwide - Austin facility: "Giga Texas" battery and vehicle manufacturing

Tesla's relocation to Texas encapsulates the Sunbelt story. Elon Musk cited California's high costs, regulatory burden, and COVID policies. Texas offered land for a

massive factory, no corporate income tax, and a generally permissive regulatory environment.

Giga Texas, on the outskirts of Austin, is one of the largest manufacturing facilities in the country: 10 million square feet producing Model Y vehicles and battery cells. The facility employs over 20,000 workers, making Tesla one of the Austin area's largest private employers.

The relocation also brought Tesla's legal domicile, shifting shareholder lawsuits from California to Texas courts. The full ecosystem migration—headquarters, manufacturing, and legal incorporation—represents the comprehensive arbitrage Sunbelt states offer.

## Citadel

**Quick Facts** - Headquarters: Miami, FL (relocated from Chicago in 2022) - Assets under management: \$60 billion - Founder: Ken Griffin - Employees: 2,900

Citadel's move from Chicago to Miami in 2022 marked a turning point in the financial industry's geography. Ken Griffin, Citadel's billionaire founder, cited Chicago's crime, taxes, and political environment. Florida offered no income tax, a more favorable regulatory stance, and lifestyle amenities.

The relocation brought not just Citadel's hedge fund but also Citadel Securities, the market-making arm that executes roughly 25% of all U.S. equity trades. Supporting staff, technology infrastructure, and related businesses followed. Griffin's personal philanthropy and civic engagement have increasingly focused on Miami.

The move accelerated Miami's transformation into a hedge fund and wealth management hub, attracting other firms seeking similar advantages.

## Hyundai Motor Group

**Quick Facts** - Headquarters: Seoul, South Korea - Georgia investment: \$7.6 billion (Metaplant America) - Location: Bryan County, Georgia (near Savannah) - Projected employment: 8,500 direct jobs

Hyundai's Metaplant America represents the new industrial policy in action. The \$7.6 billion investment will produce electric vehicles and batteries on a 2,900-acre site near Savannah. Georgia provided roughly \$2 billion in incentives; the Inflation Reduction Act's EV tax credits require North American production.

The project illustrates the Sunbelt's advantages for manufacturing: available land, lower costs, proximity to the Port of Savannah (America's fastest-growing container port), and state governments competing aggressively for investment.

When fully operational, the plant will be one of the largest manufacturing facilities in the Southeast and the centerpiece of an EV supply chain clustering in the region.

# Data Sources and Further Reading

## Key Data Sources

- **BEA Regional Accounts:** State and metro GDP
- **Census Bureau:** Population estimates and migration flows
- **Bureau of Labor Statistics:** State and metro employment
- **Federal Reserve Banks:** Dallas, Atlanta, and Kansas City district reports

## Further Reading

- Moretti, Enrico. *The New Geography of Jobs* (2012)
- Case, Anne and Angus Deaton. *Deaths of Despair* (2020) - For contrast with declining regions
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- Florida Office of Economic and Demographic Research

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**Word count:** roughly 4,600 words

Note: For industry-specific analysis of energy, manufacturing, and technology, see the relevant chapters in Part II.

## Exercises

### Review Questions

1. Between 2019 and 2024, Texas added 2.3 million residents and Florida added 1.9 million—together absorbing more population than the bottom 30 states combined. The chapter distinguishes between “extensive” growth (more people, more jobs) and “intensive” growth (higher productivity per worker). Using per capita income data from the chapter (Texas at \$67,500, Florida at \$70,000, versus the national average of \$70,000), explain why the Sunbelt’s rapid total GDP growth may overstate its economic performance relative to the Northeast or West.
2. Houston is described as “the command center” of global energy, with every major integrated oil company now headquartered in its metropolitan area. But the chapter also notes Houston’s diversification into the Texas Medical Center (120,000 employees) and energy transition technologies. Evaluate the risks and benefits of Houston’s continued concentration in energy. How does the city’s pivot toward hydrogen, carbon capture, and renewables represent an attempt to leverage existing engineering talent for a different purpose?
3. Austin’s emergence as a technology hub is described as “one of the most successful economic development stories in American history,” yet the chapter raises concerns about infrastructure strain, housing costs that quintupled since 2010, and the displacement of the creative culture that originally attracted tech workers. Is Austin’s growth model sustainable? Compare Austin’s trajectory to a

more mature tech hub (San Francisco or Boston) and assess whether infrastructure constraints will “cap its potential” or whether the city can adapt.

4. The Sunbelt’s “zero income tax” advantage is identified as the primary attractor for high-earning households—a relocating family earning \$500,000 effectively receives a 10-13% raise by moving from California or New York to Texas or Florida. But the chapter notes that property taxes, insurance costs, and other expenses partially offset this advantage. Analyze the full cost equation facing a hypothetical household deciding between remaining in a high-tax coastal state and relocating to a Sunbelt metro. What non-tax factors (schools, climate risk, cultural amenities) enter the decision?
5. The chapter identifies a “red states, blue cities” tension across the Sunbelt, with Austin, Atlanta, Miami, and Charlotte politically diverging from the state legislatures that govern them. Using specific examples—Texas preempting Austin’s local regulations, Florida’s conflict with Disney, or Georgia’s intervention in Atlanta’s governance—explain how this political dynamic affects economic development and business recruitment.
6. The ERCOT grid’s isolation and the February 2021 freeze are described as revealing a fundamental vulnerability in Texas’s infrastructure model. Why does the Texas grid operate independently from the rest of the country? What are the economic consequences when this isolation means “there’s no backstop”? How do growing demands from AI data centers and cryptocurrency mining compound the grid’s capacity challenges?
7. Hyundai’s \$7.6 billion Metaplant near Savannah, Georgia, illustrates a broader pattern of Sunbelt states competing for advanced manufacturing investment. Identify the combination of advantages the chapter attributes to the Sunbelt for manufacturing: available land, lower costs, port access, and aggressive state incentives. What does the \$2 billion in Georgia state incentives suggest about the cost of this competition? Compare this model to the Northeast Corridor’s reliance on agglomeration and human capital.

## Data Exercises

1. Using Census Bureau population estimates (<https://www.census.gov/programs-surveys/popest.html>), download annual state population data for Texas, Florida, Georgia, Arizona, and one non-Sunbelt state of your choice (New York, Illinois, or California) for 2010 through the most recent available year. Calculate the annual growth rate for each state and plot the results. At what point did the Sunbelt-versus-non-Sunbelt growth gap widen most dramatically? Does the data support the chapter’s claim that the shift “accelerated after 2020”?
2. The Federal Housing Finance Agency (FHFA) publishes a House Price Index by metropolitan area (FRED series such as “ATNHPIUS12420Q” for Austin or “PHXHPIUS38060Q” for Phoenix). Retrieve house price index data for Austin, Phoenix, Tampa, and Dallas from 2015 to the most recent quarter. Calculate the cumulative price increase over the 2020-2024 period for each metro and compare to the national index (“USSTHPI”). Does the housing price convergence

the chapter describes—Sunbelt prices rising faster than coastal markets—hold in the most recent data, or has the trend moderated?

3. Using BEA Regional GDP data (<https://www.bea.gov/data/gdp/gdp-state>), compare GDP growth rates for Texas and Florida to the U.S. national average for each year from 2015 to the most recent available. Decompose the growth into its components where possible: is the Sunbelt’s GDP growth driven primarily by population growth (more workers) or by productivity growth (more output per worker)? What does this decomposition imply about the long-term sustainability of the Sunbelt growth model?

## **Deeper Investigation**

1. The chapter notes that Florida’s property insurance market has “entered crisis,” with major carriers withdrawing, the state insurer of last resort (Citizens) growing to 1.3 million policies, and premiums tripling in five years. Investigate the intersection of climate risk and economic growth in one Sunbelt state—Florida, Texas, or Arizona. How are rising insurance costs, water scarcity, or extreme heat events affecting household budgets, business location decisions, and property values? Use data from the National Association of Insurance Commissioners, FEMA flood maps, the National Oceanic and Atmospheric Administration (NOAA) storm damage database, and state insurance regulatory filings. Assess whether climate costs could eventually slow or reverse the migration patterns that have driven Sunbelt growth, and what policy responses (building codes, managed retreat, infrastructure investment) might alter the trajectory.

# 25. The Midwest

Drive west from Pittsburgh and the landscape tells a story of industrial might and industrial decline. Steel mills, now mostly silent, line the rivers. Factory towns bear names like Youngstown, Akron, Flint—places that once defined American manufacturing and now struggle to define their futures. But continue west to Columbus, Indianapolis, or Minneapolis, and the story changes. Cranes dot skylines. New factories rise. The Midwest is reinventing itself.

## The Industrial Heartland

The Midwest—here defined as the Great Lakes states of Ohio, Michigan, Indiana, Wisconsin, Illinois, and Minnesota—remains America’s manufacturing core. Despite decades of job losses, the region produces more industrial output than ever. The paradox is productivity: the same volume of goods requires far fewer workers.

The region’s industrial legacy shapes everything else. The Great Lakes provided water for steel mills and transportation for raw materials. The railroads converged on Chicago. The highway system, built to serve factories, created the infrastructure that now supports logistics. Even as manufacturing employment has collapsed from its 1979 peak, the physical infrastructure remains—and is being repurposed for a new industrial era.

Population tells the story of transition. Illinois has declined from 12.8 million in 2019 to 12.7 million in 2024—a modest loss that nonetheless signals stagnation in what was once America’s most dynamic industrial region. Ohio has stabilized at 11.9 million after decades of decline. Michigan, at 10.1 million, has finally stopped shrinking. The hemorrhaging has slowed, but growth remains elusive.

### Regional Economic Overview (2024)

State	GDP	Manufacturing Share	Population Trend
Illinois	\$1.05 trillion	11%	Stable/declining
Ohio	\$800 billion	16%	Stable
Michigan	\$620 billion	20%	Stable
Indiana	\$450 billion	28%	Growing
Minnesota	\$440 billion	12%	Growing
Wisconsin	\$400 billion	18%	Stable

Source: Bureau of Economic Analysis, Regional GDP; Bureau of Labor Statistics, 2024

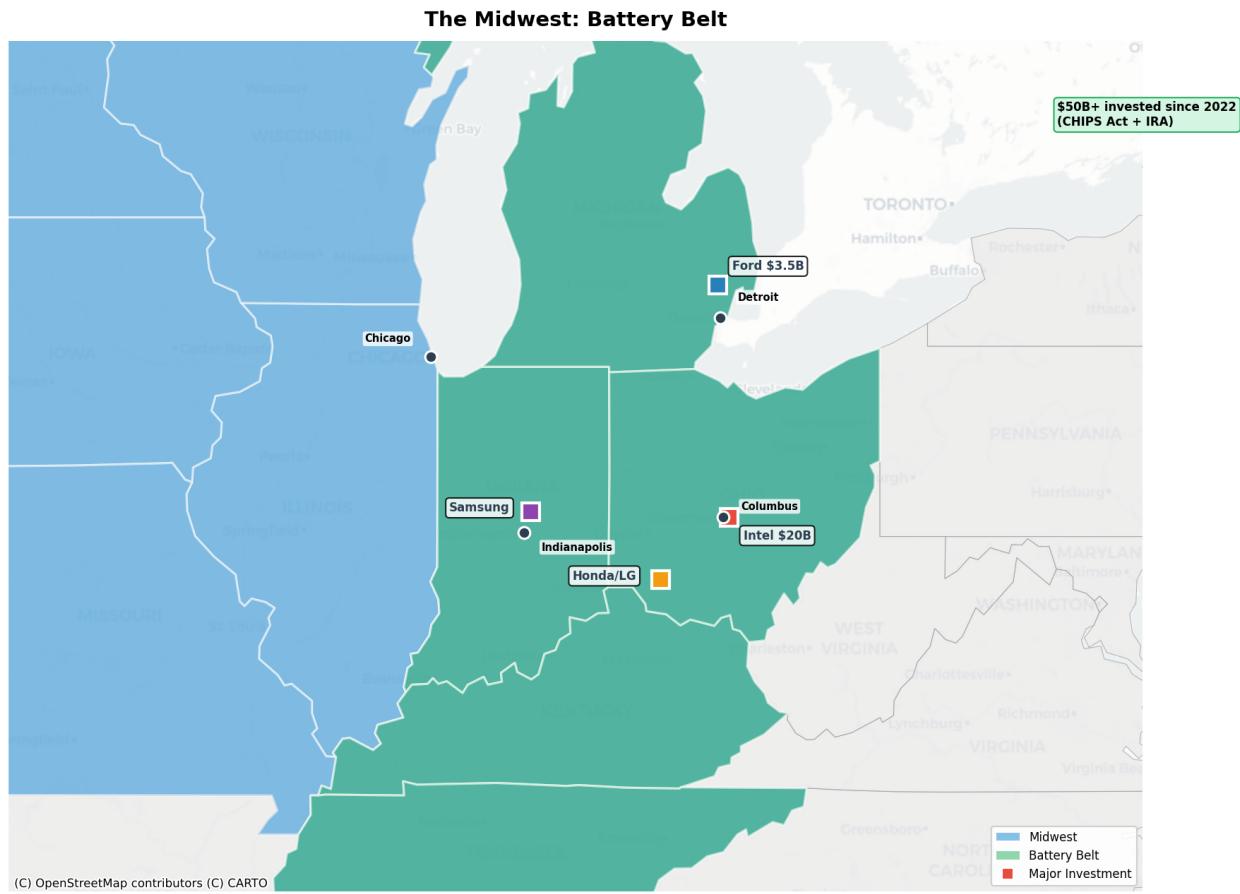


Figure 84: Figure 25.1: The Midwest and Battery Belt corridor. Major industrial investments from the CHIPS Act and IRA have directed over \$50 billion into manufacturing across Michigan, Ohio, Indiana, Kentucky, and Tennessee since 2022. Source: Company announcements, state economic development

The region's challenge is structural: manufacturing output grows through automation while manufacturing employment shrinks. Ohio ranks third nationally in manufacturing jobs (687,000), but that figure has fallen by half since 1979.

## Metropolitan Economies

### Chicago: The Midwest's Global City

Chicago stands apart from its regional neighbors. With a GDP of \$886 billion, it is the only Midwestern metropolitan area with true global status—a world financial center, transportation hub, and corporate headquarters cluster that competes directly with New York and Los Angeles.

#### Economic Pillars:

**Finance and Trading:** The Chicago Mercantile Exchange (CME Group) and Cboe

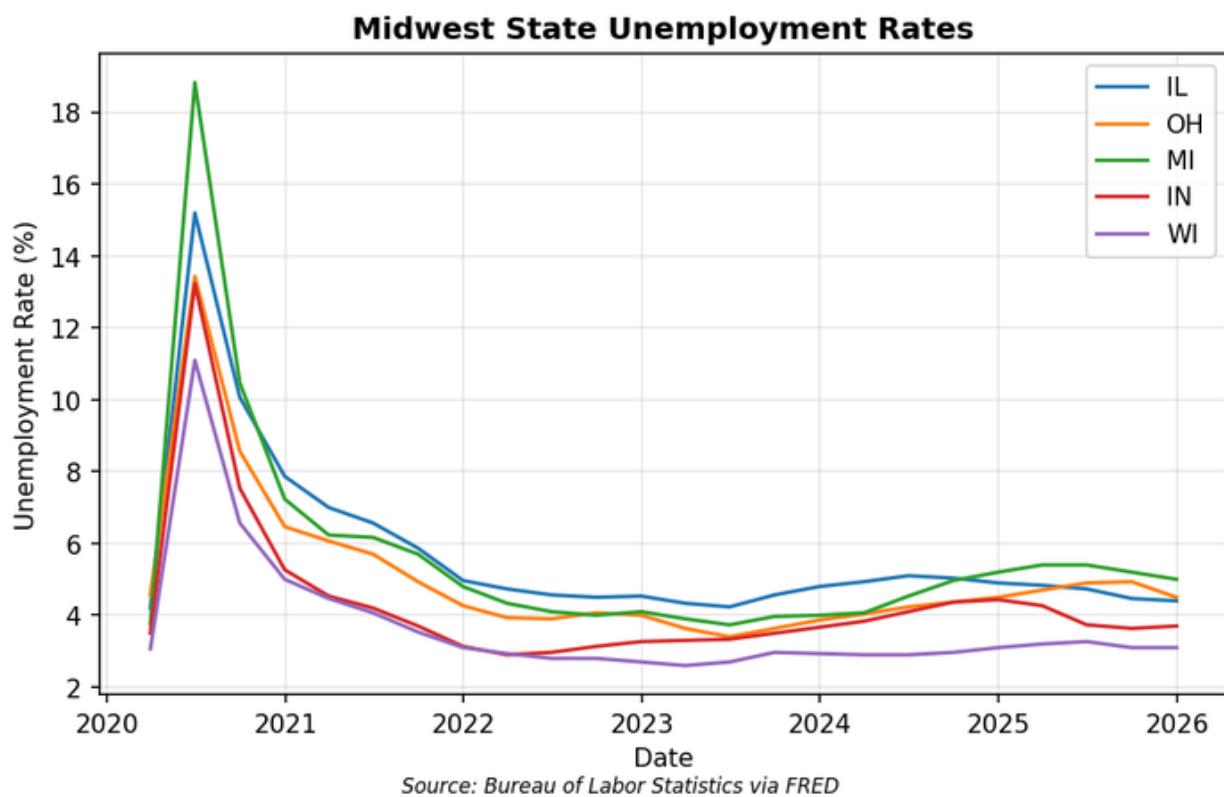


Figure 85: Figure 25.2: Midwest state unemployment rates have converged post-pandemic. The regional labor market remains tight despite manufacturing automation. Source: BLS

Global Markets make Chicago the world capital of derivatives trading. Futures and options contracts for agriculture, currencies, interest rates, and equity indices trade here first. The city's financial technology sector builds on this foundation.

**Transportation and Logistics:** Every major railroad crosses Chicago. The city handles more freight than any metropolitan area in the country. O'Hare Airport ranks among the world's busiest. The I-80/I-55 corridor has become a vast logistics zone, with warehouses stretching across the exurbs serving the entire Midwest.

**Corporate Headquarters:** McDonald's, Boeing (until 2022), United Airlines, Abbott Laboratories, Caterpillar (until 2022), Walgreens, Kraft Heinz—Chicago has historically concentrated Fortune 500 headquarters. Recent departures to Texas have raised concerns about the city's business environment.

**Universities:** The University of Chicago and Northwestern produce research and talent that feed the metropolitan economy. The Illinois Medical District anchors health-care employment.

Chicago's core challenge is population loss: the metro area has declined slightly since 2010, driven by domestic out-migration that international immigration only partially offsets. Illinois's fiscal challenges, high property taxes, and cold winters make the cost-benefit calculation increasingly unfavorable for mobile professionals.

The city's crime concerns, particularly violent crime in certain neighborhoods, have become a business recruitment issue. When Citadel relocated its headquarters to Miami, CEO Ken Griffin cited safety as a factor. Boeing's 2022 decision to move its headquarters to Virginia followed years of executive complaints about Chicago's business environment.

Yet Chicago retains assets no other Midwestern city can match. Its cultural institutions—the Art Institute, the Chicago Symphony, the architecture—rival New York's. Its restaurant scene is world-class. Its lakefront provides recreational amenities unusual for a major city. For residents who accept the trade-offs, Chicago offers genuine urban life at a fraction of coastal costs.

The Loop's office market has struggled post-pandemic, with vacancy rates exceeding 20% by late 2024. The hybrid work shift hit Chicago hard: employees accustomed to commuting from distant suburbs found little reason to maintain five-day office presence. The city is experimenting with office-to-residential conversions and downtown activation strategies.

## **Detroit: Reinventing Mobility**

Detroit's identity remains inseparable from automobiles, but the content of that identity is transforming. The region that perfected the internal combustion engine is now betting on electric vehicles.

**Key Statistics:** - Metropolitan GDP: \$280 billion - Automotive employment: 200,000+  
- Major employers: Ford, General Motors, Stellantis

General Motors' Factory ZERO in Hamtramck, Ford's investments in Michigan, and the battery plants clustering nearby represent tens of billions in capital expenditure.

The goal is to make Michigan the center of EV manufacturing just as it was the center of gasoline vehicles.

But the workforce implications are disruptive. Electric vehicles require fewer workers to assemble—no transmissions, fewer parts, simpler systems. The United Auto Workers' 2023 strike targeted exactly this transition: how to protect jobs and wages as the technology changes.

Detroit's broader metropolitan economy has diversified around healthcare (Henry Ford Health, Beaumont) and technology (a small but growing startup scene around mobility and automation). But the city proper remains troubled: population has fallen by 60% since 1950, and large swaths of former residential neighborhoods have been demolished.

The distinction between Detroit the city (population 620,000) and metropolitan Detroit (4.4 million) is crucial. The suburbs—Oakland County, Macomb County, parts of Wayne County—retain substantial wealth and economic activity. The auto industry's technical and engineering functions cluster in towns like Dearborn, Auburn Hills, and Troy. The city proper struggles with a weak tax base, underperforming schools, and infrastructure decay.

Recent years have brought genuine revitalization to downtown and selected neighborhoods. Quicken Loans (now Rocket Mortgage) founder Dan Gilbert has invested billions in downtown real estate. Tech startups have clustered near Wayne State University. But the revival remains geographically confined, and the city's population continues to decline slowly.

## **Minneapolis-St. Paul: The Corporate Fortress**

The Twin Cities present an anomaly: a metropolitan area of 3.7 million people in the upper Midwest with an extraordinary concentration of corporate headquarters. Target, UnitedHealth Group, 3M, General Mills, Best Buy, U.S. Bank—the Fortune 500 density per capita rivals New York.

**Key Statistics:** - Metropolitan GDP: \$280 billion - Fortune 500 headquarters: 17 - Major sectors: Retail, healthcare, manufacturing

This “corporate fortress” provides unusual economic stability. The headquarters economy generates high-wage jobs in management, finance, and professional services. The companies’ historical commitment to their hometown—unusual in an era of corporate mobility—has sustained civic institutions and philanthropic activity.

The Twin Cities also lead in healthcare and medical device manufacturing. Medtronic, the world’s largest medical device company, is headquartered in the suburbs. The Mayo Clinic lies 90 minutes south in Rochester.

Minnesota’s economic model creates a distinctive dynamic: higher taxes fund better public services and education, which attract employers seeking skilled workers. The state consistently ranks near the top in educational attainment, health outcomes, and quality of life. The trade-off is cost: Minnesota is the most expensive Midwestern state, and businesses cite taxes as a recruitment challenge.

The region's Nordic heritage and progressive politics create a civic culture that differs from the rest of the Midwest. Corporate philanthropy rates are among the nation's highest. Public transit, though limited, exceeds regional peers. The university system maintains strong ties to the business community.

## **Columbus: The Silicon Heartland**

Columbus is the Rust Belt's growth story. While Cleveland and Detroit lost population, Columbus grew faster than almost any metropolitan area in the region.

**Key Statistics:** - Metropolitan GDP: \$182 billion (2023) - Population growth 2010-2024: 18% - Key development: Intel chip fabs (\$20 billion investment)

The city benefits from Ohio State University's 67,000 students, a young demographic profile, and relative affordability. But Intel's decision to build two massive chip fabrication plants in suburban Licking County has transformed Columbus's trajectory. Though initial timelines targeting 2025 have slipped—production is now expected to ramp up later in the decade—the construction and supplier clustering are already reshaping the regional economy.

The "Silicon Heartland" branding reflects broader ambition: federal CHIPS Act funding has directed billions toward Ohio, and a cluster of suppliers, research centers, and related industries is forming around the Intel anchors.

Columbus has also become a test market for tech companies. The metropolitan area's demographic profile—near the national median in income, education, and diversity—makes it representative of the broader American consumer. Companies from Amazon to Uber pilot products in Columbus before national rollout.

The city's governance structure, unified under strong mayoral control, enables faster decision-making than fragmented metros. Columbus absorbed its suburbs through aggressive annexation; the result is a municipal government that captures suburban tax base rather than losing it.

## **Cleveland and Pittsburgh: Eds and Meds**

Cleveland and Pittsburgh represent the most successful version of post-industrial reinvention: the "eds and meds" model, where research universities and teaching hospitals replace factories as economic anchors.

**Cleveland:** The Cleveland Clinic is now the region's largest employer, having grown into a globally recognized healthcare system. Its research in cardiac care and various medical specialties attracts patients worldwide. Case Western Reserve University and the surrounding University Circle form a cultural and research district.

**Pittsburgh:** Carnegie Mellon University's robotics and artificial intelligence programs have made Pittsburgh a genuine technology center. Self-driving vehicle companies (Uber's advanced research, Aurora, Argo AI before its closure) chose Pittsburgh specifically for CMU access. The University of Pittsburgh Medical Center (UPMC) employs over 90,000 people across Western Pennsylvania.

Both cities have stabilized after decades of decline, though neither has returned to population growth. The healthcare and education sectors provide employment floors that manufacturing once provided—but they require different skills and pay different wages.

Pittsburgh's transformation is particularly striking. A city that lost 200,000 manufacturing jobs has reinvented itself around robotics, artificial intelligence, and life sciences. Google, Apple, Facebook, and Uber all maintain Pittsburgh offices; Carnegie Mellon's computer science graduates command Silicon Valley-level salaries.

The “eds and meds” model has limits. Universities and hospitals don’t generate the supplier networks that manufacturing did. Their employment tends toward bimodal distribution: well-paid professionals and low-wage service workers, with limited middle-skill opportunities. The working-class path to prosperity that manufacturing once provided—high school diploma to union factory job to middle-class life—no longer exists.

## **Indianapolis: Crossroads and Life Sciences**

Indianapolis’s identity as “the crossroads of America” reflects its location at the intersection of major interstates. FedEx operates a major hub there; logistics companies have clustered to serve the national market from a central location.

**Key Statistics:** - Metropolitan GDP: \$180 billion - Life sciences employment: 75,000+  
- Flagship: Eli Lilly (headquartered in Indianapolis)

Eli Lilly, one of the world’s largest pharmaceutical companies, anchors an extensive life sciences cluster. Roche Diagnostics, Anthem (now Elevance Health), and numerous medical device companies employ tens of thousands in the region. Indiana University’s medical school and research facilities feed this ecosystem.

The city’s moderate costs—substantially below Chicago, Columbus, or the Twin Cities—provide competitive advantage for employers seeking Midwest location without Midwest’s highest expenses.

## **The Manufacturing Revival**

The “Rust Belt to recovery” narrative has shifted from hope to reality—at least in selected locations. Federal industrial policy has directed enormous investment into the region.

### **Major Industrial Policy Investments:**

Company	Location	Investment	Product
Intel	Columbus, OH	\$20 billion	Semiconductor fabs
Honda/LG	Fayette County, OH	\$3.5 billion	EV battery plant
Ford	Marshall, MI	\$3.5 billion	Battery plant
Samsung SDI/Stellantis	Kokomo, IN	\$3.1 billion	EV batteries
Gotion	Big Rapids, MI	\$2.3 billion	EV batteries

Source: Bureau of Economic Analysis; Company Announcements; State Economic Development Offices, 2024

Combined with state incentives, the CHIPS Act and Inflation Reduction Act have funneled over \$50 billion in clean energy and semiconductor investments into the region since 2022.

This represents genuine re-industrialization—but of a different character than the old manufacturing. The new factories are heavily automated, requiring chemical engineers and robotics technicians rather than assembly line workers. Employment per dollar of output is far lower than at the plants these investments replace.

## **The Battery Belt**

A new industrial corridor is forming: the “Battery Belt” running from Michigan through Ohio, Indiana, and Kentucky. Every major automaker is building EV battery capacity in this corridor, attracted by existing supply chains, workforce skills, and proximity to vehicle assembly plants.

The corridor represents a strategic bet: that electrification will revitalize Midwestern manufacturing rather than destroy it. The UAW’s concern is that battery plants employ fewer workers than engine plants, and many are joint ventures with Korean battery makers less accommodating of union organizing.

The 2023 UAW strike, which targeted Ford, GM, and Stellantis simultaneously, won substantial wage increases (25% over four years) and extended union representation to battery plant workers. This victory demonstrated that the EV transition need not mean the end of union manufacturing—but the fundamental tension between automation and employment remains.

## **Workforce and Skills**

The Midwest’s industrial legacy created a distinctive skills base: generations of workers trained in precision manufacturing, quality control, and industrial maintenance. These skills transfer to new industries—a machinist can adapt to semiconductor equipment maintenance—but the transition requires retraining and often relocation.

Community colleges have emerged as critical infrastructure. Programs at institutions like Lorain County Community College (Ohio) and Ivy Tech (Indiana) provide accelerated training in semiconductor technician skills, robotics maintenance, and industrial automation. Federal and state funding supports these programs, but scaling remains challenging.

The demographic pressure is acute. Skilled manufacturing workers are aging out; many will retire in the next decade. Younger workers, educated to expect white-collar careers, show limited interest in factory work. The solution requires making manufacturing jobs attractive again—which the new industrial plants, with wages often exceeding \$30 per hour plus benefits, are beginning to accomplish.

## The Farm Economy

The Midwest's agricultural economy remains globally significant—the “Corn Belt” produces the feedstocks for American food and fuel—but it has become economically marginal for rural communities.

- 2025 Agricultural Outlook:**
- Net farm income: Projected to rebound 37-40% from 2024 lows
  - Driver of recovery: Livestock (cattle, poultry) and government payments
  - Challenge: Row crops (corn, soybeans) face low prices and high costs

The region illustrates agriculture's productivity paradox: output reaches record levels while the farm population continues to decline. Fewer, larger farms operated by fewer workers produce more than ever before. The result is that small towns and rural counties throughout the Corn Belt continue losing population even as their agricultural output grows.

Ethanol production ties the region's agriculture to energy markets. Iowa alone has 43 ethanol plants; Illinois, Nebraska, and Minnesota host dozens more. These facilities consume roughly 40% of the nation's corn crop, making farm incomes sensitive to renewable fuel mandates and oil prices. The Renewable Fuel Standard, which mandates ethanol blending in gasoline, provides price support that shapes planting decisions across millions of acres.

Corporate agriculture has transformed the business model. Family farms persist as operators, but financing, seed, fertilizer, and marketing often flow through integrated supply chains controlled by companies like ADM, Cargill, and Bunge. Farmers operate with substantial debt and narrow margins, vulnerable to commodity price swings and interest rate changes.

## Demographics and Talent

The Midwest's demographic trajectory presents its greatest long-term challenge. The region is aging; young people continue leaving for the coasts and the Sunbelt; without international immigration, populations would decline outright.

### Net Domestic Migration (2020-2024)

State	Net Migration
Illinois	-340,000
Michigan	-80,000
Ohio	-50,000
Minnesota	-40,000
Indiana	+25,000
Wisconsin	-30,000

Source: Census Bureau, Population Estimates and Migration Flows, 2024

International immigration offsets much of this loss, but the “brain drain” of college-educated professionals remains acute. Graduates of the region's excellent

universities—Michigan, Ohio State, Northwestern, Wisconsin—frequently relocate to Chicago, the coasts, or the Sunbelt upon graduation.

**Exceptions:** Columbus, Indianapolis, and Madison (Wisconsin) have succeeded in retaining young professionals, offering the combination of urban amenities, moderate costs, and job opportunities that attracts graduates. Wisconsin has shown improved talent retention in recent years through aggressive efforts to keep state university graduates.

## Regional Profiles

### CME Group

**Quick Facts** - Headquarters: Chicago, IL - Revenue: \$5.6 billion (2024) - Employees: 4,300 - Daily trading volume: \$13 billion in notional value

CME Group, formed from the merger of the Chicago Mercantile Exchange and the Chicago Board of Trade, is the world's largest derivatives exchange. Futures and options on interest rates, stock indices, currencies, energy, metals, and agricultural commodities trade on its platforms.

The company's origins trace to the 19th-century grain markets—farmers and merchants seeking to manage price risk created standardized futures contracts. That innovation became the foundation for modern financial risk management.

Today, CME Group operates electronically, but Chicago remains its headquarters and its regulatory domicile. The concentration of trading expertise, clearinghouse operations, and financial talent keeps the derivatives industry rooted in the Midwest even as other financial activities have dispersed.

### Cleveland Clinic

**Quick Facts** - Headquarters: Cleveland, OH - Revenue: \$14.8 billion (2024) - Employees: 77,000 - Patients (annual): 12 million+ visits

Cleveland Clinic exemplifies the transformation of Rust Belt cities into healthcare centers. Founded in 1921, the clinic has grown into one of the world's most prestigious medical institutions, consistently ranked among America's top hospitals.

The organization has become Cleveland's economic anchor. Its main campus employs tens of thousands; its purchasing power supports local suppliers; its construction projects provide years of work. Medical tourism—patients traveling from across the country and around the world for specialized care—brings outside money into the regional economy.

The model has limits: healthcare employment doesn't scale the way manufacturing once did, and the jobs cluster at the extremes of the wage distribution (physicians and executives at the top, service workers at the bottom). But for Cleveland, the clinic provides economic stability that the steel industry no longer can.

## **Intel (Ohio Fabs)**

**Quick Facts** - Parent company: Intel Corporation (Santa Clara, CA) - Ohio investment: \$20 billion (phase one) - Location: Licking County, near Columbus - Projected employment: 3,000 direct, 10,000+ construction

Intel's Ohio project represents the largest single private investment in the state's history. Two chip fabrication plants, with potential expansion to eight, will produce advanced semiconductors using Intel's latest manufacturing processes.

The project is industrial policy in action. The CHIPS Act provides billions in subsidies; Ohio contributed \$2 billion in incentives. The goal is strategic: reduce American dependence on Taiwanese chip production and establish domestic capability for the most advanced semiconductors.

For Ohio, the investment anchors broader ambitions. The state is recruiting semiconductor suppliers, research centers, and related businesses. Ohio State University is expanding engineering programs. A semiconductor cluster is forming that could define the regional economy for decades—much as automobiles once defined Detroit.

## **Data Sources and Further Reading**

### **Key Data Sources**

- **BEA Regional Accounts:** State and metro GDP
- **Federal Reserve Bank of Chicago:** Midwest Economy Index, agricultural reports
- **Federal Reserve Bank of Cleveland:** Regional economic analysis
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- Autor, Dorn, and Hanson. "The China Syndrome" (2016) - Manufacturing job losses
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**Word count:** roughly 4,100 words

Note: For detailed treatment of manufacturing, automotive, and agriculture, see the relevant chapters in Part II.

## **Exercises**

### **Review Questions**

1. The chapter identifies a central paradox of the Midwest economy: “the region produces more industrial output than ever” while manufacturing employment has “collapsed from its 1979 peak.” Using Indiana’s 28% manufacturing share of GDP and Ohio’s 687,000 manufacturing jobs (down by half since 1979) as examples, explain how automation and productivity growth can increase output while reducing employment. What does this mean for communities whose identities and social structures were built around factory work?
2. Chicago is described as “the only Midwestern metropolitan area with true global status,” yet the chapter documents population loss, corporate headquarters departures (Caterpillar, Boeing, Citadel), and office vacancy rates exceeding 20%. Evaluate whether Chicago’s assets—CME Group’s derivatives exchange, the freight rail convergence, world-class universities, and cultural institutions—are sufficient to sustain its position, or whether the departures signal a structural decline. What factors distinguish Chicago’s challenges from those of smaller Rust Belt cities like Cleveland or Detroit?
3. Detroit is “betting on electric vehicles,” with General Motors’ Factory ZERO and Ford’s Michigan investments representing tens of billions in capital expenditure. But the chapter warns that EVs “require fewer workers to assemble—no transmissions, fewer parts, simpler systems.” Analyze the workforce implications of the EV transition for the Detroit region. How did the 2023 UAW strike address this tension, and is the union’s strategy of extending representation to battery plant workers likely to preserve middle-class manufacturing employment?
4. The “eds and meds” model adopted by Cleveland (Cleveland Clinic) and Pittsburgh (Carnegie Mellon, UPMC) represents “the most successful version of post-industrial reinvention.” But the chapter identifies limits: healthcare and education “don’t generate the supplier networks that manufacturing did” and create a “bimodal distribution” of wages. Compare the “eds and meds” model to manufacturing as an economic base. What is lost when a city’s anchor employer shifts from a factory to a hospital?
5. Columbus is described as the “Rust Belt’s growth story,” with 18% population growth since 2010 and Intel’s \$20 billion chip fabrication investment. What combination of factors—Ohio State University, demographic representativeness, unified governance through annexation, and CHIPS Act funding—explains Columbus’s divergence from Cleveland, Detroit, and other Midwest metros? Is the “Silicon Heartland” branding likely to attract a self-sustaining semiconductor cluster, or does it depend on continued federal subsidies?
6. The chapter describes a “Battery Belt” forming from Michigan through Ohio, Indiana, and Kentucky, where every major automaker is building EV battery capacity. Using the Major Industrial Policy Investments table, calculate the total investment and explain the strategic logic: why is this corridor attracting battery plants rather than the Sunbelt or the coasts? What role do existing automotive

supply chains, workforce skills, and proximity to vehicle assembly plants play?

7. Illinois lost 340,000 residents to net domestic migration between 2020 and 2024, while Indiana gained 25,000. The chapter attributes the Midwest’s “brain drain” to college-educated professionals relocating to the coasts and the Sunbelt after graduating from the region’s “excellent universities.” What policies or conditions have allowed Columbus, Indianapolis, and Madison to retain young professionals where other Midwest cities have failed?

## Data Exercises

1. Using BEA Regional GDP data (<https://www.bea.gov/data/gdp/gdp-state>), download annual GDP for the six Midwest states discussed in this chapter (Illinois, Ohio, Michigan, Indiana, Minnesota, Wisconsin) from 2010 to the most recent year. Calculate each state’s manufacturing share of GDP using the NAICS sector breakdowns. Which states have seen manufacturing’s share grow versus shrink? Plot the results alongside the national manufacturing share (FRED series “VAPGDPMA” or equivalent). Does the data support the chapter’s claim that the Midwest “remains America’s manufacturing core”?
2. The Federal Reserve Bank of Chicago publishes the Midwest Economy Index (available via FRED series “CFNAIMA3”). Retrieve this monthly index from 2015 to present and plot it alongside the national CFNAI. Identify periods when the Midwest economy outperformed and underperformed the nation. How does the index behave during the pandemic recession and the subsequent recovery? Does the manufacturing investment boom described in this chapter appear in the data yet?
3. Using the Census Bureau’s population estimates and migration flow data (<https://www.census.gov/topics/population/migration.html>), construct a table showing net domestic migration for each of the six Midwest states for the most recent five years. Which states are losing population, which are gaining, and which are stable? Compare these flows to the chapter’s net migration table. For one state that is losing population, identify the top three destination states. What does the migration pattern reveal about the Midwest’s competitive position?

## Deeper Investigation

1. Intel’s \$20 billion investment in semiconductor fabrication near Columbus, Ohio, is described as “the largest single private investment in the state’s history” and a test case for whether CHIPS Act industrial policy can create a self-sustaining technology cluster in the Midwest. Investigate the historical precedents for cluster formation around a single anchor investment. Did the original semiconductor cluster in Silicon Valley, the automotive cluster in Detroit, or the biotech cluster in Boston begin with a comparable catalytic investment? What supporting conditions—university research, supplier ecosystems, venture capital, workforce training—were necessary for the cluster to become self-sustaining? Using Ohio State University’s engineering program expansion plans, the Ohio De-

partment of Development's project tracking, and Semiconductor Industry Association data, assess whether the "Silicon Heartland" has the preconditions for success or whether Intel's fabs risk becoming an isolated outpost of advanced manufacturing in a region that otherwise lacks the supporting ecosystem.

# 26. The West

Stand in downtown San Francisco and you are at the center of something unprecedented: the most valuable cluster of private enterprise in human history. Within a 50-mile radius sit Apple, Alphabet, Meta, Nvidia, Tesla, Salesforce, and thousands of companies aspiring to join them. The market capitalization concentrated in this geography exceeds the GDP of most nations.

The American West—the Pacific Coast states plus the Mountain West—represents the country's technological frontier, its cultural laboratory, and the site of its most acute resource challenges. California alone, if it were a country, would rank as the world's fifth-largest economy.

## California: The Colossus

California defies comparison. With a GDP of \$4.1 trillion in 2024, it exceeds the entire output of the United Kingdom. The state leads the nation in manufacturing (by value), agriculture, entertainment, and technology. One in eight Americans lives in California; one in seven dollars of American output is produced there.

### California's Scale (2024)

Metric	Value	National Rank
GDP	\$4.1 trillion	1st
Population	39 million	1st
Manufacturing output	\$350 billion	1st
Agricultural output	\$60 billion	1st
Tech employment	1.9 million	1st

Source: Bureau of Economic Analysis, Regional GDP; Bureau of Labor Statistics, 2024

The state's dominance reflects accumulated advantages: decades of federal investment (defense, aerospace, research universities), unmatched natural amenities (climate, coastline, mountains), and network effects that make success self-reinforcing. Silicon Valley became the technology center because it was the technology center; the density of talent, capital, and ideas created feedback loops that no other region could replicate.

## The West

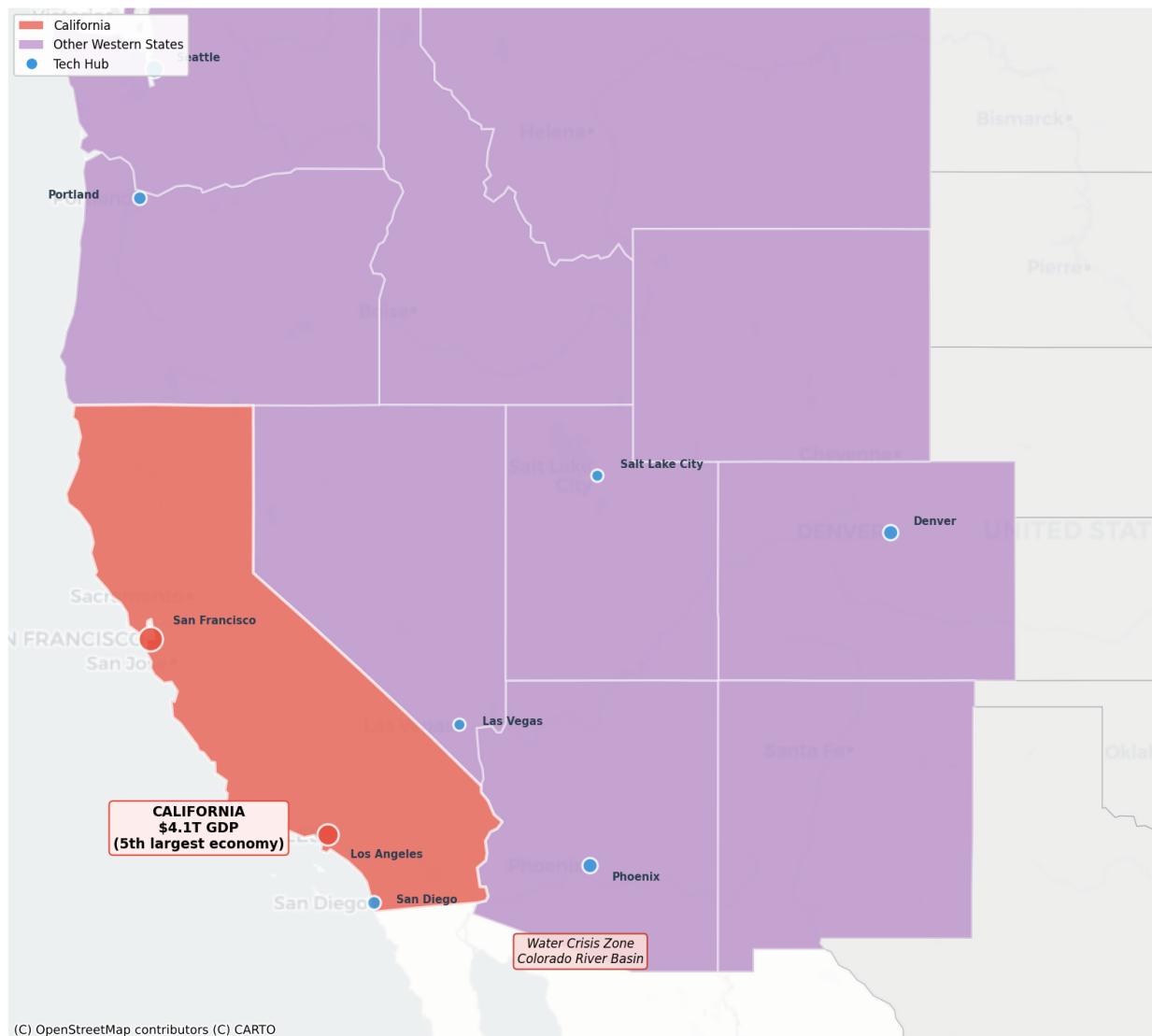


Figure 86: Figure 26.1: The American West. California alone generates \$4.1 trillion in GDP—the world's 5th largest economy if independent. Major tech hubs cluster along the coast, while the Colorado River Basin faces existential water constraints. Source: BEA, Bureau of Reclamation

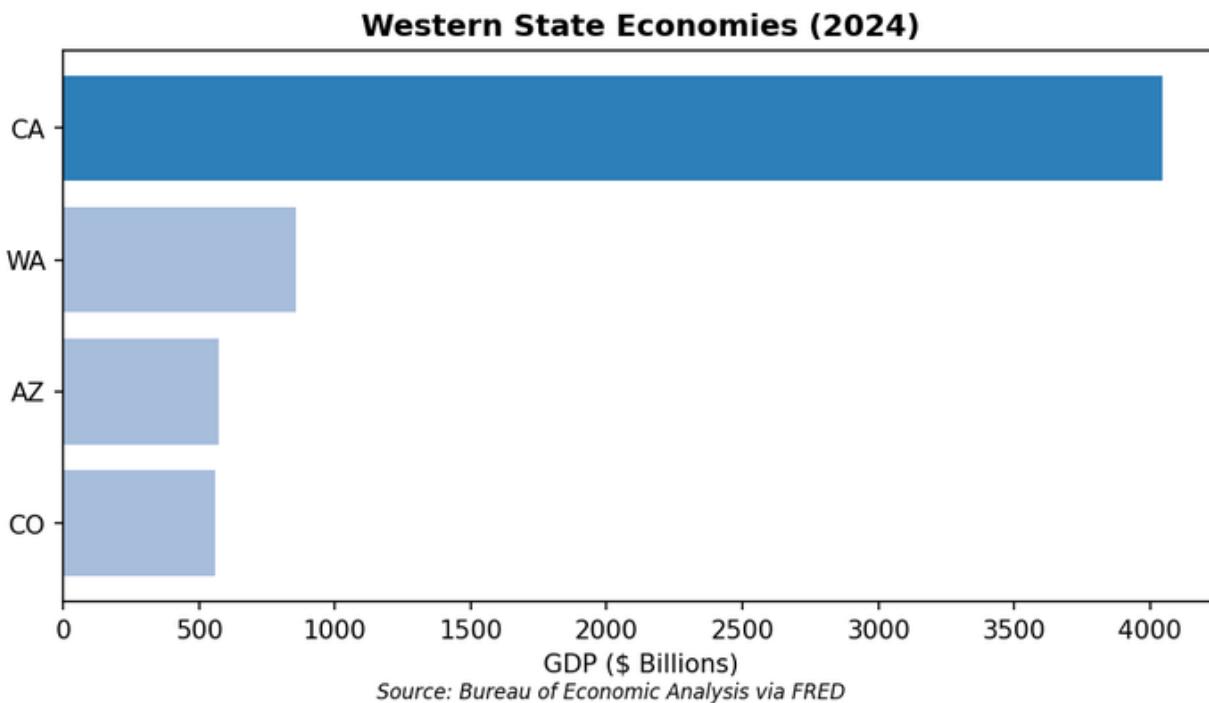


Figure 87: Figure 26.2: GDP of Western states (2023). California dominates, producing more than all other Western states combined. Source: BEA

California's population has stabilized at around 39.4 million after unprecedented losses during the pandemic years. The state lost 400,000 residents between 2020 and 2022—the first population decline in recorded history—as remote work enabled professionals to flee astronomical housing costs. International immigration returned California to slight growth in 2023-2024, but net domestic migration remains stubbornly negative.

The departures follow a pattern: middle-class families priced out of homeownership, retirees seeking lower costs and taxes, businesses relocating headquarters to Texas or other low-tax states. What remains is increasingly bifurcated: wealthy knowledge workers who can afford \$1.5 million homes and service workers crowded into overpriced apartments, with the middle class hollowed out.

## **Metropolitan Economies**

### **San Francisco Bay Area: The Innovation Machine**

The Bay Area—San Francisco, Oakland, and San Jose—is the undisputed capital of the information age. The concentration of technology companies, venture capital, and engineering talent has no parallel anywhere in the world.

**Key Statistics:** - Combined metropolitan GDP: \$1.3 trillion - Venture capital concentration: 50%+ of U.S. total - Tech employment: 500,000+ - Major employers: Alphabet, Apple, Meta, Nvidia, Salesforce

The region's technological leadership has persisted across multiple waves of innovation: semiconductors in the 1970s, personal computers in the 1980s, the internet in the 1990s, mobile computing in the 2000s, cloud computing in the 2010s, and artificial intelligence in the 2020s. Each wave might have dispersed to other locations; each wave intensified the Bay Area's dominance instead.

The current AI boom, concentrated in San Francisco, has reversed some pandemic-era dispersal. OpenAI, Anthropic, and dozens of AI startups have made San Francisco their headquarters. The city's tech-critic reputation ("Tech is over") proved premature; the industry simply shifted from consumer internet to infrastructure and intelligence.

The costs are legendary: median home prices exceed \$1.3 million; office rents in premium locations top \$100 per square foot; a family earning \$150,000 qualifies as "low income" for housing assistance. These costs push out the middle class, hollow out the public sector (teachers, police, nurses cannot afford to live there), and create the homelessness visible on city streets.

The region's venture capital ecosystem remains unmatched. Of the \$170 billion invested in U.S. startups in 2023, roughly \$85 billion—half—flowed through Bay Area investors into Bay Area companies. This dominance has persisted despite predictions of tech diaspora; if anything, the AI boom has concentrated venture activity even further.

The two metropolitan areas within the Bay Area—San Francisco and San Jose—function as distinct but interconnected economies. San Jose and Silicon Valley proper (Santa Clara and San Mateo counties) host the hardware and established technology companies: Apple, Alphabet, Nvidia, Intel. San Francisco hosts the younger software and AI companies: Salesforce, Uber, Airbnb, OpenAI, Anthropic. The two have different characters—San Jose is suburban, car-dependent, corporate; San Francisco is urban, walkable, startup-oriented—but workers and companies move fluidly between them.

## **Los Angeles: The Diversified Giant**

Los Angeles is often misunderstood as "just entertainment." In fact, the metropolitan economy is remarkably diversified—and enormous.

**Key Statistics:** - Metropolitan GDP: \$1.1 trillion - Population: 13 million - Largest manufacturing center in the U.S. (by employment) - Ports of LA/Long Beach: 30%+ of U.S. container imports

The entertainment industry remains significant: the studios, the talent agencies, the streaming services, the music industry, the video game studios. But manufacturing employs more workers than entertainment. Aerospace (Northrop Grumman, Boeing, SpaceX in nearby Hawthorne) combines with fashion, food processing, and plastics to make Southern California a genuine industrial region.

The ports of Los Angeles and Long Beach, side by side at San Pedro Bay, are the nation's busiest. Thirty percent of all U.S. container imports enter through these facilities, connecting the American consumer to Asian manufacturing. The logistics

industry stretching inland to the “Inland Empire” (Riverside and San Bernardino counties) represents one of the country’s largest employment clusters.

Los Angeles also hosts the nation’s largest concentration of immigrants, many of whom power the region’s manufacturing and service sectors. The garment industry, food processing, and small-scale manufacturing depend on immigrant labor. This creates a distinctive metropolitan economy: high-end entertainment and technology coexisting with working-class manufacturing in ways unusual for coastal California.

The region’s challenges are immense. Traffic congestion is legendary—the 405 freeway is a national byword for gridlock. Housing costs, while below the Bay Area, remain prohibitive for middle-class families. Homelessness is visible across the metropolitan area. Yet the regional economy continues to generate substantial output, and population has stabilized after pandemic-era losses.

## **Seattle: Cloud Capital**

Seattle’s economy rests on two pillars: cloud computing and aerospace. Amazon and Microsoft, the two largest cloud providers, are both headquartered in the Seattle metro (Amazon in Seattle proper, Microsoft across Lake Washington in Redmond).

**Key Statistics:** - Metropolitan GDP: \$450 billion - Amazon employees in region: 80,000+ - Microsoft employees in region: 60,000 - Boeing commercial aviation workforce: 50,000

The cloud computing concentration creates extraordinary wealth: median household income in Seattle exceeds \$115,000, highest among major metropolitan areas. The spillover effects are visible in real estate (home prices doubled in a decade) and in the proliferation of startups founded by Amazon and Microsoft alumni.

Boeing’s presence—while diminished by the 737 MAX crisis, the move of headquarters to Virginia, and the loss of some production to South Carolina—remains significant. The engineering workforce and supplier base represent a century of accumulated expertise that would be difficult to replicate elsewhere.

Life sciences are a growing third pillar. The Fred Hutchinson Cancer Center, the University of Washington, and the Allen Institute have attracted biotechnology investment, though Seattle remains far behind Boston in this sector.

Washington State’s economy extends beyond Seattle. The eastern part of the state, centered on Spokane, depends on agriculture (wheat, apples, wine grapes) and hydroelectric power from the Columbia River dams. The Hanford nuclear site, legacy of the Manhattan Project, is both a cleanup challenge and an employment anchor. The contrast between the Seattle metropolis and eastern Washington creates political tensions that mirror the urban-rural divide nationally.

Seattle’s immigrant population, particularly from China, India, and Vietnam, provides both technical talent (software engineers at Amazon and Microsoft) and entrepreneurial energy (small businesses throughout the metropolitan area). The region’s Asian heritage is visible in cuisine, culture, and economic linkages across the Pacific.

## **Denver: The Mountain Hub**

Denver has emerged as the economic capital of the Mountain West, combining altitude with ambition.

**Key Statistics:** - Metropolitan GDP: \$250 billion - Population: 2.9 million - Key sectors: Aerospace, telecommunications, energy, technology

The city's location makes it a natural hub: central time zone, equidistant from coasts, international airport connecting the region to the world. United Airlines operates its largest hub at Denver International; the airport anchors a concentration of logistics and corporate operations.

The technology sector has grown substantially, benefiting from workers fleeing Bay Area costs while seeking mountain access. Telehealth company Teladoc, software firm Arrow Electronics, and numerous smaller tech companies have established Denver presence.

Aerospace and defense remain significant: Lockheed Martin's satellite manufacturing, Ball Corporation's aerospace division, and the Air Force's Space Operations Command at Peterson Space Force Base in nearby Colorado Springs anchor the sector.

## **San Diego: Biotech Beach**

San Diego has developed a distinctive economy combining biotechnology, defense, and tourism.

**Key Statistics:** - Metropolitan GDP: \$280 billion - Biotech companies: 1,200+ - Military personnel: 110,000 - Research institutions: UCSD, Scripps Research, Salk Institute

The concentration of PhDs and research institutions per capita ranks among the highest in the world. The Torrey Pines mesa hosts clusters of genomics, pharmaceutical, and biotechnology companies spun out of UCSD, Scripps, and Salk. Illumina, the dominant provider of gene sequencing equipment, is headquartered here.

The Navy's presence—Pacific Fleet headquarters, multiple bases, and shipbuilding—provides economic stability and substantial federal spending. The border location facilitates trade with Mexico and, increasingly, manufacturing partnerships across the border in Tijuana.

## **Salt Lake City: Silicon Slopes**

Utah's capital has quietly become one of America's fastest-growing technology centers.

**Key Statistics:** - Metropolitan GDP: \$140 billion - GDP growth (2024): 4.5% (highest among major metros) - Notable companies: Qualtrics, Pluralsight, Domo, Ancestry

The "Silicon Slopes" nickname reflects genuine substance: a concentration of software companies, many founded by Brigham Young University graduates, that has

achieved critical mass. Qualtrics' \$8 billion acquisition by SAP (and subsequent re-IPO) demonstrated that Utah companies could reach global scale.

The advantages are straightforward: lower costs than California, an educated workforce, quality of life (skiing within 45 minutes of downtown), and a business-friendly regulatory environment. The LDS Church's cultural influence—emphasis on education, clean living, large families—creates a distinctive talent pool.

## **Portland: The Silicon Forest**

Portland's economy centers on hardware manufacturing—a rarity on the West Coast.

**Key Statistics:** - Metropolitan GDP: \$200 billion - Major employers: Intel, Nike, Columbia Sportswear - Semiconductor manufacturing employment: 30,000+

Intel's Oregon operations produce some of the company's most advanced processors. The "D1X" fab in Hillsboro has received billions in investment and CHIPS Act funding. The surrounding ecosystem of semiconductor equipment suppliers and materials companies makes the Portland area a genuine chip manufacturing cluster.

Athletic apparel is the second pillar: Nike's world headquarters in Beaverton, Columbia Sportswear's headquarters in Portland, and Adidas's North American headquarters create an apparel design and marketing cluster.

Portland's challenges—high homelessness, drug use visible in the downtown core, business departures—have garnered national attention. The city's economic fundamentals remain solid, but quality-of-life concerns have dampened growth.

Oregon's economy also includes substantial timber and agriculture sectors in the rural regions. The Willamette Valley produces hazelnuts, berries, and wine grapes; eastern Oregon's ranching and farming continue despite population decline. The tension between Portland's progressive politics and rural Oregon's conservative orientation shapes state policy debates.

## **Las Vegas: The Service Economy**

Las Vegas presents a distinctive Western economic model: tourism and gaming as the primary drivers.

**Key Statistics:** - Metropolitan GDP: \$160 billion - Gaming revenue: \$15 billion annually - Tourism employment: 300,000+ - Annual visitors: 40 million+

The "Strip" casinos—MGM, Caesars, Wynn—generate revenues that fund a broader service economy. Conventions, sports (the city now hosts the Raiders, Golden Knights, and Formula 1), and entertainment diversify the base beyond gambling.

Las Vegas faces acute water constraints. The Southern Nevada Water Authority has pioneered conservation and recycling, achieving reductions in per capita use even as population grew. But the fundamental limit—dependence on Lake Mead and the Colorado River—constrains long-term growth.

## Housing and the Affordability Crisis

The West's economic success has created its most severe challenge: housing costs that threaten the regional economic model.

### Housing Cost Comparison (2024)

Metro	Median Home Price	Median Household Income	Price/Income Ratio
San Jose	\$1,450,000	\$140,000	10.4x
San Francisco	\$1,300,000	\$136,000	9.6x
Los Angeles	\$890,000	\$85,000	10.5x
Seattle	\$850,000	\$115,000	7.4x
Denver	\$610,000	\$93,000	6.6x
National	\$417,000	\$80,000	5.2x

Source: Census Bureau; National Association of Realtors; Federal Housing Finance Agency, 2024

The result is out-migration. California lost population for the first time in recorded history between 2020 and 2023. While international immigration restored modest growth in 2024, net domestic migration remains negative: roughly 200,000 Californians leave for other states annually.

The destinations reveal the calculus: Texas, Arizona, Nevada, Utah. Middle-class families seeking homeownership, retirees seeking lower taxes and costs, and businesses seeking lower operating expenses all make similar decisions.

## Water: The Existential Constraint

No economic factor matters more for the Western future than water.

### The Colorado River Crisis

The Colorado River serves 40 million people across seven states and Mexico. It irrigates the Imperial Valley's winter vegetables, fills the swimming pools of Phoenix, provides drinking water to Los Angeles and San Diego. And it is running dry.

**Current Status (2025):** - Lake Mead: approaching 28% of capacity (new historic lows) - Lake Powell: 32% of capacity - Mandatory cutbacks: Arizona and Nevada under "Level 1 Shortage" - Negotiations: Post-2026 operating guidelines under dispute

The math is unforgiving: average annual flow has declined by 20% since 2000, and consumption has exceeded sustainable yield for decades. Climate change accelerates the decline. The reservoirs that buffer supply from demand are depleting.

The agricultural sector, which consumes 70% of Colorado River water, faces the sharpest cuts. But urban growth also cannot continue indefinitely. Phoenix's construction moratoriums in water-short areas signal the constraint. Las Vegas has invested billions in conservation and recycling, but fundamental limits remain.

## **California's Dual Challenge**

California faces both Colorado River constraints (Southern California depends on the river) and its own water complexity. The state's agricultural Central Valley relies on snowpack that climate change is reducing and groundwater that is being overdrafted.

The Sacramento-San Joaquin Delta, which provides water to 25 million Californians and 3 million acres of farmland, is increasingly stressed. Proposed solutions—tunnels, desalination, water markets—face political and environmental obstacles.

## **Policy Laboratories**

The West showcases America's starker divide in state economic policy.

### **The California Model**

California bets that agglomeration effects outweigh high costs. The logic: people and companies stay because the talent pool is unmatched, the universities are excellent, and the network effects are irreplaceable. High taxes fund public investments (universities, infrastructure) that reinforce advantages.

State policies push environmental and social agendas aggressively: zero-emission vehicle mandates, aggressive renewable energy targets, high minimum wages, strong worker protections. The bet is that these policies attract values-aligned talent and lead markets that other states will eventually follow.

**The Critique:** Business departures, population loss, and housing unaffordability suggest the model may be reaching limits. When Oracle, Tesla, Hewlett Packard Enterprise, and Chevron relocate headquarters, the warning signals are clear—even if engineering talent often remains.

### **The Alternative Model**

Mountain West states and nearby Texas offer counter-programming: low or no income tax, light regulation, faster permitting, pro-housing development. Utah and Idaho consistently rank among the nation's fastest-growing states; Colorado has thrived with a hybrid approach.

The competition is direct: California companies establishing Texas operations, workers relocating to Nevada for tax savings, manufacturing choosing Arizona for regulatory simplicity.

## **Workforce and Immigration**

The West's economy depends on immigration to a degree unmatched elsewhere in the country. California alone is home to 10 million immigrants—roughly one-quarter of all immigrants in the United States. Foreign-born workers constitute over 30% of California's labor force.

## **The Tech Workforce**

The H-1B visa program, which allows employers to hire skilled foreign workers, funnels disproportionately to the West Coast. Amazon, Google, Apple, and Meta are among the largest H-1B sponsors; their Seattle and Bay Area offices rely heavily on workers from India, China, and other countries. The uncertainty around H-1B policy—caps, lottery systems, green card backlogs—creates business planning challenges and pushes some operations offshore.

International students at Stanford, UC Berkeley, and the University of Washington provide a talent pipeline. Those who remain after graduation often launch startups; more than half of Silicon Valley's venture-backed companies have at least one immigrant founder.

## **Agriculture and Service Workers**

At the other end of the skill spectrum, California's agriculture depends almost entirely on immigrant labor. Farmworkers harvesting Central Valley produce, processing workers in food plants, and dairy workers in the state's substantial milk industry are overwhelmingly immigrant, many unauthorized.

The service sector—hotels, restaurants, construction, landscaping—similarly depends on immigrant labor. When immigration enforcement tightens, these industries face acute worker shortages. The economic reality of this dependence creates tension with restrictive immigration sentiment in some communities.

## **Recent Trends**

### **The AI Entrenchment**

The 2023-2024 generative AI boom unexpectedly strengthened San Francisco's position. OpenAI, Anthropic, and most AI startups chose San Francisco headquarters. Major tech companies concentrated AI research in Bay Area offices. The narrative of tech dispersal gave way to AI concentration.

### **Office Vacancy Crisis**

San Francisco and downtown Portland face some of the nation's highest office vacancy rates—exceeding 30% in central business districts. Remote and hybrid work, combined with tech layoffs in 2022-2023, hollowed out urban cores designed for daily commuters.

The response varies: San Francisco is converting some office buildings to residential use and rethinking downtown's future. Portland struggles with compound challenges of homelessness and retail departures. Seattle has weathered the transition better, with Amazon's office presence providing stability.

## **Industrial Policy Investment**

CHIPS Act and Inflation Reduction Act funding has flowed substantially to the West: Intel's Oregon fab, TSMC's Arizona facilities (though not Western by most definitions), clean energy projects across the region. The federal government's renewed interest in industrial policy disproportionately benefits regions with existing manufacturing capability and worker skills.

## **Regional Profiles**

### **Alphabet/Google**

**Quick Facts** - Headquarters: Mountain View, CA - Revenue: \$350 billion (2024) - Employees: 180,000 worldwide; 50,000+ in Bay Area - Market cap: roughly \$4 trillion

Alphabet exemplifies the Bay Area's innovation machine. From a Stanford research project to a company worth more than most countries' GDP, Google's trajectory demonstrates the region's capacity to scale ideas into global enterprises.

The company's campuses—the Googleplex in Mountain View, expanding facilities in San Jose, offices throughout San Francisco—employ the world's largest concentration of AI researchers, software engineers, and computer scientists. The “Google brain drain” (employees leaving to found startups) has created an ecosystem of companies, many focused on enterprise software and AI.

Alphabet's advertising business remains dominant, but cloud computing and AI investments represent bets on future growth. The company's challenges—antitrust pressure, AI competition, employee activism—are the challenges of any enterprise at this scale.

### **Nvidia**

**Quick Facts** - Headquarters: Santa Clara, CA - Revenue: \$130 billion (FY 2025) - Employees: 30,000 - Market cap: roughly \$4.5 trillion

Nvidia's journey from video game graphics to the world's most valuable company illustrates the West's capacity for reinvention. The company's GPUs, originally designed for gaming, proved ideal for machine learning. When the AI boom arrived, Nvidia controlled the essential hardware.

The result: revenue grew fivefold in two years; market capitalization exceeded \$3 trillion; founder Jensen Huang became the face of the AI revolution. Data centers worldwide queue to purchase Nvidia's H100 and successor chips. The supply cannot meet demand.

Nvidia's headquarters in Santa Clara anchors Silicon Valley's continued relevance. While software can be developed anywhere, the company's hardware design, manufacturing relationships, and talent pool remain rooted in the region that created the semiconductor industry.

## Kaiser Permanente

**Quick Facts** - Headquarters: Oakland, CA - Revenue: \$100 billion (2024) - Members: 12.7 million - Employees: 300,000

Kaiser Permanente represents a different kind of Western innovation: the integrated health system. Combining insurance and care delivery under one organization, Kaiser has created efficiencies that elude fragmented healthcare systems elsewhere.

The organization operates primarily in California, with significant presence in Colorado, the Pacific Northwest, and mid-Atlantic states. Its scale makes it the largest private employer in several California cities. Its approach—emphasizing prevention, managing chronic disease, coordinating care—has influenced healthcare thinking nationally even if the model has not widely spread.

Kaiser's challenges are California's challenges: high costs, labor shortages, competitive pressures from specialized providers. But its regional footprint anchors healthcare employment across the Western economy.

## Data Sources and Further Reading

### Key Data Sources

- **BEA Regional Accounts:** State and metro GDP
- **Bureau of Reclamation:** Colorado River data
- **California Employment Development Department:** State employment data
- **Silicon Valley Institute for Regional Studies:** Technology sector analysis

### Further Reading

- Walker, Richard. Pictures of a Gone City (2018) - Bay Area political economy
- Saxenian, AnnaLee. Regional Advantage (1994) - Silicon Valley origins
- Reisner, Marc. Cadillac Desert (1986) - Western water history
- Pacific Northwest Economic Region reports

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**Word count:** roughly 4,500 words

Note: For detailed treatment of technology, energy, and specific industries, see the relevant chapters in Part II.

## Exercises

### Review Questions

1. California's GDP of \$4.1 trillion exceeds that of the United Kingdom, and the state leads the nation in manufacturing, agriculture, entertainment, and technology. Yet the chapter documents that California lost 400,000 residents between 2020 and 2022—the first population decline in recorded history. Explain

the paradox of a state that is simultaneously the nation's most productive economy and one from which people are fleeing. How can agglomeration advantages coexist with sustained out-migration?

2. The Bay Area has maintained technological leadership across multiple waves of innovation: semiconductors, personal computers, the internet, mobile computing, cloud computing, and now artificial intelligence. The chapter notes that "each wave might have dispersed to other locations; each wave intensified the Bay Area's dominance instead." What mechanisms of agglomeration—talent pools, venture capital concentration, knowledge spillovers, or network effects—explain why technological leadership has remained geographically sticky? Is there any reason to believe the AI wave will be different?
3. Los Angeles is described as "often misunderstood as 'just entertainment'" when in fact it is the nation's largest manufacturing center by employment and handles 30%+ of U.S. container imports through the ports of LA/Long Beach. Using examples from the chapter, explain how entertainment, manufacturing, logistics, and immigration interact to create a "diversified giant." How does the Inland Empire's warehouse and logistics corridor connect LA's port economy to the broader national supply chain?
4. Seattle's economy "rests on two pillars: cloud computing and aerospace," with Amazon (80,000 employees) and Microsoft (60,000 employees) dominating the metropolitan economy. Median household income exceeds \$115,000—highest among major metros. Analyze the benefits and risks of this concentration. What happens to Seattle's economy and housing market if one of these companies significantly reduces its local workforce, as Boeing partially has by moving operations to South Carolina and its headquarters to Virginia?
5. The chapter contrasts the "California model" (high taxes funding public investments, aggressive environmental and social regulation, reliance on agglomeration effects) with the "alternative model" of Mountain West states (low taxes, light regulation, pro-development). Using specific examples—Oracle and Tesla relocating to Texas, Utah's "Silicon Slopes" attracting BYU graduates, Colorado's hybrid approach—evaluate whether the competition between these models is producing a race to the bottom or a productive sorting of economic activity.
6. Water is described as "the existential constraint" on the Western economy. The Colorado River serves 40 million people across seven states, yet average annual flow has declined 20% since 2000. Using the chapter's data on Lake Mead and Lake Powell (both below 35% capacity), explain how water scarcity constrains future growth in Phoenix, Las Vegas, and Southern California. Who bears the costs of cutbacks—agricultural users (70% of consumption) or urban residents—and what political dynamics shape this allocation?
7. The chapter profiles Nvidia, whose market capitalization of roughly \$4.5 trillion makes it the world's most valuable company, driven by demand for its AI-training GPUs. Compare Nvidia's trajectory with that of Intel, which maintained Oregon manufacturing operations but lost its leading-edge position to TSMC. What does this contrast suggest about whether designing chips (Nvidia's model) or manu-

factoring them (Intel's model) captures more value in the semiconductor industry? How does this relate to the broader geographic pattern of Bay Area design dominance and Asian fabrication?

## Data Exercises

1. Using BEA Regional GDP data (<https://www.bea.gov/data/gdp/gdp-state>), download California's GDP by industry sector for the most recent available year. Calculate the share attributable to information technology (NAICS 51), professional and technical services (NAICS 54), manufacturing (NAICS 31-33), and agriculture (NAICS 11). Compare California's sectoral composition to that of Texas and New York. Does the data confirm the chapter's characterization of California as uniquely diversified—leading simultaneously in technology, manufacturing, and agriculture?
2. The Bureau of Reclamation publishes Colorado River water level and storage data (<https://www.usbr.gov/lc/region/g4000/hourly/mead-elv.html> for Lake Mead). Retrieve monthly storage or elevation data for Lake Mead and Lake Powell from 2000 to the most recent available month. Plot the long-term decline alongside the mandatory shortage trigger levels. At the current rate of decline, when will the reservoirs reach “dead pool” levels at which water can no longer flow through the dams? How does this timeline compare to the projected population growth of Phoenix, Las Vegas, and Southern California (available from Census Bureau state projections)?
3. Using FRED data on median household income by metropolitan area (series such as “MHICA06075A052NCEN” for San Francisco County or equivalent), compare the median household income trajectories of San Jose, San Francisco, Seattle, Denver, and Salt Lake City from 2010 to the most recent year. Adjust for cost of living using BEA Regional Price Parities (<https://www.bea.gov/data/prices-inflation/regional-price-parities-state-and-metro-area>). After the cost-of-living adjustment, which Western metro offers the highest real purchasing power? Does this change the narrative about Bay Area prosperity?

## Deeper Investigation

1. The chapter states that “more than half of Silicon Valley’s venture-backed companies have at least one immigrant founder,” and that H-1B visa policy uncertainty “creates business planning challenges and pushes some operations offshore.” Investigate how immigration policy shapes the Western technology economy. Using USCIS H-1B employer data (available at <https://www.uscis.gov/tools/reports-and-studies>), identify the largest H-1B sponsors in the Bay Area and Seattle. Estimate the share of engineering and research positions at major technology firms filled by foreign-born workers. Then assess the economic consequences of two scenarios: (a) a significant expansion of high-skilled immigration (eliminating per-country caps, increasing H-1B quotas) versus (b) a significant restriction. How would each scenario affect the West’s technology sector, housing markets, and competition with other global technology hubs (London, Toronto, Bangalore)?

# 27. Rural America

Drive an hour beyond any major metropolitan area and the American economy changes character. The density that generates agglomeration economies in cities dissipates into landscapes where the nearest hospital might be sixty miles away, where broadband internet remains uncertain, and where the largest employers are often the local school district and the county government. This is rural America: 14% of the population spread across 72% of the land, increasingly disconnected from the metropolitan economy that dominates national statistics.

## Defining Rural

The definition of “rural” matters because policy flows from it.

### Alternative Definitions:

The Census Bureau uses a residual definition: anything not “urban” is rural. Urban areas require population density above certain thresholds; everything else defaults to rural status.

The Office of Management and Budget (OMB) uses a county-based classification that most economic analysis follows: - **Metropolitan counties**: Contains an urban core of 50,000+ population - **Micropolitan counties**: Contains an urban cluster of 10,000-49,999 - **Noncore counties**: No urban cluster of 10,000+

By the OMB definition, roughly 46 million Americans—14% of the population—live in nonmetropolitan counties. These populations spread across 72% of the nation’s land area, at densities that make many urban economic activities unfeasible.

The distinction matters economically. Urban economies benefit from agglomeration: the density of workers, employers, and infrastructure that enables specialization, reduces transaction costs, and generates knowledge spillovers. Rural economies operate without these advantages. A worker in a rural county may have one or two realistic employers; a business may have one or two realistic suppliers. The “thickness” of urban markets is unavailable.

The geographic distribution of rural America is uneven. The Great Plains and Mountain West are overwhelmingly rural by land area but contain relatively few people. The Upper Midwest, Appalachia, and the Deep South combine rural landscapes with meaningful population. The Northeast and West Coast have few rural counties because their land areas are small.

# The Rural Economies

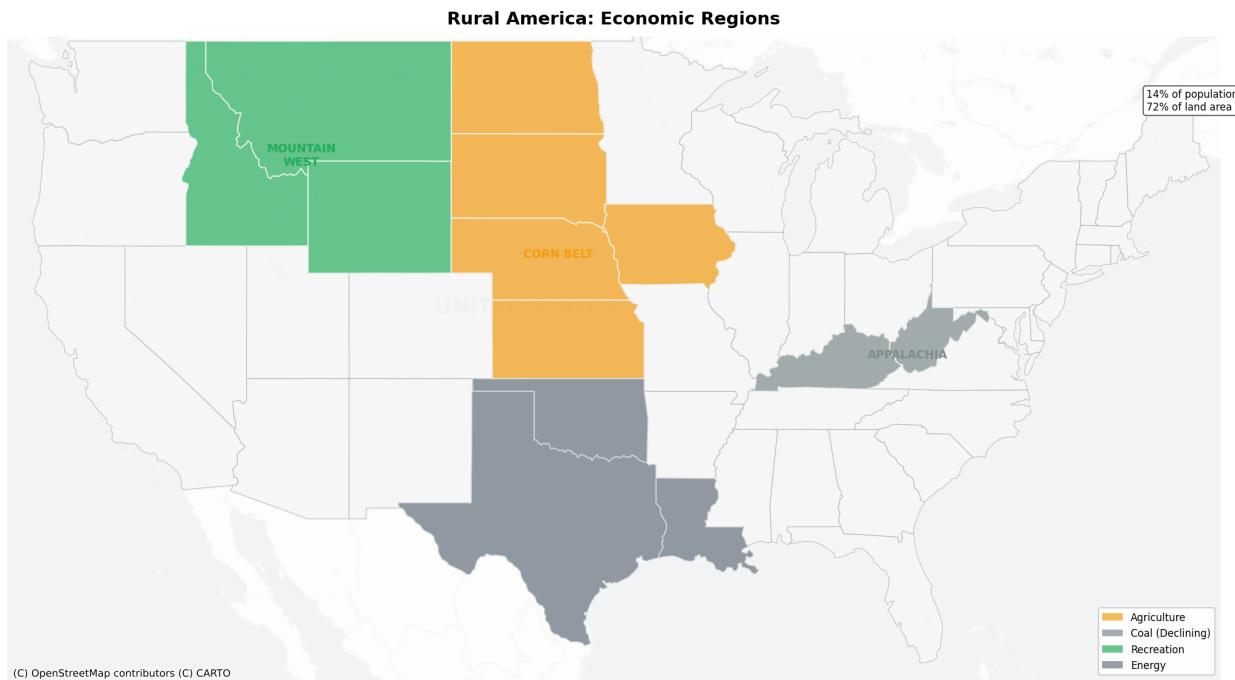


Figure 88: Figure 27.1: Rural America's diverse economies. The Great Plains Corn Belt depends on agriculture; Appalachia faces coal decline; the Mountain West attracts recreation and remote workers; the Permian Basin booms from energy extraction; and the Wind Belt emerges with renewable energy. Source: USDA ERS, Census Bureau

Rural America is not one economy but several, each with distinct dynamics.

## Agriculture

Agriculture remains the iconic rural industry, though it employs fewer people each decade.

**Key Statistics:** - Farm employment: 2.6 million (1.7% of U.S. employment) - Farm share of rural employment: 6% - Farms in the U.S.: 2 million (declining) - Agricultural output: \$500+ billion annually

The paradox is productivity. American agriculture produces record output with fewer workers than ever before. A single operator with modern equipment can farm thousands of acres. The combines harvesting Kansas wheat or Iowa corn represent millions of dollars in capital substituting for the labor that once filled rural towns.

The result is economic marginalization. Counties dependent on agriculture lose population even as agricultural output grows. The consolidation into larger farms—capital-intensive, often corporate-owned—generates wealth that accrues to landowners and equipment suppliers, not to small-town main streets.

**Agricultural Outlook (2024-2025):** Net farm income is projected to rebound 37-40% from 2024 lows, driven primarily by livestock (cattle, poultry) and government payments exceeding \$40 billion. Row crop farmers (corn, soybeans) face compressed margins from low commodity prices and high input costs—the perpetual squeeze between global markets and local costs.

The scale of modern agriculture creates a distinctive rural landscape. Farmhouses separated by miles, grain elevators visible for ten miles, equipment worth more than most houses—the economics require vast operations. A corn farm generating adequate income might span 3,000 acres, well beyond what a single family could work a generation ago. Custom operators, seasonal labor, and hired managers fill the gap.

Corporate involvement in agriculture takes multiple forms. Direct ownership of farmland is less common than the mythology suggests, but contract farming—where processors specify practices and guarantee purchases—dominates poultry, hogs, and increasingly cattle. Farmers become managers of assets owned by integrators, bearing production risk while following corporate specifications.

## **Energy Production**

Energy extraction creates the highest-wage rural jobs, but with extreme volatility.

**Major Producing Regions:** - **Permian Basin (Texas/New Mexico):** The world's most productive oil field - **Bakken (North Dakota):** Shale oil - **Marcellus/Utica (Pennsylvania/Ohio/West Virginia):** Shale gas - **Powder River Basin (Wyoming):** Coal (declining) - **Great Plains "Wind Belt":** Wind energy

Fossil fuel extraction brings economic booms—Midland, Texas has among the highest median incomes in the country—but also busts when commodity prices fall. The 2014-2016 oil price collapse emptied boom towns; the 2020 pandemic crash repeated the cycle. Workers migrate in and out, straining local services during booms and leaving behind debts and vacancies during busts.

Renewable energy represents a growing share of rural land use. Wind farms now dot the Great Plains from Texas to Minnesota. The economics are straightforward: wind is strongest where population is sparsest. Landowners receive lease payments (typically \$5,000-\$10,000 per turbine annually) that supplement farm income and reduce agricultural risk.

Solar development has expanded into rural areas as well. Utility-scale solar farms—thousands of acres of panels—increasingly compete with agricultural use for land, particularly in the Sun Belt. The economics favor relatively poor agricultural land: if an acre generates \$200 in farm income but \$800 in solar lease payments, the transition is compelling. Concerns about farmland loss and community character have prompted some counties to restrict solar development.

Battery storage facilities, essential for grid integration of renewable energy, add another dimension. These industrial installations in rural settings bring construction jobs, property taxes, and ongoing employment—modest but meaningful for small communities.

## **Mining and Extraction**

Coal mining's decline has devastated Appalachian and Wyoming communities.

**Coal Industry Collapse:** - U.S. coal production: Down 50% since 2008 - Coal mining employment: 42,000 (down from 90,000 in 2012) - Counties affected: Eastern Kentucky, southern West Virginia, southwest Virginia, northeast Wyoming

The transition has been brutal. Coal counties typically lack the educational infrastructure, physical infrastructure, and population density to attract replacement industries. Younger residents leave; those who remain face limited options.

Emerging "critical minerals" mining offers some new opportunity. Lithium deposits in Nevada and North Carolina, copper in Arizona, rare earth elements in Wyoming attract investment driven by electrification demand. But these projects are capital-intensive and contentious—environmental concerns limit development.

## **Recreation and Tourism**

The "amenity economy" represents rural success stories.

**High-Growth Rural Counties:** Counties with natural amenities—mountains, lakes, national parks, ski resorts—consistently outperform other rural areas on population growth and income. The Intermountain West (Colorado, Utah, Montana) has seen particularly strong growth as remote workers seek outdoor access.

**Examples:** - Teton County, Wyoming (Jackson Hole): Median household income exceeds \$130,000 - Summit County, Colorado (Breckenridge): Strong real estate, tourism economy - Flathead County, Montana (Kalispell): Gateway to Glacier National Park

The model is fragile. These economies depend on wealthy visitors and second-home owners; they often push out working-class residents who can't afford housing. The local workforce commutes long distances or lives in mobile homes invisible to tourists. One bad ski season or wildfire can crater revenues.

## **The Rural-Urban Divide**

The divergence between rural and metropolitan America has accelerated across multiple dimensions.

### **Economic Divergence**

Since the 2008 financial crisis, metropolitan areas have captured over 90% of net new job growth. Rural recovery has been slower and less complete.

#### **Key Metrics (2024):**

Measure	Rural	Urban
Median household income	\$66,000	\$86,000

Measure	Rural	Urban
College degree attainment	22%	35%
Labor force participation	57%	63%
GDP growth (2015-2024)	1.8% annually	2.4% annually

Source: USDA Economic Research Service; Bureau of Economic Analysis, 2024

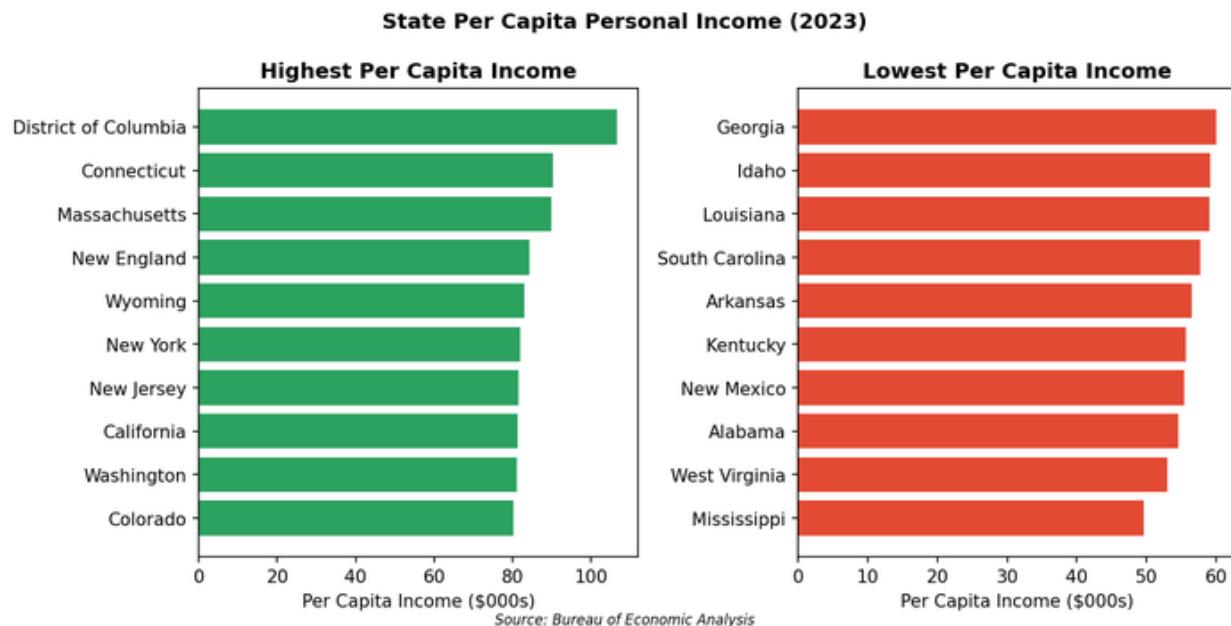


Figure 89: Figure 27.1: Per capita income by state (2023). The highest-income states exceed the lowest by more than \$40,000 per person. Source: BEA

The income gap understates the divide. Rural costs are lower, but the gap in opportunity—the availability of high-paying jobs, the chance for advancement—is wider than the income statistics suggest.

## The Brain Drain

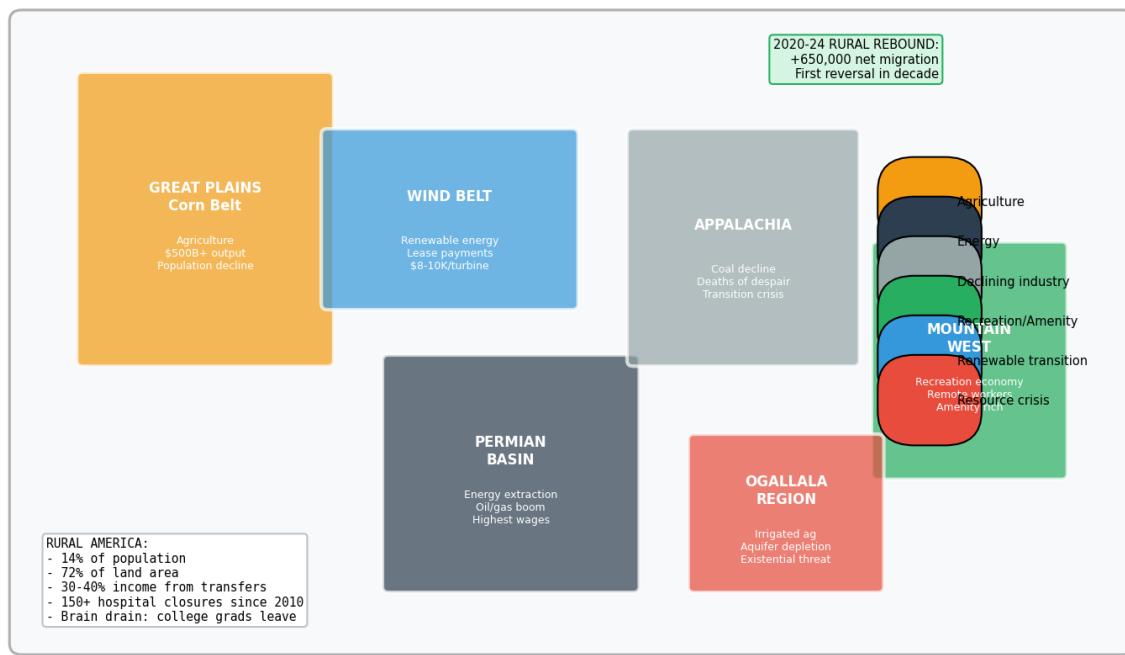
The fundamental demographic challenge is simple: young people leave. Graduates of rural high schools move to cities for college and rarely return. Those with the most education and ambition are most likely to go.

The result is population aging and skill depletion. Rural counties increasingly skew older; working-age adults with college degrees are scarce. Employers seeking skilled workers face thin labor pools.

This pattern is self-reinforcing. The absence of skilled workers deters employers; the absence of employers drives young people away. Breaking the cycle requires interventions at multiple points simultaneously.

Some rural communities have had success with “grow your own” workforce strategies: scholarships requiring recipients to return home, loan forgiveness programs

## Rural America: Economic Typologies



Source: USDA ERS, Census Bureau | Author analysis

Figure 90: Figure 27.2: Economic typologies of rural America. Different regions face distinct economic dynamics: agriculture in the Corn Belt, energy extraction in the Permian, coal decline in Appalachia, recreation economies in the Mountain West, and resource depletion in the Ogallala region. Source: USDA ERS, Census Bureau

for professionals serving rural areas, and aggressive recruitment of hometown graduates. But these programs operate at the margins; the fundamental economic forces favor concentration.

The educational pipeline presents particular challenges. Rural schools, often excellent despite limited resources, prepare students for higher education. But the higher education itself occurs in cities: state universities, community colleges, technical schools are metropolitan institutions. Once students relocate for education, the return rate is low. This geographic mismatch between where rural students grow up and where they must go to acquire marketable skills creates structural brain drain.

## **Deaths of Despair**

Economist Anne Case and Angus Deaton documented a phenomenon concentrated in rural America: rising mortality among middle-aged white adults without college degrees, driven by suicide, drug overdose, and alcoholic liver disease.

The pattern reflects economic dislocation: the loss of manufacturing and mining jobs that provided identity and income without requiring educational credentials. The opioid epidemic hit hardest in rural areas, beginning with prescription painkillers and evolving through heroin and fentanyl. Recovery is slow.

The geography of despair overlaps with the geography of economic decline but isn't identical. Some struggling rural areas have avoided the worst mortality trends; some relatively prosperous areas have high rates. Social cohesion, community institutions, healthcare access, and cultural factors all matter. But the general pattern is clear: where economic hope diminishes, health outcomes worsen.

Treatment resources are particularly scarce in rural areas. Addiction medicine specialists, mental health professionals, and rehabilitation facilities cluster in metropolitan areas. Rural residents may need to travel hours for treatment—if they can access it at all. Telehealth has expanded access but cannot substitute for in-person care in many cases.

## **Infrastructure Gaps**

Rural infrastructure deficits compound economic challenges.

### **Healthcare Access**

Rural hospital closures have accelerated, with more than 150 facilities closing or converting to outpatient-only status since 2010.

**Drivers of Closure:** - Low patient volumes (insufficient scale) - Adverse payer mix (high Medicaid/Medicare, low private insurance) - Workforce shortages (inability to recruit physicians and nurses) - Distance (long travel times deter utilization)

The consequences are severe. Over half of rural counties lack hospital obstetric services, forcing pregnant women to travel long distances for delivery—associated with

increased maternal and infant mortality. Emergency response times stretch to an hour or more. Chronic disease management suffers without accessible primary care.

“Critical access hospitals”—small facilities receiving enhanced Medicare reimbursement—provide a partial safety net, but many operate on thin margins with aging equipment and exhausted staff.

## Broadband

The digital divide is a rural divide.

**Connectivity Statistics (2024):** - Urban areas with 100+ Mbps access: 98% - Rural areas with 100+ Mbps access: 72% - Rural areas with reliable service (real-world measures): 70-80%

FCC maps historically overstated coverage; actual access often falls short. The “last mile” problem is severe: running fiber to dispersed homes is expensive, and the revenue doesn’t cover costs without subsidy.

Federal programs—the BEAD infrastructure program, Rural Digital Opportunity Fund—are investing billions to close the gap. Starlink and other satellite services offer alternatives where fiber is impractical. Progress is real but incremental, with coverage improving several percentage points annually.

But broadband alone doesn’t solve the rural economic challenge. Telecommuting requires not just connectivity but skills and job opportunities in the first place.

## Physical Infrastructure

Rural counties maintain disproportionate road miles relative to their tax base. The federal highway system serves metropolitan traffic; local roads that connect farms to markets and residents to services often suffer from deferred maintenance.

Thousands of bridges classified as “structurally deficient” serve low-traffic rural routes. Water systems aging past their design lives serve small towns unable to afford replacement. The infrastructure gap is not visible from the interstate but shapes daily life for rural residents.

## Federal Transfers

The rural economy increasingly depends on federal transfer payments.

**Transfer Dependency:** In the most rural “noncore” counties, transfer payments (Social Security, Medicare, Medicaid, veterans’ benefits, disability) constitute 30-40% of total personal income. This shields communities from economic fluctuations but reflects the absence of self-sustaining economic activity.

**The Farm Bill:** Federal agricultural policy flows primarily through the quinquennial Farm Bill, which combines farm subsidies, nutrition programs (SNAP), crop insurance, and conservation programs. Subsidy payments disproportionately benefit

large producers of specific commodities (corn, cotton, soybeans, wheat, rice)—often corporate operations rather than family farms.

The politics of the Farm Bill links rural agricultural interests with urban nutrition programs in an alliance that ensures bipartisan support. The result is durable but also resistant to reform.

## **The Political Economy of Rural America**

Rural communities punch above their weight politically. The Senate allocates two seats per state regardless of population; rural states like Wyoming (population 580,000) have the same representation as California (39 million). The Electoral College slightly favors smaller states. State legislatures often over-represent rural areas.

This political power does not translate straightforwardly into economic policy favorable to rural areas. Rural voters tend conservative; conservative economic policy tends toward limited government intervention. The tension between “leave us alone” politics and “help us out” economic needs creates contradictions. Federal agricultural programs, healthcare subsidies, and infrastructure investments that rural economies depend upon sometimes conflict with the ideology of rural representatives.

Immigration policy illustrates the contradiction acutely. Many rural economies—meatpacking plants, dairy farms, construction in resort towns—depend on immigrant labor, often unauthorized. Restrictive immigration enforcement threatens these labor supplies even as rural voters support such enforcement politically.

The geographic sorting of American politics has intensified the divide. Rural areas vote overwhelmingly Republican; urban areas vote overwhelmingly Democratic. The cultural differences that accompany this sorting—on guns, religion, social issues—have become as salient as economic differences. Rural resentment of metropolitan elites combines economic grievance with cultural alienation.

## **Success Stories**

Amid the general challenges, some rural communities have found formulas that work.

### **Destination Economies**

Communities with natural or cultural amenities attract tourism dollars and, increasingly, remote workers.

**Examples:** - **Bend, Oregon:** Transformed from timber town to outdoor recreation destination - **Bozeman, Montana:** Growth pole for Greater Yellowstone region - **Asheville, North Carolina:** Arts, food, and mountain tourism

These communities attract wealth but also face pressures: housing costs rise, long-term residents are displaced, service workers cannot afford to live where they work. Success can undermine itself.

## **Niche Manufacturing**

Small towns with specialized manufacturing capabilities can thrive if they find their niche.

**Examples:** - Precision machining clusters serving aerospace or medical devices - Food processing tied to regional agricultural production - Recreational vehicle and manufactured housing production

The common thread is specialization: skills and supply chains that cannot easily be replicated elsewhere. These niches are fragile—dependent on a few customers or a specific technology—but they provide middle-class employment outside metropolitan areas.

## **Zoom Towns**

The pandemic's remote-work experiment created a new category: "Zoom towns" where remote workers relocated seeking affordable housing, natural amenities, or connection to family.

**Characteristics:** - Often high-amenity locations (mountains, beaches, college towns) - Influx of high-income remote workers - Rapid housing price appreciation - Strain on local services and affordability

The phenomenon's durability remains uncertain. Some remote workers have returned to metropolitan areas; others have embedded in new communities. The lasting impact likely concentrates in places that offer genuine lifestyle advantages—not struggling towns hoping that broadband alone will attract telecommuters.

## **Recent Trends**

### **The Rural Rebound**

Between 2020 and 2024, nonmetropolitan counties experienced a population rebound driven by net migration of over 650,000 people—sufficient to offset natural decrease (more deaths than births) and break a decade-long pattern of losses. Domestic migration accounts for roughly 70% of this gain; international immigration accounts for the remainder.

**Caveats:** - Growth concentrates in the South and amenity-rich Mountain West - Great Plains and Corn Belt counties continue losing population - The rebound follows a historic low point; many counties remain below 2010 populations

Whether this represents a durable shift or a pandemic anomaly will become clear over the coming decade.

### **Energy Community Investments**

The Inflation Reduction Act specifically targets "energy communities"—areas with closed coal mines, retired coal plants, or significant fossil fuel employment—for clean

energy investment. Tax credits for solar, wind, and battery projects are enhanced when built in these areas.

The policy explicitly aims to replace fossil fuel employment with clean energy jobs in the same communities. Results are early but visible: battery plants in coal country, solar installations on retired mine lands.

## **The Farm Income Squeeze**

Despite the projected 2025 rebound in net farm income, the underlying pressures on mid-sized farms continue. Input costs (fertilizer, fuel, equipment) remain elevated; commodity prices reflect global competition; land values have appreciated faster than farming can justify as investment return.

The result is continued consolidation: large operations absorbing smaller neighbors, family farms maintained as part-time enterprises while operators work off-farm jobs.

## **Regional Profiles**

### **The Ogallala Region**

**Quick Facts** - Location: High Plains from South Dakota to Texas - Water source: Ogallala Aquifer - Primary economy: Irrigated agriculture, feedlots  
- Population trend: Declining

The Ogallala Aquifer, one of the world's largest underground water reserves, enabled the transformation of semi-arid High Plains into productive farmland. Center-pivot irrigation systems dot the landscape from the air; corn and cattle feed operations prosper in what was once short-grass prairie.

But the aquifer is depleting. In some areas, the water table has dropped over 100 feet. Recharge is negligible on human timescales. Current extraction rates are unsustainable over decades.

The economic implications are existential. As wells go dry, irrigated agriculture becomes impossible. The communities built on irrigation face reversion to dryland farming or abandonment. The time horizon is visible: some Kansas and Texas areas are already transitioning; others have a generation before constraints bite.

### **Appalachian Coal Country**

**Quick Facts** - States: Eastern Kentucky, southern West Virginia, southwest Virginia - Historic economy: Coal mining - Current challenges: Post-coal transition - Population trend: Declining

Appalachian coal country represents the most visible example of structural economic decline. The coal that powered American industrialization and electricity generation came disproportionately from these mountains. The industry's collapse—driven by cheap natural gas, environmental regulation, and automation—has left communities without economic purpose.

Median incomes in coal counties run 40-50% below national averages. Drug overdose rates are among the nation's highest. Working-age population has declined as those who can leave do.

Recovery efforts focus on tourism (the Appalachian Trail, outdoor recreation), health-care (hospitals as anchor employers), and technology (call centers, data processing). Progress is incremental at best. The infrastructure of extraction—rail lines, electrical substations, industrial skills—doesn't easily convert to post-industrial uses.

## The Wind Belt

**Quick Facts** - Location: Great Plains from Texas to Minnesota - Primary development: Utility-scale wind energy - Economic impact: Land lease payments, property taxes - Population trend: Stable to declining

The Great Plains have some of the best wind resources in the world: steady, strong, and located where land is cheap and transmission is (relatively) available. Wind turbines now dominate the landscape in much of Kansas, Oklahoma, and Iowa.

For rural landowners, turbine lease payments provide income diversification. A single turbine might generate \$8,000-\$10,000 annually for the landowner—significant supplemental income that continues regardless of crop prices or weather. Counties collect property taxes on improvements that would otherwise not exist.

The employment impact is more limited. Construction provides temporary jobs; ongoing operations require only a handful of technicians per wind farm. But in counties with few economic options, even modest employment and tax revenue matter.

## Data Sources and Further Reading

### Key Data Sources

- **USDA Economic Research Service:** Rural economy data, Atlas of Rural and Small-Town America
- **Census Bureau:** American Community Survey, population estimates
- **Bureau of Economic Analysis:** Regional GDP
- **USDA NASS:** Agricultural statistics

### Further Reading

- Carr, Patrick and Maria Kefalas. Hollowing Out the Middle (2009) - Brain drain dynamics
- Case, Anne and Angus Deaton. Deaths of Despair (2020) - Rural mortality crisis
- Wuthnow, Robert. The Left Behind (2018) - Rural-urban cultural divide
- USDA Rural Development reports

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**Word count:** roughly 4,200 words

Note: For detailed treatment of agriculture, energy, and healthcare, see the relevant sector chapters in Part II.

## Exercises

### Review Questions

1. The chapter defines rural America as “14% of the population spread across 72% of the land.” Explain why this dispersal creates economic disadvantages that urban areas do not face. Using the concept of agglomeration, describe at least three economic activities that become unfeasible at rural population densities. How does the “thickness” of urban labor markets differ from the “one or two realistic employers” available to a rural worker?
2. American agriculture produces record output with fewer workers than ever before, yet counties dependent on agriculture continue to lose population. The chapter calls this the “productivity paradox.” Explain the mechanism: how does consolidation into larger, capital-intensive farms generate wealth that “accrues to landowners and equipment suppliers, not to small-town main streets”? What role does contract farming—where processors like ADM, Cargill, and Bunge specify practices and guarantee purchases—play in this dynamic?
3. Energy extraction is described as creating “the highest-wage rural jobs, but with extreme volatility.” Compare the economic dynamics of fossil fuel communities (Permian Basin, Bakken) with emerging renewable energy communities (Great Plains Wind Belt). How do wind turbine lease payments (\$8,000-\$10,000 per turbine annually) compare to fossil fuel employment in terms of income level, stability, and the number of jobs created? Can renewable energy replace the economic base that fossil fuels provided?
4. The chapter identifies a self-reinforcing “brain drain” cycle: “The absence of skilled workers deters employers; the absence of employers drives young people away.” What interventions—scholarships requiring recipients to return home, loan forgiveness for rural professionals, or “grow your own” workforce strategies—does the chapter describe? Why do these programs “operate at the margins” against the “fundamental economic forces” favoring metropolitan concentration?
5. In the most rural “noncore” counties, federal transfer payments (Social Security, Medicare, Medicaid, veterans’ benefits, disability) constitute 30-40% of total personal income. Explain the economic implications of this transfer dependency. How does it shield communities from market fluctuations, and what does it reveal about the absence of self-sustaining economic activity? How does the Farm Bill’s linkage of agricultural subsidies with nutrition programs (SNAP) create a political coalition that ensures bipartisan support?
6. The chapter describes “deaths of despair”—rising mortality from suicide, drug overdose, and alcoholic liver disease among middle-aged white adults without college degrees—as concentrated in rural America. Using the framework of economic dislocation, explain the connection between the loss of manufacturing

and mining jobs and worsening health outcomes. Why are treatment resources (addiction specialists, mental health professionals) particularly scarce in rural areas, and how does this scarcity compound the crisis?

7. The chapter profiles three types of rural success stories: destination economies (Bend, Bozeman, Asheville), niche manufacturing (precision machining, food processing), and “Zoom towns” (remote workers relocating for amenities). For each model, identify the key conditions that enable success and the vulnerabilities that threaten sustainability. Which model is most replicable, and which is most dependent on circumstances that cannot be manufactured?

## **Data Exercises**

1. The USDA Economic Research Service publishes the *Atlas of Rural and Small-Town America* (<https://www.ers.usda.gov/data-products/atlas-of-rural-and-small-town-america/>), which provides county-level data on population, income, employment, and education across all rural counties. Select one state with substantial rural population (Iowa, Kansas, West Virginia, Montana, or Mississippi) and use the *Atlas* to compare economic indicators across that state’s rural counties. Identify the counties with the highest and lowest per capita income, the fastest and slowest population growth, and the highest transfer payment dependency. What geographic or economic characteristics distinguish the thriving rural counties from the declining ones?
2. Using the Census Bureau’s American Community Survey (<https://data.census.gov/>), compare educational attainment (percent with bachelor’s degree or higher), median household income, and labor force participation rates for nonmetropolitan counties versus metropolitan counties nationally for the most recent available year. Then retrieve the same metrics for 2010 and calculate the change over the intervening period. Has the rural-urban gap on these measures widened, narrowed, or remained stable? Compare your findings to the key metrics table in this chapter (22% college attainment in rural areas versus 35% in urban areas).
3. The USDA National Agricultural Statistics Service (<https://www.nass.usda.gov/>) publishes annual data on farm numbers, farm size, and farm income. Download the number of farms and average farm size (in acres) for the United States from 2000 to the most recent available year. Plot the trend in both series. Then retrieve net farm income data from the USDA ERS (FRED series “B1400C1A027NBEA” or from <https://www.ers.usda.gov/data-products/farm-income-and-wealth-statistics/>). Does the data confirm the chapter’s narrative of consolidation into “fewer, larger farms” producing “more than ever before”? How volatile is net farm income over this period?

## **Deeper Investigation**

1. The Ogallala Aquifer, described in the chapter as facing depletion that is “existential” for the High Plains economy, presents a case study in the economics of exhaustible natural resources. The water table has dropped over

100 feet in some areas; “recharge is negligible on human timescales”; and some Kansas and Texas areas are “already transitioning” to dryland farming. Investigate the economic future of one Ogallala-dependent county. Using data from the Kansas Geological Survey’s water level monitoring network (<https://www.kgs.ku.edu/HighPlains/OHP/>), USDA Census of Agriculture county-level data, and Census Bureau population estimates, document the relationship between declining water availability, agricultural output, and population change over the past two decades. What adaptation strategies—dryland crop varieties, water-efficient irrigation technology, economic diversification—are being attempted? Estimate the economic cost of transitioning from irrigated to dryland agriculture in terms of lost output per acre and reduced employment. Is managed decline inevitable, or can policy intervention extend the aquifer’s useful life long enough for meaningful economic transition?

## **Part VI: Institutions and Governance**

# 28. Federal Economic Governance

When markets crash, when inflation spikes, when unemployment rises, Americans look to Washington for answers. But “Washington” is not a single actor—it is a sprawling apparatus of agencies, councils, and commissions, each with distinct authorities, constituencies, and institutional cultures. Understanding how economic policy actually gets made requires charting this institutional architecture.

## The Policy-Making Core

Economic policy emerges from the interaction of a handful of key institutions, co-ordinated (imperfectly) by the White House.

### The Troika

Three agencies form the core of executive branch economic policy-making:

**The Treasury Department** is the primary economic agency, managing federal finances, collecting taxes, enforcing sanctions, and serving as diplomat for the U.S. dollar. The Secretary of the Treasury speaks for the administration on economic matters, negotiates with Congress on fiscal policy, and represents the United States at international economic summits.

Treasury houses several key policy offices: - **Office of Economic Policy**: Macroeconomic analysis and revenue estimation - **Office of Tax Policy**: Develops tax legislation and international tax treaties - **Office of International Affairs**: Manages relations with IMF, World Bank, and currency policy - **Office of Financial Stability**: Created after 2008, monitors systemic risk

With roughly 100,000 employees (80,000+ at the IRS), Treasury is by far the largest economic agency.

**The Office of Management and Budget (OMB)** is the implementation and enforcement arm. OMB constructs the President’s Budget, oversees agency management, and clears regulations before they take effect. The Office of Information and Regulatory Affairs (OIRA) within OMB serves as the “gatekeeper” that reviews significant regulations for cost-benefit compliance—a chokepoint that gives OMB enormous influence over the regulatory state.

**The Council of Economic Advisers (CEA)** serves as the president's internal think tank, providing objective empirical analysis rather than political advocacy. The CEA produces the annual Economic Report of the President and brings academic economic expertise into policy deliberations. Three members (one Chair) are supported by a rotating staff of economists, typically drawn from university faculties on temporary appointments.

## **The National Economic Council**

The **National Economic Council (NEC)**, created by President Clinton in 1993, coordinates economic policy across agencies. The NEC Director serves as an "honest broker," managing the flow of options to the president rather than advocating for particular positions.

Unlike the CEA's analytical focus, the NEC is process-oriented: convening meetings, resolving interagency disputes, and ensuring the president receives clear choices. The NEC's influence depends heavily on the director's relationship with the president and willingness to enforce coordination.

## **The Independent Fed**

The **Federal Reserve** operates outside the executive branch's policy apparatus, conducting monetary policy independently of political direction. The Fed Chair—currently Jerome Powell, whose term extends through May 2026—is arguably the most influential individual economic actor in the country.

The Fed's independence is institutional rather than constitutional: Congress could theoretically restructure or eliminate it. But the norm of Fed independence has become deeply entrenched since the Volcker era, and presidents generally avoid public criticism of monetary policy decisions.

The Fed also serves as the primary regulator of bank holding companies and an important supervisor of large banks, giving it regulatory authority that extends well beyond monetary policy.

## **Data and Statistics**

Economic governance requires data, and the federal statistical system provides it.

**The Bureau of Economic Analysis (BEA)**, housed within the Commerce Department, produces the GDP statistics, trade data, and regional economic accounts that measure the economy. With roughly 370 staff, BEA punches far above its weight—its quarterly GDP releases move markets and shape policy debates worldwide.

**The Census Bureau**, also within Commerce, conducts the decennial census and produces continuous economic statistics: the Economic Census, the Survey of Manufacturers, retail sales data, and housing statistics. With 12,000 employees, Census operates the surveys that underpin most economic measurement.

**The Bureau of Labor Statistics (BLS)**, within the Labor Department, produces employment statistics (the monthly jobs report), inflation measures (CPI), productivity data, and wage statistics. The monthly employment situation release is the most market-moving regular data publication.

These agencies operate with unusual independence for executive branch entities, protected by statistical integrity policies that limit political interference with data collection and publication.

## Regulatory Agencies

Beyond the policy-making core, a constellation of regulatory agencies shapes economic activity through rule-making and enforcement.

### Financial Regulators

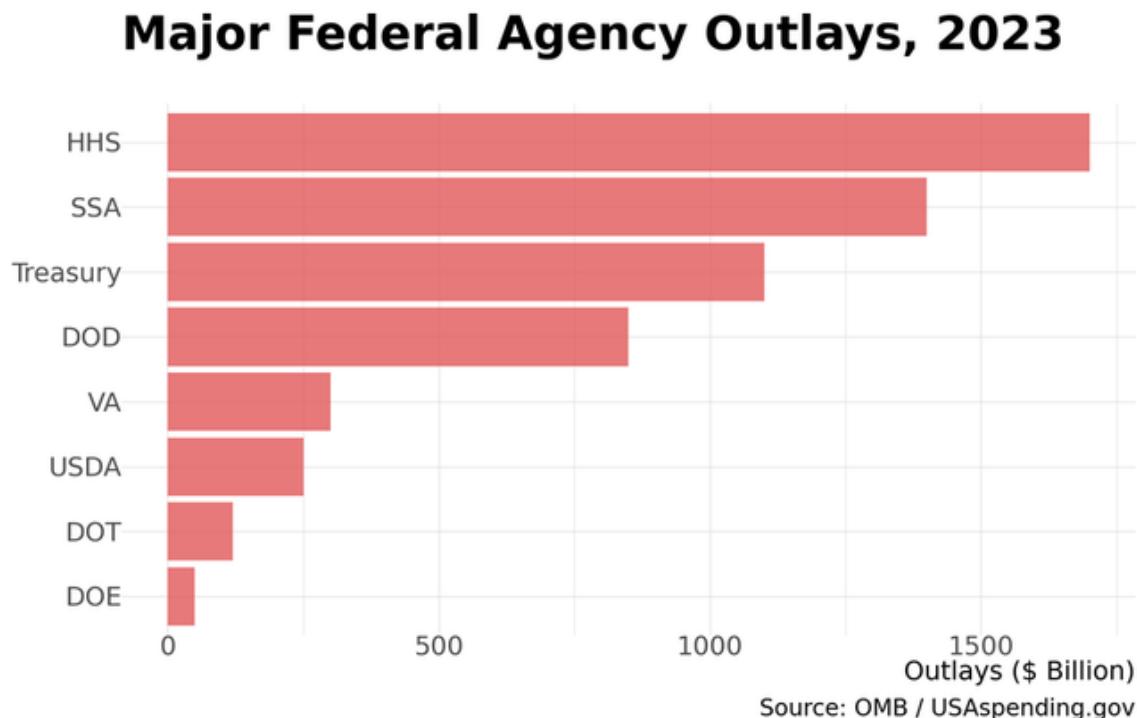


Figure 91: Figure 28.1: Key financial regulatory agency budgets. The FDIC, funded by bank premiums, dwarfs the SEC and other agencies that rely on congressional appropriations. Source: Agency budget documents

### Key Financial Regulatory Agencies (2025)

Agency	Focus	Budget	Staff
FDIC	Bank deposit insurance and resolution	\$3.0 billion	6,900
SEC	Securities markets and investor protection	\$2.6 billion	5,600
OCC	National bank supervision	\$1.4 billion	3,600
CFPB	Consumer financial protection	\$750 million	1,700
CFTC	Derivatives and futures markets	\$400 million	550

Source: Agency budget justifications and congressional appropriations, FY 2025

The **Securities and Exchange Commission (SEC)** regulates securities markets, requiring disclosure from public companies and policing fraud. The SEC's jurisdiction has expanded as capital markets have grown, though its budget has not kept pace—leading to persistent complaints about under-enforcement.

The **Commodity Futures Trading Commission (CFTC)** regulates derivatives markets with a staff roughly one-tenth the size of the SEC's. The CFTC's jurisdiction over cryptocurrency remains contested, with ongoing “turf wars” between SEC and CFTC over which agency should regulate digital assets.

The **Federal Deposit Insurance Corporation (FDIC)** insures deposits and resolves failed banks. Funded by bank premiums rather than congressional appropriations, the FDIC maintains unusual independence. Its resolution authority proved critical during the March 2023 bank stress, when it seized Silicon Valley Bank and Signature Bank over a single weekend.

The **Office of the Comptroller of the Currency (OCC)**, an independent bureau within Treasury, supervises national banks. The **Consumer Financial Protection Bureau (CFPB)**, created after 2008, regulates consumer financial products with funding from Federal Reserve transfers that insulate it from congressional appropriations pressure.

## Other Economic Regulators

The **Federal Trade Commission (FTC)** enforces antitrust law and consumer protection statutes, sharing antitrust authority with the Justice Department's Antitrust Division. The FTC's current leadership has pursued an aggressive enforcement agenda against technology platforms and expanded merger scrutiny.

The **Occupational Safety and Health Administration (OSHA)**, within the Labor Department, sets workplace safety standards. With roughly 2,200 employees covering millions of workplaces, OSHA relies heavily on employer self-compliance and targeted enforcement.

The **Environmental Protection Agency (EPA)**, while not primarily an economic agency, shapes economic activity through environmental regulations affecting energy, manufacturing, transportation, and agriculture.

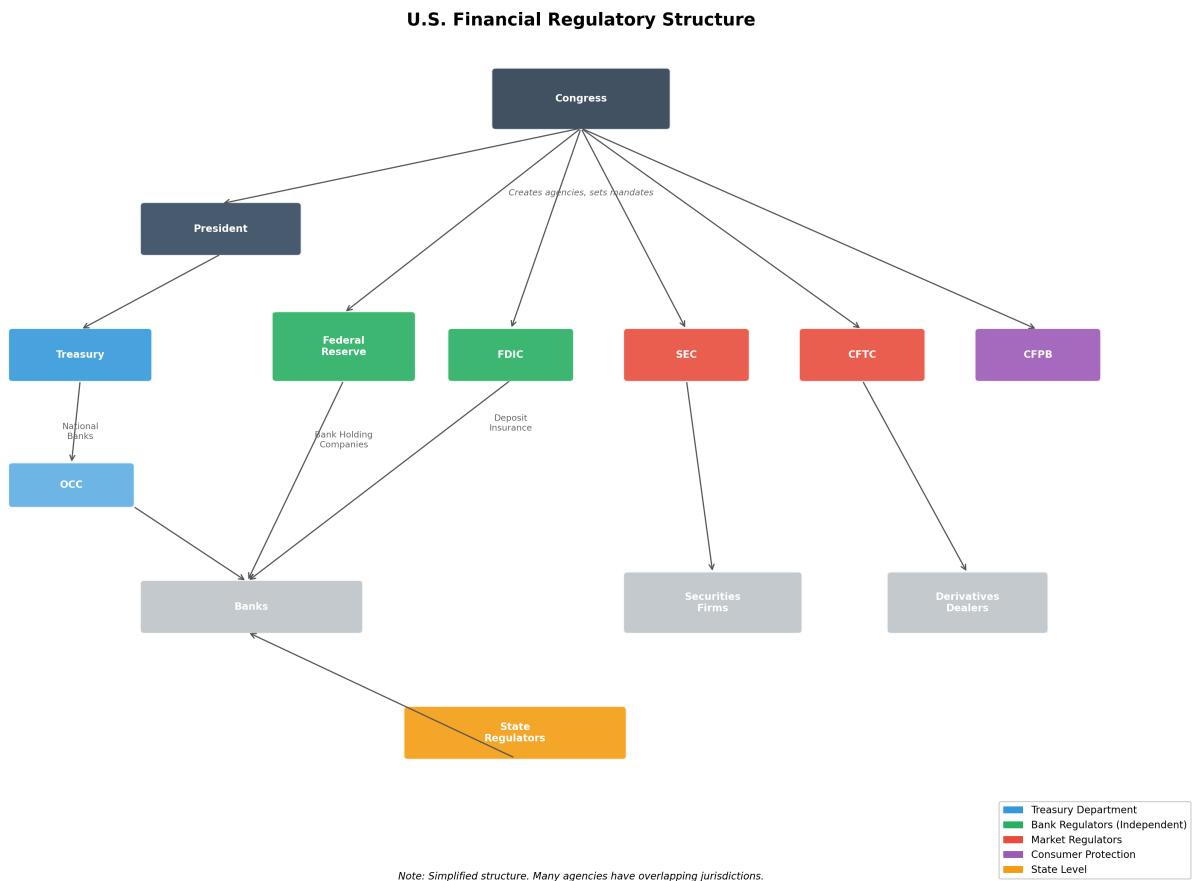


Figure 92: Figure 28.2: U.S. financial regulatory structure. Congress creates agencies with overlapping jurisdictions. The Treasury and Fed share bank supervision with the FDIC and OCC. Securities and derivatives are split between SEC and CFTC. State regulators add another layer. Source: Author synthesis

## The Budget Process

Federal spending flows through an elaborate process that divides into mandatory and discretionary categories.

### Mandatory vs. Discretionary

**Mandatory spending** (roughly 60-65% of the budget) occurs automatically based on eligibility laws. Social Security, Medicare, Medicaid, and interest on the debt require no annual appropriation—spending continues unless Congress changes the underlying statutes. This category grows on autopilot as the population ages and healthcare costs rise.

**Discretionary spending** (roughly 30-35%) requires annual appropriations. Defense spending (roughly \$895 billion in FY 2025) and non-defense discretionary (\$711 billion) must be enacted each year through the appropriations process.

**Net interest** has grown dramatically as debt has accumulated and interest rates have risen, now rivaling defense spending at over \$800 billion annually.

### The Appropriations Cycle

The budget process follows a predictable (if frequently delayed) calendar:

1. **President's Budget (February)**: The administration's proposal, constructed by OMB with agency input
2. **Budget Resolution (April target)**: Congress sets aggregate spending limits
3. **Appropriations (May-September)**: Twelve subcommittees write actual spending bills
4. **Fiscal Year Begins (October 1)**: New appropriations take effect

In practice, this process rarely functions as designed. Congress routinely misses deadlines, funding the government through continuing resolutions that extend prior-year spending levels. Government shutdowns—when funding lapses entirely—have become periodic political weapons.

## The Scorekeepers

Two legislative agencies exercise enormous influence by determining the official cost of legislation.

**The Congressional Budget Office (CBO)** produces the “baseline”—projections of spending and revenue under current law—and “scores” that estimate the cost of proposed legislation. CBO’s roughly 275 staff (mostly PhD economists) operate with scrupulous nonpartisanship; their estimates often determine whether legislation is politically viable.

**The Joint Committee on Taxation (JCT)** serves as the official revenue estimator for tax legislation. Its small, elite staff of lawyers and economists calculates how tax

changes would affect federal revenue—determinations that shape what tax bills can pass under budget reconciliation rules.

**The Government Accountability Office (GAO)**, with 3,400 staff, serves as the “congressional watchdog,” auditing spending and evaluating program performance. GAO reports often surface waste, fraud, and management failures that drive oversight hearings.

## Recent Institutional Developments

### Industrial Policy Coordination

The CHIPS Act and Inflation Reduction Act have created a new institutional challenge: implementing industrial policy at scale. This requires coordination across agencies accustomed to operating independently.

The Commerce Department’s new CHIPS Program Office manages \$52 billion in semiconductor incentives, evaluating applications and negotiating with companies. Treasury administers the IRA’s tax credits for clean energy. The National Economic Council coordinates with the National Security Council on strategic investment decisions.

This represents a significant departure from the market-neutral posture that characterized federal economic policy for decades. The government is now explicitly picking winners—or at least picking sectors—requiring institutional capacities that had atrophied.

### IRS Transformation

The Inflation Reduction Act provided \$80 billion for IRS modernization and enforcement, the largest investment in the agency in decades. The agency has focused on technology upgrades (paperless processing, unified APIs) and increased audits of high-wealth taxpayers.

Implementation has been uneven. A “strategic pause” in 2025 reprioritized technology projects amid budget uncertainty. Political controversy over enforcement priorities continues.

### Regulatory Jurisdiction Disputes

The rapid growth of cryptocurrency and digital assets has exposed jurisdictional gaps and overlaps in the regulatory structure. The SEC claims most crypto tokens are securities requiring registration; the CFTC argues many are commodities subject to its oversight; state regulators assert their own authority.

Legislative clarity remains pending, leaving market participants uncertain about which rules apply and which agency enforces them.

## Institutional Profiles

### The Congressional Budget Office

**Quick Facts** - Established: 1974 - Staff: roughly 275 - Director: Phillip Swagel (since 2019) - Location: Ford House Office Building, Capitol Hill

CBO was created by the Congressional Budget Act of 1974, part of Congress's reassertion of power over the budget process after conflicts with the Nixon administration. The agency provides Congress with independent analysis, free from executive branch spin.

CBO's influence derives from its official status as scorekeeper. A CBO estimate that a bill costs more than expected can kill legislation; a favorable score can make passage possible. This power creates incentives for gaming—designing provisions to minimize official costs even when real-world effects may differ.

The agency has maintained its nonpartisan reputation through multiple administrations, with directors appointed by agreement between House and Senate leadership. Staff turnover is relatively low for government, creating institutional memory and analytical consistency.

### The Federal Reserve Board

**Quick Facts** - Established: 1913 - Board staff: roughly 3,000 - System staff (including regional banks): roughly 23,000 - Chair: Jerome Powell (appointed 2018, reappointed 2022)

The Federal Reserve's institutional design reflects early-20th-century compromises between those who wanted a central bank and those who feared concentrated financial power. The result—a hybrid of public and private governance, with 12 regional Reserve Banks owned by member banks but supervised by the presidentially appointed Board of Governors—is unlike any other central bank.

The Fed's independence has evolved over time. Before the 1951 Treasury-Fed Accord, the Fed accommodated Treasury's financing needs. The Volcker era (1979-1987) established the modern norm of independent monetary policy focused on price stability, even at the cost of recession.

Today's Fed faces expanded responsibilities: monetary policy, bank supervision, financial stability oversight, and payment system operation. The March 2023 bank failures renewed debates about whether these functions should be consolidated or separated.

### The Securities and Exchange Commission

**Quick Facts** - Established: 1934 - Staff: roughly 5,600 - Chair: Gary Gensler (appointed 2021) - Budget: \$2.6 billion

The SEC was created during the New Deal to restore confidence in securities markets after the 1929 crash. Its core mission—requiring disclosure so investors can make informed decisions—has remained constant even as markets have transformed.

The agency operates through five divisions: Corporation Finance (disclosure), Trading and Markets (market structure), Investment Management (funds), Enforcement (violations), and Economic and Risk Analysis (data). Recent priorities have included climate disclosure requirements, cryptocurrency enforcement, and market structure reforms.

The SEC's effectiveness is perpetually debated. Critics argue its disclosure-based approach fails to prevent fraud; defenders note the agency operates with limited resources against a vast, sophisticated industry. Enforcement actions, while numerous, often result in settlements that neither admit nor deny wrongdoing.

## Data Sources and Further Reading

### Key Data Sources

- **OMB Budget Documents:** President's budget, historical tables
- **CBO Publications:** Budget projections, cost estimates, research
- **GAO Reports:** Audits and program evaluations
- **Federal Reserve:** Monetary policy statements, supervision reports

### Further Reading

- Kettl, Donald. Deficit Politics (2020) - Budget process and fiscal policy
- Irwin, Neil. The Alchemists (2013) - Central bank history
- Meltzer, Allan. A History of the Federal Reserve (2003-2010) - Definitive Fed history
- Brookings Institution governance reports

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**Word count:** roughly 2,200 words

Note: For treatment of specific policy areas (taxation, monetary policy, financial regulation), see relevant chapters in Parts II and III.

## Exercises

### Review Questions

1. Identify the three agencies that compose the executive branch's economic policy-making "Troika." For each, explain its primary function and how it differs from the other two. Why does the Office of Information and Regulatory Affairs (OIRA) within OMB serve as a particularly powerful "chokepoint" in the regulatory process?
2. The Federal Reserve's independence is described as "institutional rather than constitutional." What does this distinction mean in practice? Trace the evolution of Fed independence from the pre-1951 Treasury-Fed Accord era through the

Volcker period to the present. Why has the norm of independence become so entrenched despite having no explicit constitutional basis?

3. The chapter describes the federal statistical agencies—BEA, the Census Bureau, and BLS—as operating with “unusual independence for executive branch entities.” Why is statistical independence important for economic governance? What risks would arise if political appointees could influence the timing or methodology of GDP releases or jobs reports?
4. Explain the difference between mandatory and discretionary spending. Why has mandatory spending grown as a share of the federal budget, and what does this imply for Congress’s annual control over fiscal policy? How does the rising share of net interest payments further constrain budgetary flexibility?
5. The CBO and JCT serve as legislative “scorekeepers.” How does a CBO cost estimate determine whether legislation is politically viable, particularly under budget reconciliation rules? What incentives does the scoring process create for legislators to design provisions that minimize official costs even when “real-world effects may differ”?
6. Describe the jurisdictional overlap among the SEC, CFTC, FDIC, OCC, and CFPB in financial regulation. Why has the rapid growth of cryptocurrency exposed gaps and “turf wars” in this structure? What are the advantages and disadvantages of having multiple agencies with overlapping authority versus a single consolidated financial regulator?
7. The CHIPS Act and Inflation Reduction Act represent what the chapter calls “a significant departure from the market-neutral posture” of recent decades. What new institutional capacities does implementing industrial policy at scale require? Why does the chapter suggest these capacities had “atrophied,” and what coordination challenges arise when agencies accustomed to operating independently must work together on targeted investments?

## Data Exercises

1. **Federal Reserve Balance Sheet and Interest Rates.** Using the FRED database (<https://fred.stlouisfed.org>), retrieve the following series: the effective federal funds rate (FEDFUNDS), the Federal Reserve’s total assets (WALCL), and the 10-year Treasury constant maturity rate (DGS10). Plot all three from 2006 to the present. Identify the periods corresponding to quantitative easing, the 2022-2023 tightening cycle, and any rate cuts. Write a one-page memo explaining how the Fed’s balance sheet expansion and contraction relate to its interest rate decisions, and why the 10-year rate does not always move in lockstep with the federal funds rate.
2. **Regulatory Output Over Time.** Visit the Federal Register’s search tool (<https://www.federalregister.gov>) and search for “final rule” documents published by (a) the SEC, (b) the CFPB, and (c) the EPA over the past ten years. Tabulate the number of final rules by agency and by year. Do you observe variation across presidential administrations? Write a brief analysis (300-500 words) discussing whether regulatory output—measured by rule counts—is

a good proxy for regulatory impact, and what other metrics might be more informative.

3. **Comparing Scorekeeper Projections.** Download the most recent CBO Budget and Economic Outlook (available at <https://www.cbo.gov/topics/budget>) and compare its 10-year deficit projections to those published five years earlier. How much have projected deficits changed? Identify the major factors CBO cites for the revision—legislative changes, economic assumptions, or technical adjustments. Using FRED series for federal debt held by the public as a percentage of GDP (FYGFGDQ188S), plot the historical trajectory and overlay CBO's projected path. Discuss whether the trend appears sustainable.

## Deeper Investigation

1. The chapter notes that the IRS received \$80 billion for modernization and enforcement under the Inflation Reduction Act but faced a “strategic pause” and political controversy. Research the current status of IRS modernization efforts: How has the funding been allocated? What technology upgrades have been implemented? How have enforcement priorities shifted across administrations? Drawing on GAO reports (<https://www.gao.gov>), Treasury Inspector General for Tax Administration (TIGTA) audits, and IRS strategic operating plans, write a research paper (1,500–2,000 words) evaluating whether the investment is achieving its stated goals of closing the “tax gap” and improving taxpayer service. Consider both the administrative evidence and the political constraints on sustained implementation.

# **29. Trade Associations and Business Organization**

Walk down K Street in Washington and you pass the headquarters of organized business: the trade associations, lobbying firms, and policy shops where industries coordinate their interests and communicate with government. The U.S. Chamber of Commerce occupies a full block across from the White House. The American Petroleum Institute sits nearby. PhRMA, the pharmaceutical trade group, is a short walk away. This is where the American economy organizes itself politically—part of a broader ecosystem that includes labor unions, consumer advocates, environmental groups, and other interests competing to shape policy.

## **The Business of Influence**

Trade associations exist to solve a collective action problem. Individual firms have interests in common—favorable tax treatment, light regulation, access to markets—but each firm would prefer to free-ride on others' political efforts. Associations pool resources, coordinate strategy, and speak with a unified voice that commands attention.

The scale is enormous. Total federal lobbying spending exceeded \$4.5 billion in 2024. But lobbying registration captures only direct advocacy; the broader “influence industry”—including public relations, grassroots mobilization, and think tank funding—employs over 100,000 people in the Washington area alone.

## **The Big Four Business Associations**

Four organizations dominate cross-sector business representation, each with distinct membership, strategy, and ideological orientation.

### **U.S. Chamber of Commerce**

The Chamber is the world's largest business organization, claiming to represent 3 million businesses through its network of state and local affiliates. Direct corporate membership is smaller but includes most Fortune 500 companies.

## Top Industries by Lobbying Spending

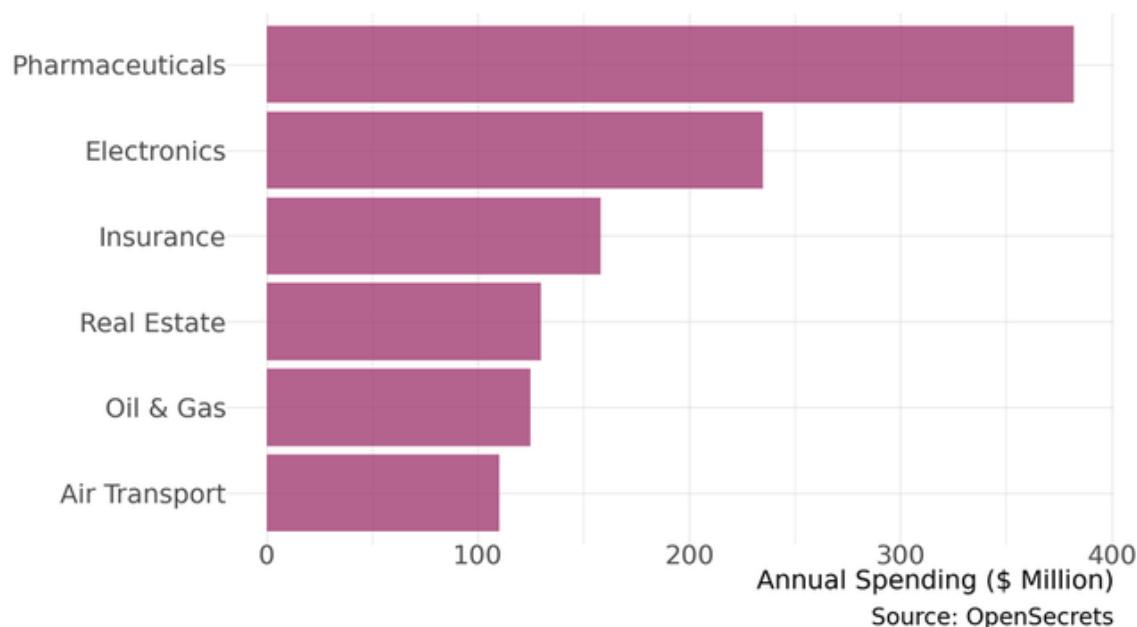


Figure 93: Figure 29.1: Federal lobbying spending has tripled since 2000. Industry groups, trade associations, and corporations compete for political influence. Source: OpenSecrets

**Key Statistics:** - Revenue: \$226 million (2024) - Lobbying spending: \$70-80 million annually (consistently #1 or #2) - Focus: Tax policy, deregulation, legal reform, trade

The Chamber's influence derives from its scale and staying power. While individual companies engage on specific issues, the Chamber maintains permanent capacity across the entire policy landscape. Its positions skew reliably pro-business and generally Republican, though it has occasionally broken with the GOP on immigration and trade.

### **National Association of Manufacturers (NAM)**

NAM represents the industrial sector, with 14,000 member companies (roughly 85% small and medium enterprises). Its focus on manufacturing gives it particular credibility on trade, energy, and labor policy.

**Key Statistics:** - Revenue: \$62 million (2024) - Membership: 14,000 companies - Focus: Tax cuts, regulatory rollback, energy independence

NAM's strength is grassroots mobilization. Factory owners in congressional districts carry political weight that Washington lobbyists cannot match. When NAM activates its members, legislators notice.

### **Business Roundtable**

The Business Roundtable takes a different approach: exclusive membership limited to CEOs of leading companies. With roughly 200 members, it offers high-level access rather than grassroots scale.

**Key Statistics:** - Membership: roughly 200 CEOs - Lobbying spending: \$24 million (first nine months of 2024—a record) - Focus: Corporate governance, trade, workforce development

The Roundtable's 2019 "Statement on the Purpose of a Corporation"—moving slightly away from pure shareholder primacy toward stakeholder considerations—generated headlines but limited policy impact. The organization remains focused on traditional C-suite priorities.

### **National Federation of Independent Business (NFIB)**

NFIB represents small business with a heavily Republican ideological orientation. Its "Key Vote" alerts—signaling that a vote will affect endorsement decisions—are feared by legislators in competitive districts.

NFIB has increasingly turned to litigation, filing lawsuits challenging regulations affecting small business. Its legal challenges to the Affordable Care Act, OSHA mandates, and other policies have reached the Supreme Court.

## Industry-Specific Associations

While the Big Four represent business generally, industry-specific associations often outspend them on issues affecting their sectors.

### Major Industry Associations (2024)

Association	Industry	Lobbying Spending	Membership
NAR	Real estate	\$86 million	1.49 million
PhRMA	Pharmaceuticals	\$30 million	37 companies
AMA	Physicians	\$25 million	Physicians
AHIP	Health insurers	\$9 million	100+ payers
API	Oil and gas	\$8-10 million	600 companies
ABA	Lawyers	\$3 million	400,000
NAHB	Home builders	\$3-4 million	140,000

Source: OpenSecrets.org, Lobbying Database, 2024

### The National Association of Realtors

NAR is the “sleeping giant” of the lobbying world. With 1.49 million members—real estate agents in virtually every congressional district—and \$86 million in annual lobbying spending, NAR wields unmatched political influence on housing policy.

NAR’s priorities include protecting the mortgage interest deduction, maintaining favorable capital gains treatment for home sales, and opposing policies that might reduce transaction volumes. The association’s political action committee is consistently among the largest, contributing to candidates of both parties.

The 2024 antitrust settlement requiring changes to NAR’s commission practices may reshape the organization, but its political apparatus remains formidable.

### PhRMA

The Pharmaceutical Research and Manufacturers of America represents brand-name drug companies. PhRMA’s \$30 million in disclosed lobbying is supplemented by advertising campaigns, support for patient advocacy groups, and funding for policy research.

PhRMA’s core mission is maintaining the pricing environment that funds pharmaceutical R&D. The industry argues that high U.S. prices subsidize the risky, expensive research that produces new treatments, and that price controls would reduce innovation. Critics counter that prices exceed what innovation requires, that much basic research is publicly funded, and that other countries with lower prices still produce pharmaceutical breakthroughs. When Congress debates Medicare negotiation, importation, or reference pricing, both sides mobilize. The Inflation Reduction Act’s Medicare negotiation provisions represented the first major change to pharmaceutical pricing policy in decades.

## **The American Medical Association**

The AMA represents physicians, though its membership has declined from near-universal to roughly one-third of practicing doctors. The association's primary policy focus is maintaining adequate Medicare reimbursement rates and advocating on scope-of-practice issues.

The AMA also plays significant roles in medical education (accrediting medical schools), specialty board certification, and clinical guidelines. The organization argues these functions protect patient safety and maintain professional standards. Critics contend that some activities—particularly restrictions on medical school capacity and scope-of-practice limitations on nurse practitioners—restrict competition and contribute to physician shortages and high healthcare costs. As with most professional associations, the line between quality assurance and occupational protection is contested.

## **How Trade Associations Function**

### **Lobbying and Information Provision**

Direct lobbying—meeting with legislators and staff, testifying at hearings, providing information and analysis—remains the core function. Associations maintain permanent lobbying operations, supplemented by contract lobbyists hired for specific campaigns.

Much of this work involves genuine information provision. Legislators writing laws for complex industries—pharmaceuticals, energy, financial services—often lack the technical expertise to anticipate how rules will work in practice. Trade associations aggregate knowledge from thousands of member companies, identifying implementation problems, unintended consequences, and practical alternatives that regulators might not consider. A congressional staffer drafting legislation on drilling safety standards benefits from hearing from engineers who actually operate drilling equipment.

This informational role is why lobbying persists despite public skepticism. Associations provide what political scientists call “legislative subsidy”—research, bill language, talking points, and technical analysis that understaffed congressional offices need. A lobbyist who provides genuinely useful information gets meetings; one who wastes time or misleads does not get invited back. The challenge for policymakers is weighing industry expertise, which is real, against industry interests, which inevitably color that expertise.

### **Standards and Self-Regulation**

Many associations set industry standards that carry quasi-regulatory force. The American Petroleum Institute's standards for drilling equipment, the National Fire Protection Association's electrical codes, and the American National Standards Institute's certification processes shape industry practice without government mandate.

These standards often provide genuine public benefits. The NFPA's National Electrical Code has prevented countless fires and electrocutions since 1897. API's equip-

ment standards improve safety on oil rigs. Underwriters Laboratories' product certification helps consumers identify safe appliances. Industry practitioners often understand risks and best practices better than government regulators, and voluntary standards can adapt more quickly than legislation.

Self-regulation also serves industry interests: it can preempt potentially stricter government rules, signal responsibility to skeptical publics, and create compliance frameworks that established firms navigate more easily than newcomers. The balance between public benefit and industry advantage varies by sector and standard. Building codes genuinely save lives; some professional licensing requirements may primarily restrict competition.

## **Research and Analysis**

Associations produce research on their industries—economic impact studies, regulatory cost analyses, workforce surveys, and technical reports. This research serves advocacy purposes but also fills genuine information gaps. Government statistical agencies cannot track every industry in detail; trade association data on employment, production, and business conditions often provides the best available picture of specific sectors.

The challenge is that industry-funded research inevitably reflects funder perspectives. Studies on regulatory costs rarely emphasize regulatory benefits; economic impact analyses tend toward optimistic assumptions. Think tanks receiving association funding may produce rigorous work, but their research agendas and conclusions often align with funder interests. Policymakers and journalists must weigh industry expertise against industry incentives—taking the data seriously while reading the framing critically.

This “knowledge production” function has grown as policy debates have become more technical. Associations that can provide credible data and analysis shape how issues are understood, which matters as much as direct advocacy.

## **Legal Challenges**

Litigation has become an increasingly important tool. Business associations file lawsuits challenging regulations, seeking to invalidate rules in court rather than through the legislative process. The Supreme Court’s increasing skepticism of agency authority has made this strategy more promising.

NFIB’s challenges to the ACA and vaccine mandates, the Chamber’s challenges to environmental regulations, and tech industry challenges to content moderation rules all reflect this litigation-first approach.

# Political Spending

## The Money Flow

Business political spending takes multiple forms, each with different rules and disclosure requirements:

**Political Action Committees (PACs)** collect voluntary contributions from employees and shareholders, contributing directly to candidates. Contributions are capped (\$5,000 per candidate per election) and fully disclosed.

**Super PACs** accept unlimited contributions but cannot coordinate with candidates. They fund independent expenditure campaigns—typically advertising.

**501(c)(4) organizations** (social welfare groups) can engage in political activity without disclosing donors, creating “dark money” that has exploded in recent cycles. An estimated \$1.9 billion in undisclosed spending shaped the 2024 election.

**501(c)(6) organizations** (trade associations themselves) can lobby without limit and engage in some political activity, with partial disclosure requirements.

## Undisclosed Political Spending

The shift from transparent PAC contributions to spending through organizations that need not disclose donors represents a significant change in political organization. Spending through 501(c)(4) social welfare organizations and other vehicles that do not require donor disclosure grew substantially after the Supreme Court’s Citizens United decision in 2010. An estimated \$1.9 billion in undisclosed spending shaped the 2024 election cycle.

Trade associations have become one channel for this spending. A company contributing to a 501(c)(4) affiliated with an industry association can support political activity without the public association that direct corporate political engagement would bring. Defenders argue this protects companies from boycotts and harassment over political views; critics argue it undermines democratic accountability by hiding who funds political messages.

# The Policy Infrastructure

## Think Tanks

Think tanks provide the intellectual framework that makes lobbying effective. A policy proposal with academic imprimatur and detailed analysis commands more attention than naked advocacy.

### Major Think Tanks

Organization	Orientation	Budget (2024)
Heritage Foundation	Conservative	\$134 million
Brookings Institution	Centrist/Liberal	\$109 million

Organization	Orientation	Budget (2024)
Cato Institute	Libertarian	\$80 million
American Enterprise Institute	Conservative	\$68 million

Source: OpenSecrets.org, Lobbying Database, 2024

Heritage has been particularly influential in staffing Republican administrations; “Project 2025” represented an ambitious attempt to pre-plan personnel and policy for a second Trump term. Brookings provides the establishment center-left counterpart, supplying officials and analysis to Democratic administrations.

The line between think tank and advocacy organization has blurred. Many policy shops receive substantial industry funding and produce research that reliably supports funder interests, while maintaining the form of independent scholarship.

## Geographic Concentration

The influence industry concentrates geographically. “K Street” remains shorthand for lobbying, though actual firms have dispersed to surrounding neighborhoods. “Think Tank Row” along Massachusetts Avenue NW hosts policy organizations.

The Washington suburbs—particularly Northern Virginia and suburban Maryland—house the operational infrastructure: the association headquarters, the PR firms, the data analytics shops. This geographic concentration facilitates the personal relationships that make influence effective.

## Association Profiles

### U.S. Chamber of Commerce

**Quick Facts** - Headquarters: 1615 H Street NW, Washington (across from the White House) - Founded: 1912 - Revenue: \$226 million - Staff: roughly 500

The Chamber’s location—directly across Lafayette Square from the White House—symbolizes its centrality to American business politics. The building itself, completed in 1925, was designed to project permanence and authority.

The organization operates through a federated structure, with state and local chambers affiliating nationally. This provides both grassroots reach and insulation—local chambers can diverge from national positions, and the national Chamber can claim to speak for “Main Street” while primarily serving Fortune 500 interests.

The Chamber’s effectiveness has been questioned in recent years. Its positions on climate, immigration, and election integrity have created tensions with Republican politicians who are its natural allies. Some major companies have publicly distanced themselves from Chamber positions.

## National Association of Realtors

**Quick Facts** - Headquarters: Chicago (association), Washington (lobbying)  
- Founded: 1908 - Membership: 1.49 million - Revenue: \$350+ million (dues and related)

NAR operates differently from most trade associations because membership is effectively required for practicing real estate agents. Agents must join local, state, and national associations to access the Multiple Listing Service (MLS) databases that are essential to their business.

This membership structure provides resources unavailable to voluntary associations. NAR's political action committee, RPAC, is funded through assessments included with dues, creating a political operation with scale that few organizations can match. The association argues this structure allows it to effectively represent agent interests; critics note that members have limited choice about their political contributions.

The 2024 antitrust settlement, requiring changes to commission disclosure and structure, threatens this model. If commission rates fall and agent numbers decline, NAR's membership—and political power—could shrink significantly.

## PhRMA

**Quick Facts** - Headquarters: Washington, D.C. - Founded: 1958 (as PMA; renamed 1994) - Membership: 37 companies - Lobbying: \$30+ million disclosed; total spending far higher

PhRMA represents the brand-name pharmaceutical industry with resources that reflect the stakes involved. U.S. drug prices—often multiples of prices in other developed countries—are central to the industry's business model and a persistent source of political controversy.

The association's strategy combines direct lobbying with broader communications. Patient advocacy groups (some receiving PhRMA funding) argue that price controls would delay access to new treatments; advertising campaigns emphasize the industry's role in developing vaccines, cancer treatments, and other breakthroughs. Industry-funded researchers produce studies on innovation economics, while critics commission competing analyses. The debate involves genuine complexity: pharmaceutical R&D is expensive and risky, but the relationship between prices and innovation is contested.

PhRMA has been largely successful at maintaining the pricing status quo, though the Inflation Reduction Act's Medicare negotiation provisions marked a significant policy shift.

## Data Sources and Further Reading

### Key Data Sources

- **OpenSecrets**: Lobbying disclosure, campaign finance
- **ProPublica Nonprofit Explorer**: Association financials

- **Senate Lobbying Disclosure Act Database:** Quarterly reports
- **FEC:** Campaign contribution data

## **Further Reading**

- Drutman, Lee. *The Business of America Is Lobbying* (2015) - comprehensive analysis of the growth of business lobbying
  - Baumgartner, Frank et al. *Lobbying and Policy Change* (2009) - empirical study finding lobbying less decisive than commonly assumed
  - Hacker, Jacob and Paul Pierson. *Winner-Take-All Politics* (2010) - argues business organization shifted policy rightward
  - Vogel, David. *Fluctuating Fortunes* (1989) - historical account showing business political influence waxes and wanes
  - Hall, Richard and Alan Deardorff. “*Lobbying as Legislative Subsidy*” (2006) - influential article on lobbying’s informational role
- 

**Word count:** roughly 2,200 words

Note: For treatment of specific regulatory agencies and policy areas, see relevant chapters in Part II and Chapter 28.

## **Exercises**

### **Review Questions**

1. The chapter identifies a “collective action problem” that trade associations exist to solve. Using the logic of free-riding, explain why individual firms would underinvest in political advocacy without an association to coordinate their efforts. How does the National Association of Realtors’ effectively mandatory membership structure (through MLS access) solve this problem differently than the voluntary membership model used by most other associations?
2. Compare and contrast the strategic approaches of the four major cross-sector business associations: the U.S. Chamber of Commerce, the National Association of Manufacturers, the Business Roundtable, and the NFIB. How does each organization’s membership base—Fortune 500 corporations, manufacturers, CEOs, or small businesses—shape its policy priorities and tactics? Which organization is best positioned to influence (a) congressional committee hearings and (b) grassroots voter pressure, and why?
3. The chapter describes lobbying as providing “legislative subsidy”—research, bill language, talking points, and technical analysis that understaffed congressional offices need. Evaluate this framing. Under what conditions does industry expertise genuinely improve policy outcomes? Under what conditions does the informational asymmetry between lobbyists and legislators distort policy in favor of industry interests? Use the PhRMA example to illustrate both sides of the argument.

4. Explain the differences among PACs, Super PACs, 501(c)(4) organizations, and 501(c)(6) organizations in terms of contribution limits, coordination rules, and disclosure requirements. Why has spending shifted toward vehicles with less disclosure since the Citizens United decision? What does the estimated \$1.9 billion in undisclosed spending in the 2024 cycle imply for democratic accountability?
5. The chapter notes that industry associations set standards—such as API drilling equipment standards and NFPA electrical codes—that carry “quasi-regulatory force.” Identify the public benefits and the potential anti-competitive effects of industry self-regulation. Under what circumstances might self-regulation serve as a genuine alternative to government regulation, and when might it primarily function to preempt stricter rules or to raise barriers to entry for new competitors?
6. How has litigation become an increasingly important tool for business associations? Cite specific examples from the chapter (NFIB challenges to the ACA, Chamber challenges to environmental regulations) and explain why the Supreme Court’s “increasing skepticism of agency authority” has made this strategy more promising. What are the implications for the regulatory state if courts routinely overturn agency rules at the behest of trade association plaintiffs?
7. The chapter describes the blurring line between think tanks and advocacy organizations. Using the table of major think tanks (Heritage Foundation, Brookings, Cato, AEI), explain how industry funding may shape research agendas without necessarily producing “wrong” conclusions. Why is the distinction between independent scholarship and funded advocacy important for the quality of policy debate?

## Data Exercises

1. **Lobbying Concentration by Industry.** Using the OpenSecrets lobbying database (<https://www.opensecrets.org/federal-lobbying>), download lobbying expenditure data by industry sector for the most recent five years. Calculate each sector’s share of total federal lobbying spending and rank the top ten industries. Then compare the top lobbying spenders to the top industries by GDP contribution (available from BEA industry accounts at <https://www.bea.gov/data/gdp/gdp-industry>). Are the biggest industries also the biggest lobbying spenders, or do some industries lobby disproportionately relative to their economic size? Write a one-page analysis discussing what explains the discrepancies—regulatory exposure, government contracting, tax policy stakes, or other factors.
2. **Tracking a Trade Association’s Influence.** Select one industry-specific association from the chapter’s table (NAR, PhRMA, AMA, API, or NAHB). Using OpenSecrets (<https://www.opensecrets.org>), compile the following data for 2020–2024: (a) annual lobbying expenditures, (b) PAC contributions by party, and (c) the top ten recipients of PAC contributions by chamber of Congress. Then identify two or three major pieces of legislation during this period that directly affected the association’s industry. Write a brief report (500–750 words)

assessing whether the association's spending patterns—which legislators received the most, on which committees they sat—suggest strategic targeting of lawmakers with jurisdiction over the relevant policy areas.

3. **Dark Money Trends.** Using OpenSecrets' Outside Spending data (<https://www.opensecrets.org/spending>) and the ProPublica Nonprofit Explorer (<https://projects.propublica.org/nonprofits/>), compare disclosed and undisclosed political spending in the 2016, 2020, and 2024 election cycles. What share of total outside spending came from organizations that do not disclose their donors? Identify two or three 501(c)(4) organizations with the largest expenditures and, using their IRS Form 990 filings on ProPublica, examine their stated missions and revenue sources. Discuss whether the available data allow you to determine who ultimately funded these organizations' political activities.

## **Deeper Investigation**

1. The chapter describes PhRMA's argument that high U.S. drug prices "subsidize the risky, expensive research that produces new treatments" while critics counter that "prices exceed what innovation requires." Design a research project to evaluate this claim. What data would you need on pharmaceutical R&D spending (including publicly funded basic research via NIH), drug pricing across countries, and innovation output (new molecular entities approved by the FDA)? Identify specific data sources—NIH Reporter (<https://reporter.nih.gov>), FDA drug approval databases (<https://www.fda.gov/drugs>), OECD health statistics, and PhRMA's own annual reports—and outline a methodology for testing whether the relationship between U.S. pricing and global pharmaceutical innovation is as strong as the industry claims. What confounding factors would complicate your analysis?

# **30. Labor Markets and the Workforce**

In September 2023, the United Auto Workers launched a strike against all three Detroit automakers simultaneously—a first in the union’s history. By November, they had won a 25% wage increase, restored cost-of-living adjustments lost in 2008, and eliminated the two-tier wage system that had divided their membership. The strike reminded Americans that organized labor, though diminished, retains the capacity to reshape industries.

## **The State of Organized Labor**

Union membership has declined for decades, from roughly 35% of private-sector workers in the 1950s to under 6% today. The total union membership rate—including public sector workers, where unions remain strong—stands at 9.9%, representing 14.3 million workers.

### **Union Membership Trends**

Year	Total Rate	Private Sector	Public Sector
1983	20.1%	16.8%	36.7%
2000	13.4%	9.0%	37.5%
2024	9.9%	5.9%	32.2%

Source: Bureau of Labor Statistics, Union Members Summary, 2024

The divergence between sectors tells the story. Public-sector workers—teachers, firefighters, government employees—maintain union representation at six times the private-sector rate. Private-sector decline reflects deindustrialization, employer resistance, and legal changes that have made organizing increasingly difficult.

## **The Major Unions**

### **Teachers and Public Employees**

The largest unions today represent public-sector workers.

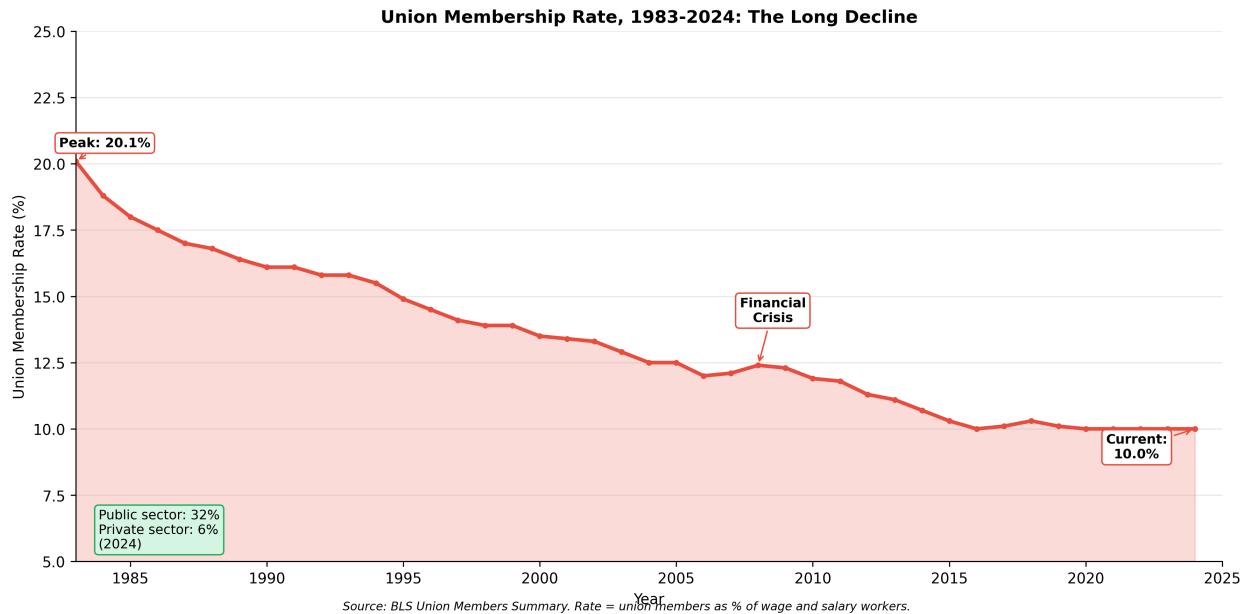


Figure 94: Figure 30.1: Union membership rate, 1983-2024. The long decline from 20% to 10% reflects deindustrialization, employer resistance, and legal changes favoring management. Source: BLS Union Members Summary

**The National Education Association (NEA)**, with roughly 3 million members, is the largest union in the country. It represents public school teachers, administrators, and support staff. The NEA's political operation is formidable; its endorsement carries weight in Democratic primaries, and its members provide campaign volunteers.

**The American Federation of Teachers (AFT)**, with 1.7 million members, is the NEA's smaller counterpart, stronger in urban districts and representing nurses and higher education faculty alongside K-12 teachers.

**AFSCME** (American Federation of State, County and Municipal Employees) represents 1.6 million public-sector workers: clerical staff, corrections officers, social workers, and other government employees. Public-sector unions face different dynamics than private-sector counterparts; their employer is the government, making collective bargaining inherently political.

## Service and Healthcare Workers

**The Service Employees International Union (SEIU)**, with roughly 2 million members, represents the diverse low-wage service economy: hospital workers, janitors, security guards, home health aides. SEIU pioneered the “corporate campaign” strategy—pressuring employers through public relations, shareholder activism, and political action rather than traditional workplace organizing.

**The United Food and Commercial Workers (UFCW)**, with 1.3 million members, represents grocery workers, meatpackers, and retail employees. UFCW’s contracts cover workers at Kroger, Albertsons, and other major grocery chains. The union has

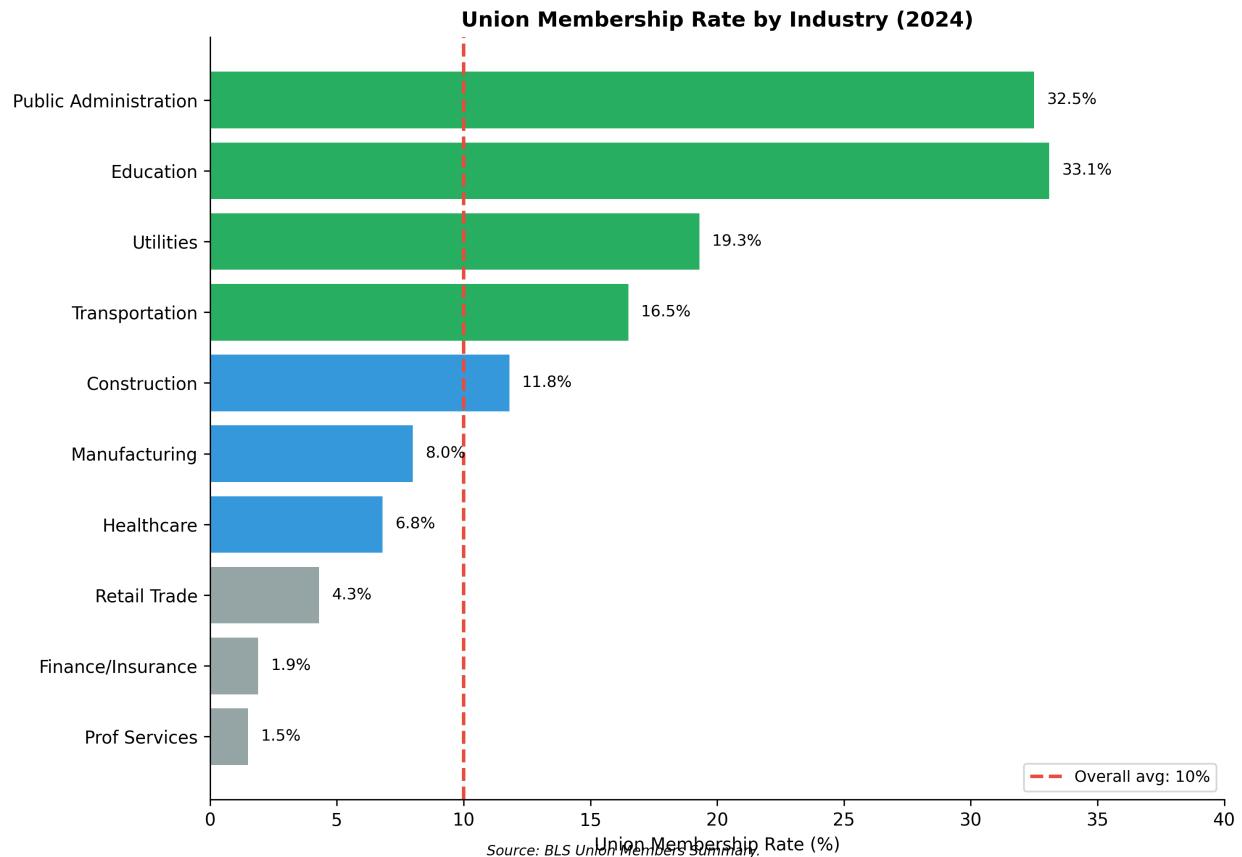


Figure 95: Figure 30.2: Union membership rate by industry (2024). Education and public administration remain heavily unionized; private-sector services like retail and finance have minimal union presence. Source: BLS

also organized cannabis dispensary workers as that industry has expanded.

## Industrial Unions

The traditional industrial unions—once the heart of the labor movement—have shrunk with the industries they represent but remain significant.

**The United Auto Workers (UAW)**, despite representing only 375,000 workers (down from over a million in the 1970s), demonstrated renewed militancy in its 2023 strike. The union has expanded beyond automotive manufacturing to represent graduate students at universities, diversifying its membership base.

**The United Steelworkers (USW)**, with 850,000 members, has similarly diversified, representing workers in steel, aluminum, tire and rubber, oil refining, and paper production.

**The International Brotherhood of Teamsters**, with 1.25 million members, represents logistics workers—truckers, warehouse employees, UPS drivers. The Teamsters' 2023 UPS contract, covering 340,000 workers, eliminated two-tier wage classifications and secured substantial wage increases.

## Building Trades

The construction unions maintain relatively high membership within their sector, benefiting from apprenticeship systems that control labor supply and infrastructure spending that creates demand.

**The International Brotherhood of Electrical Workers (IBEW)**, with 860,000 members, represents electricians in construction and utilities. **The United Brotherhood of Carpenters** represents 441,000 members in commercial and residential construction.

These unions operate through hiring halls that dispatch workers to jobs, giving unions control over labor supply that most private-sector unions have lost.

## Union Federations

### AFL-CIO

The **AFL-CIO** (American Federation of Labor and Congress of Industrial Organizations) serves as the primary federation of American unions, coordinating political action and providing services to affiliated unions. The federation itself does not bargain contracts; that remains the province of member unions.

The AFL-CIO's political operation mobilizes union members for elections, with door-knocking and voter contact that complements financial contributions. Union households remain significantly more likely to vote Democratic than non-union households in similar demographic categories.

## The Change to Win Episode

In 2005, several large unions—including SEIU and the Teamsters—split from the AFL-CIO to form **Change to Win**, arguing the federation was too focused on politics and too little on organizing new members.

The experiment largely failed. Change to Win never developed the capacity its founders envisioned. Most member unions drifted back toward the AFL-CIO—though the Teamsters left in 2022 to become independent rather than rejoin. SEIU's 2025 announcement that it would return to the federation effectively ended Change to Win as a significant entity.

## How Unions Function

### Collective Bargaining

The core union function is negotiating contracts with employers. The process follows a standard pattern:

1. **Preparation:** The union surveys members about priorities, analyzes the employer's financial position, and drafts proposals.
2. **Negotiation:** Representatives of union and management meet, exchanging proposals and counterproposals. The National Labor Relations Act requires both sides to bargain "in good faith," though what this means is contested.
3. **Tentative Agreement:** When negotiators reach a deal, they present a "tentative agreement" (TA) to union leadership.
4. **Ratification:** Members vote to accept or reject the contract. Rejection sends negotiators back to the table.

Contracts typically cover wages, benefits, work rules, grievance procedures, and job security provisions. Most run three to five years, with periodic reopeners on specific issues.

### The Strike

When bargaining fails, unions can strike—withdrawing labor to pressure employers. Strikes are relatively rare (most contracts settle without work stoppages) but remain labor's ultimate weapon.

**Economic strikes**—walkouts over wages and conditions—allow employers to hire permanent replacement workers, though few do so for skilled labor. **Unfair labor practice strikes**—protesting illegal employer conduct—provide stronger legal protections; employers cannot permanently replace ULP strikers.

Strikes impose costs on both sides. Workers forgo wages (union strike funds provide partial support); employers lose production and risk customer defection. The mutual pain creates incentives for settlement.

## The Legal Framework

The **National Labor Relations Board (NLRB)** administers federal labor law for most private-sector workers. The Board conducts union representation elections, investigates unfair labor practices, and adjudicates disputes.

The NLRB's composition—five members appointed by the president—means its decisions shift with administrations. Democratic boards have generally expanded worker organizing rights; Republican boards have restricted them. This policy instability creates uncertainty for both unions and employers.

**Right-to-work laws** in 26 states prohibit union security agreements—provisions requiring workers to pay union dues as a condition of employment. In right-to-work states, unions must represent all workers in a bargaining unit but cannot compel non-members to contribute. This creates free-rider problems that weaken union finances.

Michigan's 2024 repeal of its right-to-work law—the first such repeal in decades—signaled potential change, but most right-to-work states show no signs of following.

## Recent Labor Actions

### The UAW Stand Up Strike (2023)

The UAW's strike against General Motors, Ford, and Stellantis employed a novel strategy: rather than striking all plants at once, the union "stood up" targeted facilities sequentially, keeping employers uncertain about which plants would be hit next.

**Key Outcomes:** - 25% wage increase over the contract term - Cost-of-living adjustments restored (eliminated in 2008 concessions) - Two-tier wage system eliminated (new hires reach top pay in three years) - Right to strike over future plant closures - Battery plant workers brought under the master agreement

The strike demonstrated that industrial unions could still win significant gains when conditions were favorable: tight labor markets, strong consumer demand, and record corporate profits.

### UPS Teamsters (2023)

The Teamsters' UPS contract—the largest private-sector collective bargaining agreement, covering 340,000 workers—settled without a strike after the union authorized a walkout.

**Key Outcomes:** - \$7.50/hour wage increase over five years - Minimum \$21/hour for part-time workers - Air conditioning in new vehicles; heat shields in existing trucks - Elimination of the "22.4" two-tier driver classification

The threat of a strike during peak summer shipping season gave the Teamsters leverage; UPS could not afford a work stoppage that would redirect packages to FedEx and Amazon.

## New Organizing

Beyond traditional strongholds, unions have attempted to organize workers in sectors with little union history.

**Starbucks Workers United** has organized over 500 stores since 2021, representing roughly 11,000 workers. But no first contract has been reached; Starbucks has contested elections, challenged certification, and bargained slowly. The gap between winning an election and achieving a contract illustrates the limits of current labor law.

**Amazon Labor Union** won a surprise victory at Staten Island's JFK8 warehouse in 2022. Amazon has refused to bargain, challenging the election results through legal proceedings. In 2024, ALU affiliated with the Teamsters, seeking resources and leverage to force Amazon to the table.

These campaigns have generated publicity and worker interest but limited concrete gains. Organizing without achieving contracts leaves workers without representation.

## Alt-Labor and Worker Centers

Outside the traditional union framework, **worker centers** organize low-wage and immigrant workers who face barriers to formal unionization.

Worker centers are typically nonprofit organizations—legally distinct from unions—that provide services, conduct advocacy, and pressure employers without negotiating contracts. Because they are not “labor organizations” under the NLRA, they can engage in tactics (like secondary boycotts) prohibited for unions.

**Examples include:** - **Restaurant Opportunities Centers (ROC-United)**: Restaurant worker advocacy - **NDLON (National Day Laborer Organizing Network)**: Day laborer rights - **Fight for \$15**: Minimum wage campaign (SEIU-backed)

Worker centers fill gaps in the labor movement but cannot substitute for the economic leverage that comes from representing workers in collective bargaining.

## The Gig Economy and Worker Misclassification

A structural challenge facing organized labor extends beyond declining unionization: the growing share of workers classified as independent contractors rather than employees. This “gig economy” or “1099 economy” has permeated virtually every sector of the American economy.

### Scale and Scope

Estimates vary, but roughly 36% of American workers participate in some form of gig work, though only 10-15% rely on it as primary income. The phenomenon extends far beyond the ride-share and delivery apps that dominate public perception:

- **Transportation:** Uber and Lyft drivers (roughly 2 million), DoorDash and Instacart delivery workers
- **Healthcare:** Travel nurses (agencies provide “gig-like” flexibility), home health aides, locum tenens physicians
- **Construction:** Day laborers, specialty subcontractors who cycle between jobs
- **Professional Services:** Consultants, freelance accountants, contract lawyers
- **Education:** Adjunct faculty (now 70%+ of college instructors), substitute teachers
- **Media and Tech:** Freelance journalists, contract software developers, content moderators

## **Why Classification Matters**

Independent contractors lack access to:

- Minimum wage and overtime protections (Fair Labor Standards Act)
- Unemployment insurance
- Workers’ compensation
- Employer-provided health insurance and retirement contributions
- The right to organize under the NLRA

For employers, 1099 classification can reduce labor costs by 20-30%—eliminating payroll taxes, benefits, and legal obligations. This creates powerful incentives to structure work as “independent contracting” even when the functional reality resembles employment.

## **Legal Battles**

The definition of “employee” versus “contractor” has become a central labor policy battleground. California’s AB5 (2019) attempted to reclassify gig workers as employees, but ride-share companies spent \$200 million on Proposition 22 (2020) to exempt themselves, creating a special category of “app-based workers” with some benefits but not employee status.

The federal standard remains contested. The Biden administration’s Department of Labor issued a rule tightening independent contractor classification; its durability under subsequent administrations is uncertain. The PRO Act, supported by unions, would codify the stricter “ABC test” for contractor status under federal labor law.

## **Implications for Organizing**

Gig work poses fundamental challenges for traditional unionism. Workers are dispersed, often work for multiple platforms simultaneously, and lack a stable workplace where organizing can occur. Some unions have adapted: SEIU has organized home care workers classified as contractors; the Teamsters have affiliated with the Amazon Labor Union. But the 1099 model structurally undermines the assumptions of New Deal labor law, which presumed stable employment relationships at fixed locations.

The growth of gig work represents not just a legal classification issue but a broader restructuring of the employment relationship—shifting risk from employers to workers while reducing the leverage that comes from collective action.

## **Political Activity**

Unions remain significant political actors, though their influence has declined with membership.

**Political Spending:** Unions spent an estimated \$280 million or more in the 2024 election cycle, overwhelmingly supporting Democratic candidates. But union political influence extends beyond spending; the mobilization of union members for door-knocking and voter contact provides campaign resources that money cannot directly buy.

**Policy Priorities:** Union political agendas include raising the minimum wage, strengthening labor law (the PRO Act), protecting public-sector bargaining rights, and opposing trade agreements that threaten union jobs. Unions also advocate on broader issues—healthcare, retirement security, education funding—that affect their members.

**Declining Leverage:** As membership has shrunk, so has political influence. Unions remain important within the Democratic coalition but cannot command the policy outcomes they once did. The failure of labor law reform in multiple Democratic administrations—despite union support being essential to Democratic electoral success—illustrates the limits.

## **Union Profiles**

### **United Auto Workers**

**Quick Facts** - Founded: 1935 - Membership: 375,000 - President: Shawn Fain (elected 2023) - Headquarters: Detroit, MI

The UAW's history parallels American industrial history. The union emerged from the sit-down strikes of the 1930s, built the middle class through the postwar decades, and declined with deindustrialization from the 1970s onward.

The 2023 strike represented a turning point. Under President Shawn Fain—elected on a reform slate after a corruption scandal tarnished previous leadership—the union adopted a more confrontational posture than it had shown in decades. The “Stand Up” strategy, the simultaneous targeting of all three automakers, and the explicit framing of the strike as class conflict marked a departure from the collaborative approach that had characterized recent UAW bargaining.

The union’s expansion into higher education—representing graduate student workers at NYU, Columbia, the University of California system, and elsewhere—diversifies its base beyond the shrinking automotive sector.

### **Service Employees International Union**

**Quick Facts** - Founded: 1921 - Membership: 2 million - President: April Verrett (elected 2024) - Headquarters: Washington, D.C.

SEIU transformed from a small janitorial union into one of labor's largest and most innovative organizations. Its "Justice for Janitors" campaigns of the 1990s pioneered corporate campaign tactics that targeted building owners rather than cleaning contractors, winning contracts in Los Angeles, Washington, and other cities.

The union's membership reflects the service economy: hospital workers, home care aides, janitors, security guards. These are often low-wage workers in sectors with high turnover, making traditional organizing difficult. SEIU has emphasized political action—including the Fight for \$15 minimum wage campaign—as a complement to workplace organizing.

SEIU's 2005 departure from the AFL-CIO to found Change to Win reflected frustration with the labor movement's direction. The union's 2025 return to the federation suggests that era of experimentation has ended.

## **International Brotherhood of Teamsters**

**Quick Facts** - Founded: 1903 - Membership: 1.25 million - President: Sean O'Brien (elected 2021) - Headquarters: Washington, D.C.

The Teamsters' history includes both remarkable achievements and notorious corruption. The union organized long-haul trucking, built pension funds that provided retirement security, and wielded political influence that commanded respect. It also harbored organized crime connections that led to federal oversight lasting until 2020.

Today's Teamsters have moved beyond trucking to represent workers across logistics: UPS drivers, warehouse workers, airline ground crews, beverage distributors. The 2023 UPS contract demonstrated the union's continued capacity to win major gains when it chooses confrontation.

The union's political positioning is less predictably Democratic than other major unions. President O'Brien spoke at the 2024 Republican National Convention, reflecting the Teamsters' willingness to engage across party lines—and the reality that many Teamster members vote Republican.

## **The Changing Nature of Work**

The decline of unions is one part of a broader transformation in how Americans work. The employment relationship that defined the postwar era—a full-time job with one employer, predictable hours, employer-provided benefits, and the prospect of long tenure—has eroded from multiple directions simultaneously.

### **Remote and Hybrid Work**

The COVID-19 pandemic compressed a decade of gradual workplace change into a few months. Before March 2020, roughly 5% of full paid workdays in the United States were performed remotely. By mid-2020, that figure exceeded 60%. As of 2024, it has settled at roughly 25-30%—a fivefold increase from pre-pandemic levels that shows no signs of reverting.

The shift is not evenly distributed. Remote work concentrates among college-educated workers in knowledge-economy occupations: software development, finance, consulting, management, and professional services. Workers in healthcare, manufacturing, construction, retail, and food service—roughly two-thirds of the workforce—cannot do their jobs from home. The result is a new axis of labor market inequality: those whose work is “portable” and those whose work is not.

#### **Info:**

#### **The Geography of Remote Work**

Remote work has geographic consequences. Workers untethered from offices can relocate from high-cost cities to lower-cost areas, bidding up housing prices in places like Boise, Austin, and Asheville while reducing demand for office space in Manhattan and San Francisco. This “Zoom town” effect redistributes economic activity in ways that challenge traditional assumptions about where jobs are located. For the spatial economy discussed in Chapter 3, remote work represents a genuine structural shift.

For employers, remote work reduces real estate costs but complicates management, mentoring, and corporate culture. For workers, it offers flexibility but can blur boundaries between work and personal life, and eliminates the informal social interactions that build professional networks. The long-run productivity effects remain debated: Stanford economist Nicholas Bloom’s research finds that fully remote work reduces productivity modestly (roughly 10%), while hybrid arrangements (three days in office, two remote) match or slightly exceed fully in-office productivity.

#### **From Employment to Contracting**

Beyond the gig economy discussed earlier in this chapter, a subtler shift has moved millions of workers out of traditional employment relationships. Companies increasingly use staffing agencies, outsourcing arrangements, and contract structures to perform work that was once done by employees.

This shows up across industries. A hospital may employ its doctors and nurses but contract out janitorial, food service, and billing functions. A tech company may have a core of salaried engineers but rely on contract workers for testing, content moderation, and facilities management. A hotel chain may franchise its properties, distancing itself from the workers who clean rooms and serve guests.

The consequences are concrete. Contract and outsourced workers typically earn less than employees doing comparable work, receive fewer benefits, and lack access to employer-sponsored retirement plans and health insurance. Research by economists David Weil (author of *The Fissured Workplace*) and others documents how this “fissuring” of employment reduces wages for workers at the bottom of the labor market while insulating lead firms from legal responsibility.

#### **Noncompete Agreements**

An estimated 30 million American workers—roughly one in five—are bound by non-compete agreements that restrict their ability to work for competitors or start compet-

ing businesses after leaving their current employer. These agreements, once limited to senior executives with access to genuine trade secrets, have proliferated to cover sandwich makers at Jimmy John's, warehouse workers, and entry-level employees with no access to proprietary information.

**Note:**

### The Noncompete Paradox

Noncompete agreements constrain workers who often have no idea they signed one. Many are buried in onboarding paperwork or presented after a worker has already relocated for a job. A 2019 study found that only 10% of workers reported negotiating the terms of their noncompete. When workers cannot freely move to better-paying employers, the competitive pressure that forces employers to raise wages is suppressed—even for workers who never test the agreement's enforceability.

The economic effects are significant. Research by economists Evan Starr, J.J. Prescott, and Norman Bishara finds that noncompetes reduce worker mobility by 8-10% and suppress wages, particularly for low-wage workers. States that have restricted noncompetes—notably California, which has long refused to enforce them—show higher rates of entrepreneurship and innovation. Silicon Valley's dynamism is partly attributable to California's policy: engineers can leave one firm and join or start another without legal barriers.

In 2024, the Federal Trade Commission issued a rule banning most noncompete agreements nationwide, estimating that the ban would increase worker earnings by \$300 billion annually and lead to the creation of 8,500 new businesses each year. The rule was challenged in court, and its legal status remains uncertain. Whether through FTC action, state legislation, or both, the trend is toward restricting agreements that limit worker mobility.

### The Gig Economy as a New Category

The gig economy, discussed in detail earlier in this chapter, represents the most visible manifestation of these broader trends. Platforms like Uber, DoorDash, Instacart, and TaskRabbit have created a category of work that does not fit neatly into the traditional employee/independent contractor distinction. Workers use a company's platform, serve the company's customers, and often follow the company's pricing and behavioral rules—yet are classified as independent contractors without the protections that accompany employment.

What makes the gig economy structurally significant is not just its current scale but what it reveals about the direction of the labor market: the shift of risk from firms to workers, the use of technology to manage labor without employing it, and the erosion of the regulatory framework built around the traditional employment relationship.

## Labor Market Power: Monopsony

Introductory economics courses teach that wages are set by supply and demand in competitive labor markets. In this model, if an employer offers below-market wages, workers simply leave for a competitor. The real world is more complicated.

### When Employers Set Wages

**Monopsony**—market power on the buyer’s side of the labor market—occurs when workers have few alternative employers. The textbook example is a company town with a single employer, but the phenomenon is far more widespread than that extreme case suggests. A nurse in a rural area with one hospital, a meatpacker in a small town with one processing plant, or a teacher in a county with one school district all face monopsonistic conditions: their employer has significant power to set wages below what a competitive market would produce.

Recent research has documented how common this is. A landmark study by economists José Azar, Ioana Marinescu, and Marshall Steinbaum measured labor market concentration using job posting data and found that the average labor market in the United States is “highly concentrated” by the standards antitrust authorities apply to product markets. In many local occupation-markets—say, registered nurses in a mid-sized metro area or software developers in a smaller city—a handful of employers account for most of the hiring.

#### Info:

#### Measuring Monopsony

Economists measure labor market concentration using the Herfindahl-Hirschman Index (HHI), the same tool antitrust regulators use to evaluate mergers in product markets. An HHI above 2,500 is considered “highly concentrated.” Azar, Marinescu, and Steinbaum found that the average labor market (defined by occupation and commuting zone) has an HHI above 3,100—well into the range where market power is a concern. This does not mean workers are trapped, but it does mean employers often face less competition for workers than textbook models assume.

### Tools of Employer Power

Monopsony is not just about market structure. Employers actively use legal and contractual tools to suppress competition for their workers:

- **Noncompete agreements** (discussed above) directly prevent workers from taking their skills to a competitor, reducing the competitive pressure that would otherwise force employers to raise wages.
- **No-poach agreements** between franchisees—common in fast food, hotels, and other franchise systems—prevent workers at one location from being hired by another location of the same chain, even though the locations are technically separate employers. The Department of Justice has prosecuted several no-poach arrangements as antitrust violations.

- **Wage-fixing agreements**, in which employers collude to set wages, are per se illegal under antitrust law. A prominent case involved major Silicon Valley firms (Apple, Google, Intel, Adobe) agreeing not to recruit each other's engineers—suppressing wages for some of the most highly compensated workers in the economy.
- **Information asymmetry**: Many employers prohibit or discourage workers from discussing their pay, despite the fact that the National Labor Relations Act protects this right. When workers do not know what their colleagues or competitors' employees earn, they cannot effectively negotiate.

## **Why Monopsony Matters for Policy**

The monopsony framework helps explain a puzzle that has long divided economists: why moderate increases in the minimum wage do not always reduce employment, as the competitive model predicts they should.

In the classic competitive labor market, a minimum wage above the market-clearing level should cause employers to hire fewer workers. But a series of studies beginning with David Card and Alan Krueger's influential 1994 research on New Jersey fast food restaurants found that moderate minimum wage increases had little or no negative effect on employment. This finding has been replicated across many settings and is now the dominant empirical result in the literature, though it remains contested.

Monopsony offers a straightforward explanation: if employers are already paying below the competitive wage because they have market power, a minimum wage increase can raise pay without reducing employment—up to the point where the minimum exceeds the competitive wage. In monopsonistic markets, minimum wages can simultaneously raise wages and increase employment by pulling the market closer to the competitive outcome.

This does not mean any minimum wage at any level is costless. Very high minimum wages (relative to local market conditions) can reduce employment. But the monopsony framework explains why the employment effects of moderate increases have been consistently smaller than the competitive model predicts.

## **Immigration and the Labor Market**

The American labor force includes roughly 29 million foreign-born workers—about 18% of total employment. Immigrants are not uniformly distributed across the economy; they concentrate in specific sectors and occupations where their presence shapes labor market conditions in ways that vary significantly by industry and skill level.

### **Scale and Distribution**

Foreign-born workers are overrepresented at both ends of the skill spectrum. They account for a disproportionate share of workers with less than a high school education (agriculture, construction labor, food preparation) and also a disproportionate

share of workers with advanced degrees (medicine, engineering, computer science, academic research).

### Foreign-Born Workers by Industry (2024)

Industry	Foreign-Born Share
Agriculture	~40%
Construction	~30%
Accommodation & Food Services	~28%
Professional, Scientific, Technical	~20%
Healthcare	~18%
Manufacturing	~20%

Source: Bureau of Labor Statistics, Foreign-Born Workers: Labor Force Characteristics, 2024

This bimodal distribution means that immigration's labor market effects are complex and vary enormously depending on which segment of the workforce is being discussed.

## The Visa System

Two major visa programs channel foreign workers into specific sectors:

**The H-1B program** admits roughly 85,000 new workers annually (plus unlimited additional visas for university and research institution employees) in "specialty occupations" requiring at least a bachelor's degree. In practice, the program is dominated by the technology sector: the top H-1B sponsors include Amazon, Google, Microsoft, Meta, and—most controversially—IT staffing firms (Infosys, Tata Consultancy Services, Wipro) that provide contract technology workers to other companies. Critics argue that the staffing firm model displaces American tech workers rather than filling genuine shortages; defenders note that the demand for H-1B visas far exceeds supply, suggesting real employer need.

**The H-2A program** provides temporary agricultural visas with no annual cap. Usage has grown dramatically—from roughly 79,000 workers certified in 2013 to over 370,000 in 2023—as domestic agricultural labor has become increasingly scarce. The program connects directly to the farm labor dynamics discussed in Chapter 16: as enforcement has reduced the supply of unauthorized workers and domestic workers continue to exit agriculture, H-2A has become the industry's primary mechanism for securing labor. Employers must provide housing, transportation, and pay the "adverse effect wage rate" set by the Department of Labor, which typically exceeds local minimum wages.

### □ Info:

#### The H-2A Surge

The rapid growth in H-2A visa usage reflects a structural shift in agricultural labor markets. As the unauthorized immigrant population has stabilized

and younger unauthorized immigrants increasingly bypass agriculture for better-paying urban work, farmers have turned to the legal guest-worker system despite its higher costs and bureaucratic requirements. The trend suggests that American agriculture's dependence on foreign labor is not diminishing but rather shifting from informal to formal channels.

## Unauthorized Workers

An estimated 7-8 million unauthorized immigrants participate in the U.S. labor force, concentrated in agriculture (where they may account for 40-50% of field workers), construction, food processing, food service, and domestic work (housecleaning, landscaping, childcare). These workers lack legal employment authorization, leaving them vulnerable to exploitation: below-minimum-wage pay, unsafe working conditions, and wage theft, with limited recourse because reporting violations risks deportation.

For employers, unauthorized workers represent a low-cost, compliant labor supply. For the broader labor market, the effects depend on the specific occupation and region. In sectors where unauthorized workers concentrate, their presence increases labor supply and may suppress wages for competing native-born workers—primarily other workers without a high school diploma. For the economy as a whole, however, the effects are more nuanced.

## What the Evidence Shows

The economic research on immigration's labor market effects is extensive and, on the central questions, reasonably convergent:

- **For most native workers, immigrants are complements rather than substitutes.** Immigrant workers tend to specialize in different tasks than native-born workers with similar education levels. An immigrant construction worker may specialize in manual tasks while a native-born worker in the same industry moves into supervisory, communication-intensive, or equipment-operating roles. This complementarity means that immigration can raise rather than lower wages for many native workers.
- **Negative wage effects concentrate among workers most similar to new immigrants**—primarily native-born workers without a high school diploma and earlier waves of immigrants. Even here, the effects are modest: Harvard economist George Borjas, the scholar most associated with finding negative immigration effects, estimates wage reductions of 3-8% for this group over a multi-decade period.
- **High-skilled immigration has broadly positive effects** on innovation, entrepreneurship, and productivity. Immigrants or their children founded roughly 45% of Fortune 500 companies. Foreign-born researchers are disproportionately represented among patent holders and Nobel laureates.
- **Fiscal effects are mixed:** immigrants (especially unauthorized immigrants) pay less in taxes on average than native-born workers but also consume fewer

government services. Over a lifetime, the fiscal impact of an immigrant depends heavily on education level and age at arrival.

**□ Note:**

### **The Political Economy of Immigration**

Immigration policy sits at the intersection of labor economics, national security, cultural identity, and partisan politics—making dispassionate policy analysis nearly impossible in the public arena. The economic evidence suggests that immigration’s net effects are positive for the economy as a whole but that specific groups of native workers bear real costs. Sound policy would address those costs directly (through wage supplements, retraining, or adjustment assistance) rather than treating immigration as either uniformly beneficial or uniformly harmful.

## **Childcare, Eldercare, and Labor Force Participation**

Labor supply is not determined solely by wages and working conditions. It is also shaped by the infrastructure—or lack of infrastructure—that enables people to work in the first place. In the United States, the most significant constraint on labor supply is the cost and availability of care: for children and, increasingly, for aging parents.

### **The Female Labor Force Participation Plateau**

American women’s labor force participation rose steadily from the 1960s through the late 1990s, tracking a global trend in developed economies. Then it stopped. The female labor force participation rate plateaued at roughly 57% in the early 2000s and has barely budged since, even as other wealthy nations continued to see gains.

The United States now ranks below most peer nations in female labor force participation. Canada, the United Kingdom, Germany, France, Australia, and the Scandinavian countries all have higher rates. The divergence is not explained by differences in education, cultural attitudes, or economic development. It is explained, in significant part, by policy: the United States is an outlier among wealthy nations in its lack of public investment in childcare and parental leave.

### **The Childcare Cliff**

The cost of formal childcare in the United States averages \$10,000 to \$15,000 per year per child, with wide geographic variation: infant care in Massachusetts averages over \$20,000 annually, exceeding the cost of in-state tuition at public universities. For a family with two young children, childcare can rival rent or mortgage payments as the largest household expense.

**□ Note:**

### **The Childcare Math**

Consider a family where one parent earns \$40,000 per year—close to the median individual income. If that parent has two children in full-time care at a combined cost of \$25,000, the after-tax gain from working may be marginal after accounting for transportation, professional clothing, and other work-related expenses. For many families, the “rational” economic choice is for one parent to leave the workforce entirely. That parent is overwhelmingly the mother. The result is not a preference-driven choice but an infrastructure failure that pushes workers out of the labor force.

The supply side is equally troubled. Childcare workers earn a median wage of roughly \$14 per hour—less than warehouse workers, retail cashiers, or fast food employees. Low pay drives chronic staffing shortages; childcare centers report vacancy rates of 10-15%, limiting the number of children they can serve. The fundamental problem is that childcare is expensive for families yet underpays its workers, with no margin remaining in between. Unlike K-12 education, which is publicly funded, early childhood care operates largely as a private market that fails on both sides: unaffordable for consumers and unsustainable for providers.

## **The Eldercare Burden**

As the American population ages—adults over 65 will grow from 58 million today to roughly 82 million by 2050—the demand for eldercare is rising. An estimated 53 million Americans provide unpaid care for an aging or disabled family member, spending an average of 24 hours per week on caregiving tasks. Many of these caregivers are working-age adults, predominantly women, who reduce their hours, decline promotions, or exit the labor force to care for aging parents.

Paid eldercare faces the same structural problems as childcare: the work is physically demanding, emotionally taxing, and poorly compensated. Home health aides—the fastest-growing occupation in the economy—earn a median wage of roughly \$15 per hour with few benefits. Nursing home care costs \$90,000-\$110,000 per year; assisted living averages \$55,000-\$65,000. Medicare does not cover long-term care, and Medicaid covers it only for those who have exhausted their assets. The result is a system that forces families to choose between financial ruin and inadequate care.

## **Care Infrastructure as Labor Market Policy**

The connection between care infrastructure and labor supply is not speculative. International evidence is clear: countries that invest in subsidized childcare and parental leave have higher female labor force participation rates.

### **Female Labor Force Participation in Selected Countries (2023)**

Country	Rate	Public Childcare Spending (% of GDP)
Sweden	68%	1.6%
France	62%	1.3%
Germany	61%	1.0%
Canada	61%	0.6%

Country	Rate	Public Childcare Spending (% of GDP)
United Kingdom	60%	0.6%
United States	57%	0.3%
Japan	54%	0.9%

Sources: OECD Labour Force Statistics; OECD Family Database, Public spending on early childhood education and care

The pattern is stark. The United States spends roughly half the OECD average on early childhood education and care as a share of GDP, and its female labor force participation rate reflects this underinvestment. The gap represents not just a social concern but a macroeconomic one: if American women participated in the labor force at the same rate as women in Canada or Germany, the economy would gain roughly 5 million additional workers—a significant boost to output, tax revenue, and economic growth at a time when labor shortages constrain multiple sectors.

#### □ Info:

#### Why Care Policy Is Economic Policy

It is tempting to categorize childcare and eldercare as “social” issues distinct from “economic” policy. The data does not support this distinction. Care infrastructure determines labor supply, which determines output, which determines growth. Countries that treat care as public infrastructure—comparable to roads, broadband, or education—consistently achieve higher labor force participation and faster economic growth than countries that treat it as a private family responsibility. The United States’ position as an outlier in care investment is also an outlier in the share of working-age adults who actually work.

## Key Takeaways

1. **Unions are diminished but not irrelevant:** Union membership has fallen from 35% of private-sector workers in the 1950s to under 6% today, yet recent actions by the UAW, Teamsters, and Starbucks Workers United show that organized labor retains the capacity to win significant gains and inspire new organizing—particularly when tight labor markets shift bargaining power toward workers.
2. **The employment relationship is fragmenting:** The postwar model of full-time employment with a single employer is giving way to gig work, independent contracting, and outsourcing arrangements that shift risk and cost from firms to workers. Remote work, accelerated by the pandemic, has further loosened the ties between workers and workplaces.
3. **Employer market power suppresses wages:** Monopsony—the concentration of hiring power among a small number of employers—is widespread in American labor markets. Noncompete agreements, no-poach deals, and wage-fixing reinforce this power. The monopsony framework helps explain why minimum wage increases have not produced the job losses predicted by competitive models.

4. **Immigration shapes specific sectors profoundly:** Foreign-born workers account for 18% of the labor force, concentrated at both the high-skill and low-skill ends. The economic evidence indicates that immigrants complement rather than substitute for most native workers, though workers most similar to new immigrants may experience modest wage effects.
5. **Care infrastructure constrains labor supply:** The United States' low public investment in childcare and eldercare helps explain why female labor force participation has plateaued below peer nations. Addressing care infrastructure is not just social policy—it is labor market and macroeconomic policy.

## Data Sources and Further Reading

### Key Data Sources

- **Bureau of Labor Statistics:** Union membership data, foreign-born worker characteristics, labor force participation
- **NLRB:** Election results, unfair labor practice charges
- **Department of Labor (OLMS):** Union financial disclosures
- **OpenSecrets:** Union political spending
- **OECD:** International labor force participation and family policy comparisons
- **Census Bureau:** American Community Survey, childcare cost data

### Further Reading

- Lichtenstein, Nelson. State of the Union (2002) - Labor history
- Rosenfeld, Jake. What Unions No Longer Do (2014) - Union decline
- McCartin, Joseph. Collision Course (2011) - Air traffic controllers strike
- Greenhouse, Steven. Beaten Down, Worked Up (2019) - Contemporary labor
- Weil, David. The Fissured Workplace (2014) - Employment restructuring and outsourcing
- Manning, Alan. Monopsony in Motion (2003) - Employer market power
- Card, David, and Alan Krueger. Myth and Measurement (1995) - Minimum wages and employment
- Bloom, Nicholas. "How Working from Home Works Out," Stanford Institute for Economic Policy Research (2020) - Remote work productivity

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**Word count:** roughly 5,800 words

Note: For treatment of specific industries and their labor markets, see relevant sector chapters in Part II.

# **Exercises**

## **Review Questions**

1. Union membership in the private sector has fallen from 16.8% in 1983 to 5.9% in 2024, while public-sector unionization has remained above 32%. Identify and explain at least three structural factors that account for this divergence. Why are public-sector workers easier to organize and harder to replace than their private-sector counterparts?
2. The UAW's 2023 "Stand Up Strike" employed a novel sequential targeting strategy rather than striking all plants simultaneously. Explain the tactical logic of this approach: how did uncertainty about which plants would be struck next give the union leverage? Why were tight labor markets, strong consumer demand, and record corporate profits essential preconditions for the strike's success? Could this strategy succeed in a recession?
3. The chapter describes the Starbucks Workers United campaign as having organized over 500 stores but reached no first contract. Explain why there is a "gap between winning an election and achieving a contract" under current labor law. What specific employer tactics—contesting elections, challenging certification, slow bargaining—exploit weaknesses in the NLRA framework? How does the Amazon Labor Union's experience reinforce this pattern?
4. Distinguish between economic strikes and unfair labor practice (ULP) strikes in terms of legal protections for workers. Why does the employer's right to hire permanent replacement workers in economic strikes dramatically alter the balance of power in collective bargaining? How does this legal framework compare to labor law in other developed nations where permanent replacement is prohibited?
5. Explain why worker classification as "independent contractor" versus "employee" has become a central labor policy battleground. What specific protections (minimum wage, overtime, unemployment insurance, NLRA organizing rights) are lost when workers are classified as 1099 contractors? Why did ride-share companies spend \$200 million on California's Proposition 22, and what does the resulting special category of "app-based workers" reveal about the political economy of classification?
6. The chapter describes "alt-labor" organizations such as worker centers (ROC-United, NDLON, Fight for \$15) as filling gaps in the labor movement. How do worker centers differ legally from unions under the NLRA? What tactics can they employ that unions cannot (such as secondary boycotts), and what core union functions (collective bargaining, contract enforcement) can they not perform? Evaluate whether worker centers represent a viable long-term alternative to traditional unionism or a supplement to it.
7. The Teamsters' political positioning is described as "less predictably Democratic" than other major unions, with President O'Brien speaking at the 2024 Republican National Convention. What does this bipartisan engagement reveal about the political tensions within the labor movement? How does the reality that "many

Teamster members vote Republican” complicate the assumption that unions are uniformly aligned with one party? What policy areas might create cross-partisan appeal for organized labor?

8. The chapter describes monopsony—employer market power—as widespread in American labor markets. Explain the concept of monopsony using the example of a nurse in a rural area with one hospital. How does the Azar, Marinescu, and Steinbaum research on labor market concentration (using the Herfindahl-Hirschman Index) demonstrate that monopsony is not limited to company towns? How do noncompete agreements, no-poach agreements, and wage-fixing reinforce employer power even in markets that appear competitive? Why does monopsony provide a coherent explanation for Card and Krueger’s finding that moderate minimum wage increases do not reduce employment?
9. The chapter notes that roughly 30% of full paid workdays are now performed remotely, compared to 5% before the pandemic. Analyze the distributional consequences of this shift: which workers benefit from remote work, and which are excluded? How does the concentration of remote work among college-educated, knowledge-economy workers create a new axis of labor market inequality? What are the geographic implications (the “Zoom town” effect) for housing costs, tax bases, and economic activity in both origin and destination cities?
10. The United States spends roughly 0.3% of GDP on early childhood education and care, compared to 1.0-1.6% in countries like Germany, France, and Sweden. Using the data presented in the chapter, explain how this underinvestment constrains female labor force participation. Why does the chapter characterize the “childcare cliff” as an infrastructure failure rather than a matter of personal preference? What is the macroeconomic cost—in terms of forgone workers, output, and tax revenue—of the participation gap between the U.S. and peer nations?
11. Foreign-born workers account for roughly 18% of the American labor force but are concentrated at both the high-skill and low-skill ends of the spectrum. Explain why this bimodal distribution means that immigration’s labor market effects vary enormously by sector and skill level. How does the concept of “complements rather than substitutes” apply to understanding immigration’s effects on native workers? Why might restricting immigration worsen labor shortages in sectors like agriculture, construction, and healthcare without meaningfully raising wages for native-born workers in other sectors?

## Data Exercises

1. **Union Wage Premium by Industry.** Using the BLS Union Members Summary (<https://www.bls.gov/news.release/union2.toc.htm>) and the Current Population Survey data available through FRED, compare median weekly earnings for union and non-union workers across at least five industries (e.g., construction, manufacturing, healthcare, retail, transportation). Calculate the “union wage premium” (percentage difference) for each industry. Then retrieve the FRED series for real median weekly earnings (LES1252881600Q) and plot the long-run trend. Write a one-page analysis discussing whether the declining union membership

rate documented in the chapter has coincided with stagnation in median real wages, and what other factors might explain the correlation (or lack thereof).

2. **Mapping Right-to-Work and Union Density.** Using BLS data on union membership rates by state (<https://www.bls.gov/news.release/union2.t05.htm>), create a table comparing union membership rates in right-to-work states versus non-right-to-work states. Then retrieve state-level median household income data from the Census Bureau's American Community Survey (<https://data.census.gov>). Calculate the average union membership rate and median household income for each group. Does the data support or complicate the argument that right-to-work laws weaken unions and reduce worker earnings? Discuss confounding factors (regional cost of living, industry mix, state demographics) that would need to be controlled for in a rigorous analysis.
3. **Gig Economy Scale and Growth.** The chapter notes that “roughly 36% of American workers participate in some form of gig work.” Using BLS data on contingent and alternative employment arrangements (<https://www.bls.gov/cps/contingent-and-alternative-arrangements-faqs.htm>) and FRED series for the number of unincorporated self-employed workers (LNS12032192), track how non-traditional employment has changed over the past two decades. Supplement with data from the Census Bureau’s Nonemployer Statistics (<https://www.census.gov/programs-surveys/nonemployer-statistics.html>), which counts businesses with no paid employees. Write a brief report (500–750 words) evaluating whether official statistics adequately capture the gig economy or whether measurement gaps make it difficult to assess the true scale of independent contracting.
4. **Childcare Costs and Labor Force Participation by State.** Using data from the Department of Labor’s National Database of Childcare Prices (<https://www.dol.gov/agencies/wb/topics/childcare>) and BLS state-level labor force participation data for women ages 25–54, create a scatterplot comparing average childcare costs (as a percentage of median household income) to female prime-age labor force participation across all 50 states. Is there a negative relationship? Identify outliers and discuss what other state-level factors (cost of living, availability of informal care, industry mix) might explain deviations from the trend. Write a one-page analysis (500–750 words) evaluating the strength of the relationship.

## Deeper Investigation

1. The chapter describes Michigan’s 2024 repeal of its right-to-work law as “the first such repeal in decades.” Research the political and economic context of this repeal: What political conditions made it possible? What arguments did proponents and opponents make? Drawing on BLS union membership data, economic performance indicators from FRED (state employment growth, wage growth, GDP growth), and academic research on right-to-work laws’ effects, evaluate the likely economic impact of the repeal on Michigan’s labor market. Compare Michigan’s experience with that of states that recently enacted right-to-work legislation (e.g., Indiana in 2012, Wisconsin in 2015). Does the available ev-

idence support clear conclusions about the economic effects of right-to-work laws, or does the research remain contested? Write a research paper (1,500–2,000 words) that engages with evidence on both sides.

2. The chapter discusses monopsony and its implications for minimum wage policy. The Card and Krueger research on New Jersey fast food restaurants (1994) is one of the most influential—and contested—findings in labor economics. Research this debate in depth: What did Card and Krueger find, and what was their methodology? How did David Neumark and William Wascher challenge the findings? What has subsequent research (including Cengiz, Dube, Lindner, and Zipperer's 2019 study using "bunching" estimators) concluded? Write a research paper (1,500–2,000 words) evaluating the current state of the minimum wage employment debate, paying particular attention to how the monopsony framework has changed economists' priors about the expected effects.
3. California has refused to enforce noncompete agreements since the 19th century, while most other states have historically permitted them. Research the economic consequences of this policy divergence. Drawing on academic research (particularly work by Evan Starr, Matt Marx, and On Amir), compare rates of worker mobility, entrepreneurship, and innovation in California versus states with strong noncompete enforcement. How did California's policy contribute to Silicon Valley's development? What do the experiences of states that have recently restricted noncompetes (such as Washington, Oregon, and Illinois) suggest about the broader economic effects? Write a research paper (1,500–2,000 words) evaluating whether the FTC's proposed ban on noncompetes is supported by the available evidence.

# **Part VII: Conclusion**

# **31. The American Economy in Perspective**

Standing at the vantage point of 2026, the American economy embodies contradictions that would puzzle a time traveler from even the recent past. We achieved the “soft landing” that economists deemed improbable—taming post-pandemic inflation without destroying the labor market—yet national sentiment remains anxious. We see a manufacturing construction boom of historic proportions in a country that has supposedly deindustrialized. We witness the world’s most aggressive pivot toward green energy in a nation that is simultaneously the world’s largest oil producer. We observe a stock market powered by artificial intelligence reaching unprecedented heights while downtown office towers—the cathedrals of the service economy—stand a quarter empty, artifacts of a work culture that may never fully return.

To conclude this survey of the American economy, we must move beyond the sectoral and regional analyses of the preceding chapters to view the system as a whole. What emerges is not a story of inevitable decline or triumphant exceptionalism, but a portrait of a distinct and dynamic organism—an economy uniquely capable of reinvention and uniquely tolerant of the disruption that reinvention leaves in its wake.

## **The View from 2026**

The statistical portrait of the United States in the mid-2020s is, by historical standards, remarkable. With a Gross Domestic Product exceeding \$29 trillion, the American economy has not just recovered from the COVID-19 shock; it has left other developed economies behind. While Europe struggled with energy shocks and China grappled with property deflation and demographic pressure, the United States powered forward, driven by its perennial engine: the American consumer.

Yet the view from Main Street differs from the view in macroeconomic data. The “vibecession” of 2023-2024 revealed a persistent gap between aggregate statistics and lived experience: households care less about the rate of change than the level of prices. That eggs no longer cost \$5 a dozen is small comfort when the memory of \$2 eggs remains fresh. The rapid increase in interest rates—from near-zero to over 5%—has created a bifurcated society. For the two-thirds of American households who own homes, many locked in at 3% mortgages, the new rate environment is an abstraction. For the young family trying to buy their first home, it is a crushing barrier that has effectively doubled the cost of shelter.

This “lock-in” effect is the defining microeconomic distortion of our time. It has frozen housing markets, reduced labor mobility (why move for a better job if it means trading a 3% mortgage for a 7% one?), and deepened generational divides. It reminds us that macroeconomic aggregates often obscure as much as they reveal.

## Distinctive Features

Throughout this book, we have encountered features that make the American economy structurally distinct from its peers. These are not merely differences of degree.

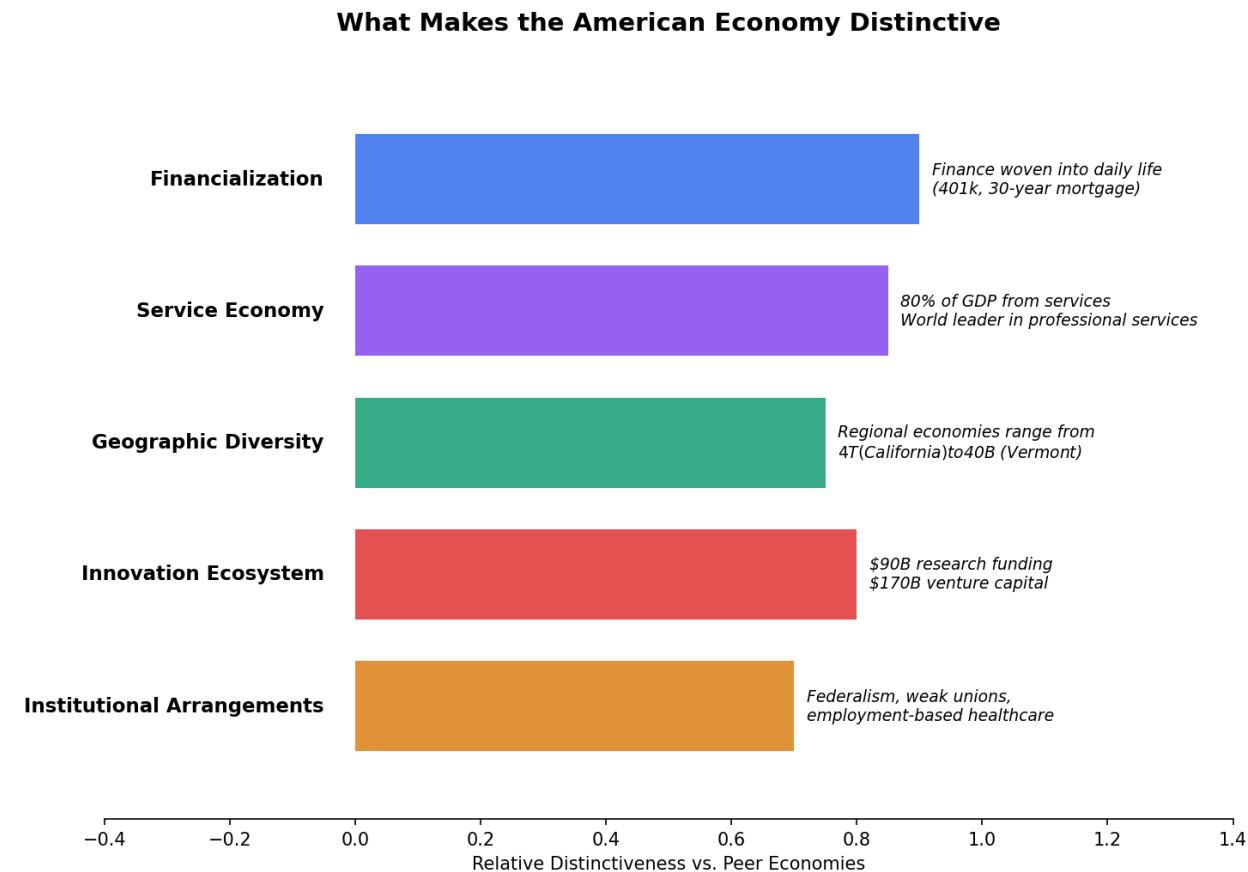


Figure 96: Figure 31.1: What makes the American economy distinctive. Finance is woven into daily life; services dominate; geographic diversity creates regional economies; innovation infrastructure remains the global standard. Source: Author analysis

## The Financialization of Daily Life

No other developed nation has woven finance so deeply into the fabric of ordinary existence. The 30-year fixed-rate mortgage is an American anomaly—a government-subsidized transfer of interest rate risk from households to the financial system that effectively turns homeowners into leveraged real estate investors. The 401(k) retirement system, having largely replaced defined-benefit pensions, forces middle-class

workers to become amateur asset managers. The depth of American capital markets—\$50 trillion in equity market capitalization, \$50 trillion in bond markets—allows the federal government to sustain deficits that would destabilize other nations, backed by the dollar’s role as the world’s reserve currency. Finance in America is not merely a sector; it is the operating system.

## **The Scale of the Service Economy**

Public discourse laments the decline of manufacturing while overlooking that the United States is the world’s service economy superpower. At nearly 80% of GDP, the service sector—professional services, healthcare, finance, technology, entertainment—has no peer. We export legal structures, management consulting, blockbuster films, and software platforms. The United States runs persistent trade deficits in goods but substantial surpluses in services. The highest value-added products in the global economy are often not physical objects but algorithms, patents, brands, and expertise.

## **Geographic Diversity**

As the regional chapters demonstrated, the United States contains multitudes. The San Francisco Bay Area, with its \$1.3 trillion economy concentrated in technology, bears little resemblance to the Houston metro area, built on energy and healthcare. The Northeast Corridor’s density-dependent service economy operates by different rules than the resource economies of rural America. This diversity provides resilience—regional shocks rarely become national crises—but also creates the political tensions of an economy that distributes its gains unevenly across space.

## **Institutional Arrangements**

American economic institutions differ markedly from those of peer nations. Federalism fragments regulation across fifty states, creating both laboratories of democracy and regulatory arbitrage opportunities. Weak labor unions mean workers bargain individually rather than collectively in most private-sector employment. The absence of universal healthcare ties insurance to employment, creating job lock and entrepreneurship barriers. Zoning authority rests with thousands of local governments, enabling wealthy communities to restrict housing supply and capture appreciation gains. These institutional choices—not natural laws—shape who benefits from economic growth.

## **How the U.S. Compares: A Structural Overview**

The institutional differences catalogued above are easier to grasp in comparative perspective. The table below sets the United States against two other major economic blocs—the European Union and the leading economies of East Asia (principally Japan and South Korea)—across eight structural dimensions. The comparison is necessarily stylized; each bloc contains internal variation. But the broad patterns are instructive.

Dimension	United States	European Union	East Asia (Japan/S. Korea)
<b>Role of government</b>	Limited direct intervention; regulation-light at the federal level; large fiscal footprint via defense, entitlements, and tax expenditures	Extensive regulatory state; active in consumer protection, environmental standards, and competition policy; fiscal policy constrained by Stability and Growth Pact	Developmental state tradition; government guides strategic sectors through planning agencies, directed credit, and public-private coordination
<b>Labor market regulation</b>	At-will employment in most states; minimal mandated benefits; low unionization (~6% private sector); high hire-and-fire flexibility	Strong worker protections; works councils and collective bargaining coverage often above 70%; generous mandated leave; dismissal procedures costly and slow	Lifetime employment norms eroding but still influential; enterprise unions in Japan; rigid dual labor markets separating regular and non-regular workers
<b>Healthcare model</b>	Employer-sponsored insurance dominant; public coverage via Medicare/Medicaid for elderly and low-income; 18% of GDP; no universal system	Universal coverage through single-payer (UK, Nordics) or multi-payer social insurance (Germany, France); 10-12% of GDP; negotiated pricing	Universal coverage via national health insurance (Japan) or single-payer (South Korea); 8-12% of GDP; aggressive cost controls and fee schedules

Dimension	United States	European Union	East Asia (Japan/S. Korea)
<b>Industrial policy approach</b>	Historically market-neutral; post-2022 shift toward targeted subsidies (CHIPS Act, IRA); defense-adjacent R&D as de facto industrial policy	Mixed; state aid rules limit national champions but allow regional development funds; Green Deal as continent-wide industrial strategy	Explicit and long-standing; MITI/METI tradition in Japan; Korean chaebol-government nexus; strategic targeting of export industries
<b>Trade policy orientation</b>	Open with selective protection; large structural trade deficit in goods; services surplus; dollar as reserve currency absorbs imbalances	Common external tariff; deep internal single market; emphasis on regulatory standards as trade tool; roughly balanced current account	Export-oriented growth model; persistent current account surpluses; currency management historically central; heavy reliance on external demand
<b>Social safety net</b>	Residualist model; means-tested programs; limited unemployment duration; no universal family policy; safety net expanded temporarily during COVID	Comprehensive welfare states; generous unemployment insurance; universal family benefits; pension systems facing demographic pressure	Firm-based welfare in Japan giving way to public programs; Korea rapidly expanding social spending from a low base; family as traditional safety net

Dimension	United States	European Union	East Asia (Japan/S. Korea)
<b>Innovation model</b>	University-driven basic research; deep venture capital markets; high tolerance for failure; immigration of global talent; winner-take-all dynamics	Public research institutions; Horizon Europe framework; strong in incremental industrial innovation; weaker in disruptive startups; fragmented capital markets	Corporate R&D dominance; incremental manufacturing process innovation; strong patent activity; weaker in software and platform businesses; limited venture ecosystem
<b>Corporate governance</b>	Shareholder primacy; quarterly earnings pressure; active market for corporate control; high executive compensation; deep equity culture	Stakeholder models; codetermination in Germany; weaker takeover markets; lower executive pay; greater emphasis on social license	Keiretsu and chaebol structures; cross-shareholding networks; relationship banking; long-term orientation but governance opacity; reform pressures mounting

Several patterns emerge from this comparison. The most fundamental is the American economy's distinctive bargain: it trades equality and security for dynamism and flexibility. The United States tolerates levels of income inequality, labor market churn, and social risk that European and East Asian societies have historically found unacceptable. In return, it generates rates of new firm formation, disruptive innovation, and aggregate growth that its peers struggle to match. This is not an unambiguous win. The American model produces both the world's most valuable technology companies and the highest poverty rate among advanced economies. It attracts the globe's most ambitious talent and leaves tens of millions of its own citizens without adequate healthcare. The trade-off is real, and reasonable people disagree about whether the terms are worth it.

The European model inverts many of these priorities. Comprehensive social insurance, strong worker protections, and universal public services produce more egalitarian outcomes and higher measures of subjective well-being across much of the income distribution. But these protections come at a cost measured in slower GDP growth, lower rates of business formation, and a persistent difficulty in scaling technology firms. Europe has produced no equivalent of the American platform giants; its venture capital markets remain a fraction of American levels. The EU's regulatory state—exemplified by frameworks like GDPR and the AI Act—reflects a societal prefer-

ence for precaution over experimentation, an orientation that protects consumers but can stifle the messy, rapid iteration that characterizes American innovation cycles.

East Asian economies offer a third template: the developmental state. Japan and South Korea achieved extraordinary postwar growth through aggressive government direction of credit and investment toward strategic export industries. This model produced globally dominant firms in automobiles, electronics, semiconductors, and shipbuilding. But it, too, carries costs. Both nations now face demographic crises more severe than America's, partly because the intense work cultures and high costs that accompanied rapid industrialization suppressed fertility rates. Japan's three decades of stagnation after its asset bubble collapsed illustrate the rigidity risks of a system built on consensus, cross-shareholding, and industrial incumbency. South Korea's chaebol-dominated economy generates impressive headline growth but concentrates wealth and opportunity in ways that fuel deep public frustration. Neither nation has replicated the American capacity for disruptive reinvention—the willingness to let entire industries die so that new ones can be born. What the comparison ultimately reveals is that there is no free lunch in institutional design: every model solves certain problems by creating others.

## **The Innovation Ecosystem**

The United States maintains an innovation infrastructure that remains the global standard. Research universities receive over \$90 billion annually in research funding. Venture capital investment—though highly cyclical—reached \$170 billion in 2024 despite a post-2021 pullback. Immigration policy, for all its dysfunction, continues to attract global talent; over 40% of Fortune 500 companies were founded by immigrants or their children. The combination of deep capital markets, tolerance for failure, and university-industry linkages creates conditions for new firm formation that other nations struggle to replicate.

## **Ongoing Transformations**

Three simultaneous transformations are reshaping the economic landscape.

### **The Return of Industrial Policy**

The era of market neutrality ended with the CHIPS and Science Act, the Inflation Reduction Act, and the Infrastructure Investment and Jobs Act. Collectively, these laws direct hundreds of billions in federal spending and tax credits toward specific industries: semiconductors, electric vehicles, batteries, clean energy, and critical minerals. The invisible hand has been joined by the visible thumb of industrial policy.

The results are already visible in construction data. Manufacturing construction spending tripled from 2021 to 2024, reaching historic levels. The “Battery Belt” across the Southeast—plants in Georgia, Kentucky, Tennessee, and South Carolina—represents billions in investment. Intel’s Ohio campus, TSMC’s Arizona fabs, and Samsung’s Texas expansion anchor a semiconductor archipelago in the desert Southwest.

### Three Simultaneous Transformations Reshaping the Economy

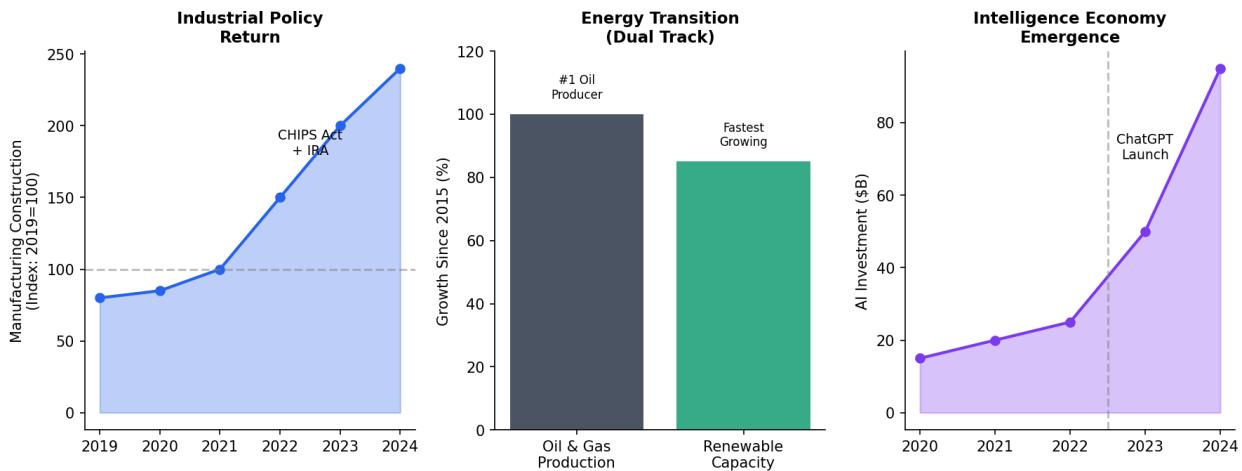


Figure 97: Figure 31.2: Three simultaneous transformations: the return of industrial policy (CHIPS Act, IRA), the dual-track energy transition, and the emergence of the AI-driven intelligence economy. Source: Author analysis

This is not a restoration of mid-century mass manufacturing employment. Modern semiconductor fabs employ hundreds, not thousands, of workers per facility. The factories being built are cathedrals of automation. But they represent a reanchoring of strategic supply chains—a recognition that efficiency and resilience can conflict, and that the United States had optimized too heavily for the former.

## The Energy Transition

The United States is attempting something no nation has accomplished: leading the transition to renewable energy while remaining the world's largest producer of oil and natural gas. We are simultaneously drilling in the Permian Basin and erecting wind turbines across the Great Plains. The Permian produced over 6 million barrels per day in 2024; Texas generated more electricity from wind than any other state.

This dual-track approach—pragmatic, perhaps hypocritical, but effective—has insulated the United States from energy security crises. While European manufacturers faced existential energy cost pressures after Russia's invasion of Ukraine, American industrial users enjoyed natural gas prices a fraction of European levels. This energy cost advantage has begun to attract European heavy industry across the Atlantic.

The energy transition will reshape regional economies. The Gulf Coast petrochemical complex faces long-term questions, even as it captures short-term gains from cheap feedstock. The renewable energy buildout creates new economic bases in the Great Plains, the desert Southwest, and offshore Atlantic waters. The transition is also a massive industrial policy exercise, with the IRA's tax credits directing private investment toward favored technologies.

## **The Intelligence Economy**

The integration of large language models and other AI systems into the workforce represents the next great discontinuity. Unlike previous waves of automation that primarily replaced physical labor, this wave targets cognitive tasks—the paralegal review, the code review, the draft memo, the customer service response.

Early evidence suggests counterintuitive effects. AI may compress wage premiums for mid-level knowledge work while supercharging the productivity of elite practitioners who can leverage these tools effectively. If the twentieth century was the era of the “college premium,” the twenty-first may become the era of the “adaptation premium”—returns to those who can most effectively integrate AI into their work.

The geographic implications remain uncertain. If AI enables more remote work on complex tasks, it could accelerate the geographic dispersion of knowledge work beyond expensive metros. Or it could further concentrate returns among those with the skills to direct AI systems, likely clustered in existing tech hubs. The Silicon Valley firms building these systems—and capturing their economic rents—have added trillions in market capitalization since 2023.

## **Persistent Tensions**

For all its dynamism, the American economy faces structural tensions that are not resolving.

## **Geographic Divergence**

The divergence between superstar metros and left-behind places has become the primary axis of economic—and political—polarization. Five states account for roughly 40% of national GDP. A handful of metropolitan areas capture the vast majority of venture capital investment. The economic logic of agglomeration, which pulls talent and capital toward dense, educated metros, clashes with the political logic of the Senate and Electoral College, which amplify the voice of less populous states and regions.

This divergence has human costs. Life expectancy, educational attainment, and economic mobility vary dramatically across regions. Deaths of despair—from opioids, alcohol, and suicide—concentrated in regions that lost manufacturing employment in the 1990s and 2000s. The phrase “two Americas” has become cliche, but the data support it.

## **The Cost Disease**

In sectors exposed to global competition—electronics, apparel, manufactured goods—prices have fallen in real terms for decades. In locally consumed services—healthcare, housing, education, childcare—prices have soared. This asymmetry, which economists call “cost disease,” means that middle-class wages purchase more televisions than ever but less security.

## Persistent Tensions in the American Economy

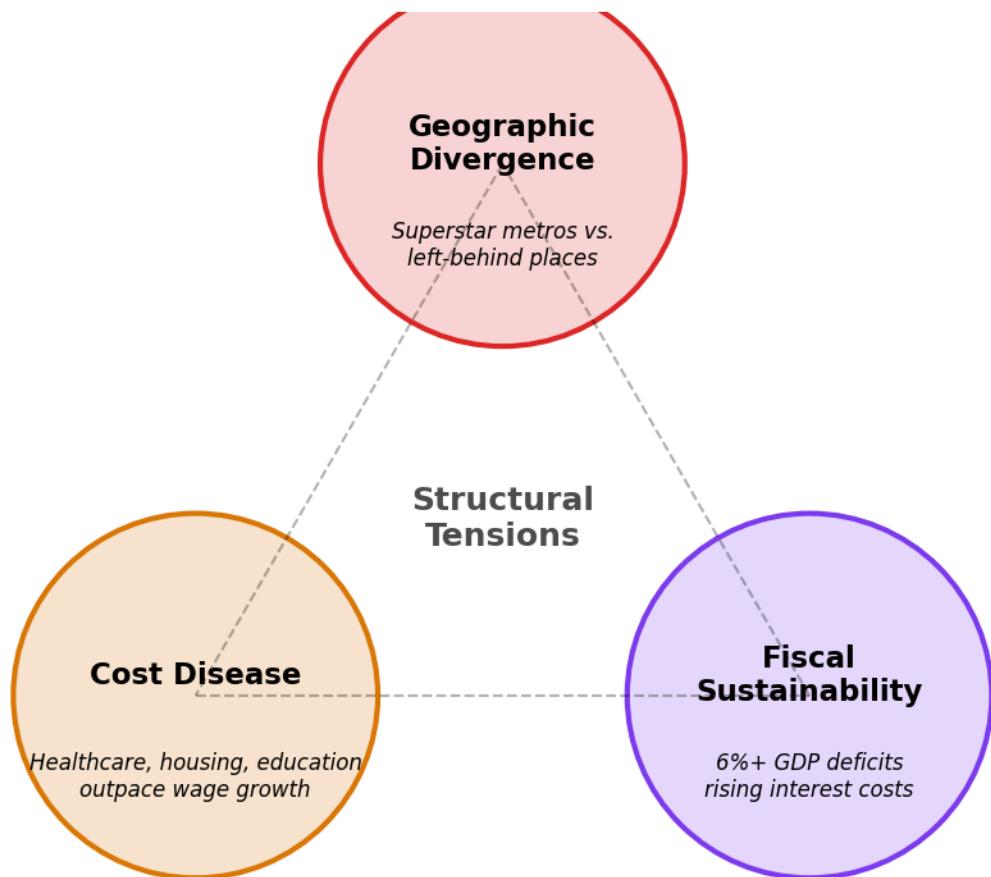


Figure 98: Figure 31.3: Three interconnected structural tensions: geographic divergence between superstar metros and left-behind places; cost disease in healthcare, housing, and education; and fiscal sustainability concerns as deficits persist at 6%+ of GDP. Source: Author analysis

Healthcare costs, at 18% of GDP, exceed those of any other developed nation without producing superior outcomes. Housing costs in productive metros consume ever-larger shares of household budgets, rationing access to opportunity. Childcare costs approach college tuition in major cities. The inability to control costs in these sectors has transformed the experience of middle-class life even as aggregate statistics show rising real incomes.

## Fiscal Sustainability

We conclude with the arithmetic that cannot be avoided indefinitely: the federal debt. The United States is running deficits exceeding 6% of GDP—levels associated historically with wartime, not peacetime expansion. We have relied on the world’s demand for dollar-denominated safe assets to fund defense, healthcare, and tax cuts simultaneously.

Interest costs on the federal debt have already exceeded defense spending and are rising rapidly as post-pandemic debt is refinanced at higher rates. At some point—whether in five years or twenty—the crowding-out effects of debt service will force choices that the political system has successfully avoided. Medicare, Social Security, defense spending, and tax policy cannot all remain on their current trajectories.

## Conclusion

To study the American economy is to be disabused of simple optimism and simple pessimism alike. It is a system that is at once rapacious and generative, innovative and calcified, fragile and resilient.

The homeless encampments in wealthy coastal cities, the hollowed-out towns of the Rust Belt, and the fragility of supply chains revealed by the pandemic make a compelling case that something is broken. Yet the fusion energy startups in Massachusetts, the battery gigafactories in Georgia, and the extraordinary productive capacity of American workers and firms make an equally compelling case that the capacity for reinvention remains intact.

What distinguishes the American economy is not that it solves problems cleanly but that it solves them at all—often problems that it created for itself. The resolution is typically messy, unequal, and incomplete. The losers from economic transformation receive inadequate compensation. The gains concentrate geographically and demographically. The political system struggles to translate economic change into policy response.

Yet the machine keeps running. The question for the coming decades is not whether the American economy will grow—it almost certainly will—but whether its gains can be shared more broadly across people and places, or whether the tensions documented in this book will eventually overwhelm its capacity for adaptation.

That question cannot be answered by economic analysis alone. It depends on political choices, institutional reforms, and social solidarities that lie beyond the scope of GDP

statistics. Economics can illuminate the trade-offs; it cannot make the choices. Those remain the work of democratic politics in an unfinished republic.

## Exercises

### Review Questions

1. The chapter describes the “vibecession” of 2023–2024 as revealing a “persistent gap between aggregate statistics and lived experience.” Explain why households may feel worse off even when GDP is growing and unemployment is low. How does the distinction between the rate of change and the level of prices help explain consumer dissatisfaction? What does this imply about the limitations of standard macroeconomic indicators as measures of well-being?
2. The 30-year fixed-rate mortgage is described as “an American anomaly” that effectively turns homeowners into “leveraged real estate investors.” Explain why this instrument is rare in other developed nations (where adjustable-rate or shorter-term fixed mortgages dominate). How does the government-backed mortgage system—through Fannie Mae, Freddie Mac, and FHA—make the 30-year fixed rate possible? What are the advantages and disadvantages of this arrangement compared to the mortgage systems of countries like Canada (5-year terms), the UK (2–5 year fixes), or Germany (10-year fixes)?
3. The chapter identifies a “lock-in” effect from the gap between existing 3% mortgages and current 7% rates. Trace the consequences of this lock-in through multiple dimensions of the economy: housing market liquidity, labor mobility, generational equity, and local government tax revenue. Why does the chapter call this “the defining microeconomic distortion of our time”? Compare this to situations in other countries where adjustable-rate mortgages transmit monetary policy changes directly to household budgets.
4. The United States is described as simultaneously leading the energy transition and remaining the world’s largest oil and gas producer. How has this “dual-track” approach provided the U.S. with competitive advantages over European nations that pursued a faster fossil fuel phase-out? What are the long-term risks of this strategy? Compare the U.S. approach to Germany’s Energiewende or Norway’s sovereign wealth fund model for managing petroleum revenues.
5. Explain the concept of “cost disease” as the chapter uses it. Why do prices fall in globally traded goods (electronics, apparel) but rise in locally consumed services (healthcare, housing, education, childcare)? How does this asymmetry affect the lived experience of middle-class households even as aggregate real incomes rise? Compare U.S. healthcare costs at 18% of GDP to those of peer nations (10–12% of GDP in most OECD countries) and discuss what structural factors—not just policy choices—account for the difference.
6. The chapter argues that American economic institutions “differ markedly” from those of peer nations—citing federalism, weak labor unions, employer-tied health insurance, and fragmented zoning authority. Select two of these institutional features and compare them to the arrangements in a European or East

Asian peer economy. For each, evaluate whether the American arrangement produces superior dynamism, greater inequality, or both. Are these institutional differences “choices” that could be reversed, or are they path-dependent features that resist reform?

7. The chapter describes three simultaneous transformations: the return of industrial policy, the energy transition, and the emergence of the AI-driven “intelligence economy.” For each transformation, identify one way it might reduce geographic divergence (by bringing investment to left-behind regions) and one way it might increase it (by further concentrating gains in already-prosperous areas). On balance, do you expect these transformations to narrow or widen the gap between “superstar metros” and “left-behind places”?

## Data Exercises

1. **Cross-Country Economic Comparison.** Using FRED and the OECD Data Explorer (<https://data-explorer.oecd.org>), compile the following indicators for the United States, Germany, Japan, the United Kingdom, and France: (a) GDP per capita in PPP terms, (b) the Gini coefficient for income inequality, (c) healthcare spending as a percentage of GDP, (d) life expectancy at birth, and (e) labor force participation rate. Present the data in a table and write a one-page analysis. Which countries outperform the U.S. on which metrics? Does the data support the chapter’s claim that the American economy is “uniquely capable of reinvention and uniquely tolerant of the disruption that reinvention leaves in its wake”?
2. **Mapping Geographic Divergence.** Using BEA regional economic accounts (<https://www.bea.gov/data/gdp/gdp-county-metro-and-other-areas>) and Census Bureau data, compare GDP per capita, median household income, and population growth across (a) the five largest metropolitan areas and (b) five non-metropolitan or small-metro areas in regions the chapter identifies as “left behind” (e.g., Appalachia, the rural Great Plains, the Mississippi Delta). Calculate the ratio of top-metro to left-behind-area incomes. Then retrieve the FRED series for labor force participation rates by state or metro (where available) to examine whether labor market engagement also diverges. Write a brief report (500–750 words) assessing whether the “two Americas” framing is supported by the most recent data.
3. **Industrial Policy Investment Tracker.** Using data from the White House “Investing in America” tracker (<https://www.whitehouse.gov/invest/>) and Treasury Department reports on IRA tax credit uptake, compile a list of at least fifteen major manufacturing investments (semiconductor fabs, battery plants, clean energy facilities) announced since 2022. For each, record the location, investment amount, projected employment, and the federal incentive involved (CHIPS grant, IRA tax credit, etc.). Map these investments geographically. Are they concentrated in particular states or regions? Do the locations align with the chapter’s description of the “Battery Belt” and “semiconductor archipelago”? Write an analysis (500–750 words) evaluating whether industrial policy is directing investment toward economically distressed areas or toward regions that were already growing.

## **Deeper Investigation**

1. The chapter states that the American economy's fiscal trajectory—deficits exceeding 6% of GDP, interest costs rivaling defense spending—"cannot be avoided indefinitely," yet the political system has "successfully avoided" making hard choices. Research the current state of federal fiscal sustainability. Using CBO long-term budget projections (<https://www.cbo.gov/topics/long-term-budget-projections>), FRED data on federal debt as a share of GDP (FYGFDQ188S), and comparative data on sovereign debt from the IMF Fiscal Monitor, write a research paper (1,500-2,000 words) that addresses: (a) What makes the U.S. fiscal position different from that of other high-debt nations like Japan or Italy—particularly the dollar's reserve currency status? (b) At what point might rising debt service costs begin to crowd out other federal spending or raise borrowing costs? (c) What combination of spending cuts and revenue increases would stabilize the debt-to-GDP ratio, and why has neither party been willing to propose them? Engage with arguments from both deficit hawks and those who argue that sovereign debt in a reserve currency nation poses less risk than conventional analysis suggests.

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**Word count:** approximately 2,200 words

# Chapter 32: How Shocks Move Through the Economy

Throughout this book, we've examined the American economy's structure: its sectors, regions, institutions, and interconnections. But structure isn't static. Understanding how the economy is built matters most when something disrupts it. This chapter brings the structural analysis to life by tracing how economic shocks propagate—through input-output linkages, financial channels, labor markets, and geographic networks.

Economic shocks are perturbations that disrupt normal patterns of production, employment, or prices. They come in many forms: a collapse in oil prices devastates Texas while benefiting consumers elsewhere; a surge in Chinese imports eliminates manufacturing jobs in specific communities; a Federal Reserve rate increase ripples through mortgage markets, housing construction, and bank balance sheets. The economy's response to these shocks depends on its structure—which is why the preceding 31 chapters matter for understanding what happens when things change.

## The Propagation Framework

Economic shocks transmit through multiple channels simultaneously. Understanding these channels helps explain why some shocks spread broadly while others remain contained, why some communities recover quickly while others never do.

### Input-Output Linkages: The Production Network

The input-output framework introduced in Chapter 2 provides the foundation for understanding how shocks propagate through the production network. Every industry purchases inputs from other industries and sells its output to downstream buyers. A shock to one sector creates ripples throughout this network.

**Direct effects** are the immediate impact on the shocked sector itself. When oil prices collapse, oil production falls.

**Indirect effects** arise through supply chain linkages. Lower oil production means reduced demand for steel pipe, drilling services, and oilfield equipment. These suppliers cut their own production and employment, reducing their purchases from their suppliers in turn.

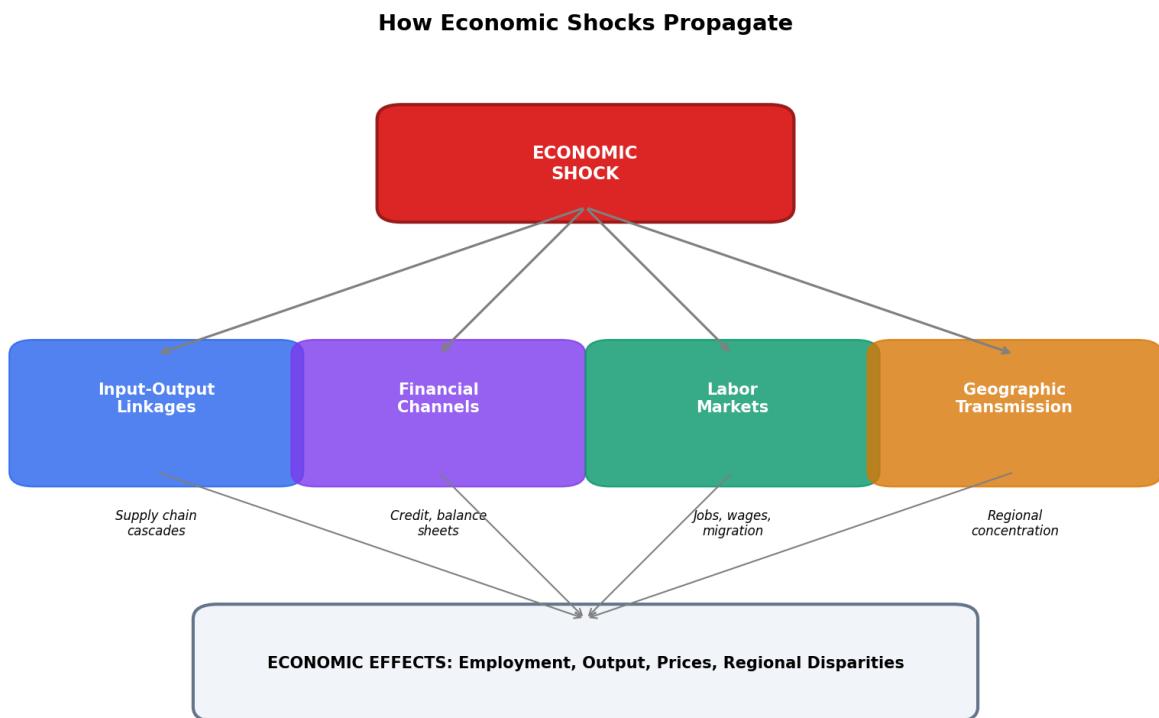


Figure 99: Figure 32.1: The four primary channels through which economic shocks propagate: input-output linkages (supply chain cascades), financial channels (credit and balance sheets), labor markets (jobs, wages, migration), and geographic transmission (regional concentration). View interactive version. Source: Author illustration

**Induced effects** occur when workers who lose income reduce their consumer spending. Laid-off oil workers buy fewer cars, eat out less, and delay home purchases. This affects sectors (retail, restaurants, housing) with no direct link to oil.

The combined impact—direct plus indirect plus induced—is the **multiplier effect**. An initial \$1 shock to final demand can reduce GDP by \$1.50 or \$2.00 once all the propagation effects work through. The multiplier depends on the sector’s position in the production network: shocks to highly connected sectors amplify more than shocks to peripheral ones.

## Geographic Transmission: Where Shocks Land

Shocks don’t fall evenly across the country. Geographic concentration creates winners and losers:

- **Producing regions** bear concentrated pain when their key industry contracts. The Bakken oil field, Midwestern manufacturing towns, and Appalachian coal communities experienced localized depressions when their industries declined.
- **Consuming regions** may benefit from the same shock. Lower oil prices that devastated Texas transferred billions in purchasing power to consumers in oil-importing states.
- **Supply chain geography** determines secondary effects. Houston suffered during the oil collapse partly because so many oilfield service and equipment companies are headquartered there—the indirect effects concentrated where the suppliers cluster.

The structural features documented in Chapters 23-27 (regional economies) determine which communities face which exposures. Diversified metros like Houston absorb shocks better than specialized towns like Midland. Elastic housing markets like Texas adjust through prices; constrained markets like San Francisco adjust through quantities.

## Financial Transmission: Credit and Balance Sheets

Financial channels amplify shocks through leverage and interconnection:

- **Asset price changes** affect household and corporate balance sheets. The 2006-2012 housing crash destroyed \$8 trillion in household wealth, contracting consumption far beyond what direct job losses would have caused.
- **Credit conditions** tighten during downturns as banks pull back lending, creating a vicious cycle: economic weakness leads to tighter credit, which deepens the weakness.
- **Financial institution stress** can cascade through the system. The 2008 crisis showed how losses at one institution—Lehman Brothers—could freeze credit markets globally.

The financial architecture described in Chapters 18-20 determines how these channels operate. Highly levered systems amplify shocks; well-capitalized systems absorb them.

## **Labor Market Transmission: Jobs and Migration**

Labor markets are where shocks become personal:

- **Job destruction** affects specific workers in specific places. The China shock didn't eliminate "manufacturing jobs" abstractly—it eliminated jobs at particular plants in particular towns.
- **Wage adjustments** spread pain or gain across workers in a sector or region. When an industry contracts, wages fall even for workers who keep their jobs.
- **Migration** is the traditional adjustment mechanism. Workers are supposed to leave declining regions for growing ones. In practice, migration has slowed dramatically, leaving communities stuck with mismatched labor markets.
- **Skills mismatch** creates persistent unemployment. A laid-off autoworker can't immediately become a software engineer, even if tech jobs are growing.

## **Time Dynamics: Immediate, Adjustment, Long-Run**

Shocks unfold over multiple time horizons:

**Immediate effects** (weeks to months): Prices adjust quickly. Employment adjusts slowly. Inventories buffer production for a time.

**Adjustment period** (1-3 years): Labor markets respond as workers are laid off or hired. Investment responds as companies expand or contract capacity. Migration begins, though slowly.

**Long-run effects** (5+ years): Some shocks leave permanent marks—"hysteresis" in the jargon. Communities that lose their economic base may never recover. Workers who exit the labor force may never return. The China shock's effects on manufacturing communities are still visible 20 years later.

## **Case Study: The 2014-2016 Oil Price Collapse**

Chapter 2 introduced this episode through the lens of input-output linkages—backward linkages to suppliers, forward linkages to consumers, and the resulting multiplier effects. Here we return to the same shock but trace it through all four transmission channels: production networks, geographic concentration, financial amplification, and labor market adjustment. The difference in scope shows why the I-O framework alone, while powerful, tells only part of the story.

### **The Initial Shock**

Brent crude oil prices fell from \$115 per barrel in June 2014 to \$28 per barrel in January 2016—a 76% decline. The proximate cause was OPEC's decision to defend market share rather than prices, flooding an already oversupplied market.

For the American economy, this was simultaneously a negative supply shock (devastating energy-producing regions) and a positive demand shock (benefiting consumers everywhere else). The net effect was roughly neutral for national GDP, but the geographic distribution was anything but neutral.

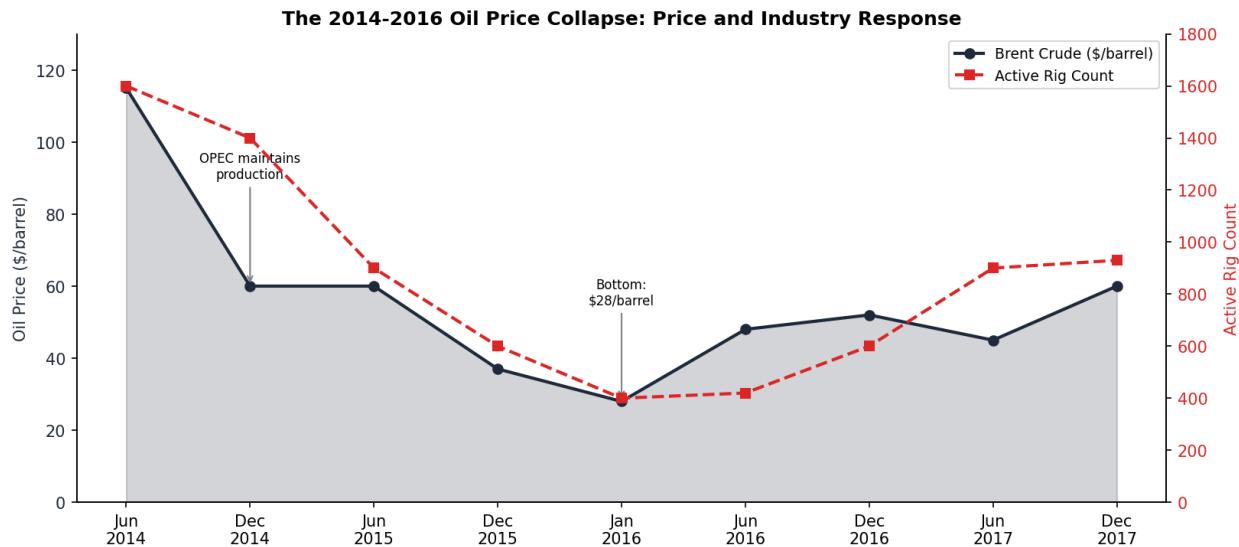


Figure 100: Figure 32.2: The 2014-2016 oil price collapse. Brent crude fell from \$115 to \$28 per barrel; the U.S. rig count collapsed 80% from 1,600 to 316. The shock devastated energy-producing regions while benefiting consumers elsewhere. Source: EIA, Baker Hughes

## First-Round Effects: The Energy Sector

The direct impact hit the oil and gas industry immediately:

**Employment:** The oil and gas extraction sector shed over 150,000 jobs between late 2014 and early 2016. Oilfield services lost even more—drillers, equipment operators, service technicians.

**Investment:** Active rig counts plummeted from 1,600 to 316—an 80% decline. Capital expenditures by exploration and production companies fell by more than half. Projects were cancelled, drilling programs suspended, expansion plans shelved.

**Corporate stress:** Over 100 North American oil and gas producers filed for bankruptcy in 2015-2016. High-yield energy bonds, which had funded much of the shale boom, suffered default rates exceeding 15%.

## Second-Round Effects: The Supply Chain

The shock propagated through input-output linkages to oil's suppliers:

**Steel pipe manufacturers:** Demand for drilling pipe collapsed. Steel mills in Arkansas and Texas cut production and laid off workers.

**Industrial equipment:** Caterpillar and other heavy equipment makers saw orders fall as mining and drilling investment contracted.

**Transportation:** Trucking companies serving the oil fields lost business. Railroads that had invested in crude-by-rail infrastructure saw volumes plummet.

**Professional services:** Engineering firms, environmental consultants, and legal practices with energy practices contracted.

**Real estate:** Houston office vacancy rates spiked as energy companies consolidated and cut space. Midland housing prices fell 20-30% as workers departed. Man-camps near drilling sites emptied.

### **Third-Round Effects: Induced Spending**

Laid-off energy workers cut their spending, creating induced effects:

**Retail:** Car dealerships in Midland reported sales falling by half. Restaurants near oil fields closed. Consumer spending in energy-producing metros visibly softened.

**Housing:** Beyond the direct real estate impact, reduced spending power depressed housing markets across Texas. The San Antonio and Austin markets, distant from drilling, still felt effects as the entire Texas economy slowed.

**Local services:** Doctors, dentists, lawyers, and other professionals serving energy workers saw reduced demand.

### **Geographic Concentration**

The shock's geographic distribution followed the production map:

**Permian Basin (West Texas/New Mexico):** The epicenter. Midland unemployment jumped from 2.4% to 4.9%. Hotel occupancy collapsed. Restaurants closed. The local housing market crashed.

**Bakken (North Dakota):** Williston, which had grown from 12,000 to 35,000 residents during the boom, contracted rapidly. Workers left as quickly as they had arrived. North Dakota's unemployment rate tripled.

**Eagle Ford (South Texas):** Employment growth in the San Antonio-New Braunfels metro slowed dramatically. Smaller towns entirely dependent on oil suffered worse.

**Gulf Coast refining:** Refiners actually benefited from lower crude prices—their input costs fell while product prices held steadier. The Houston metro's diversification across the oil value chain provided some buffer.

### **Financial Transmission**

The shock propagated through financial channels:

**High-yield energy debt:** The “junk bond” market had funded much of the shale revolution. As companies defaulted, investors fled the asset class. Energy bond spreads widened to distressed levels, shutting weaker producers out of capital markets entirely.

**Regional bank exposure:** Banks concentrated in Texas and Oklahoma faced rising non-performing loans. Several smaller banks failed. Larger regional banks like Cullen/Frost increased loan loss reserves substantially.

**Private equity losses:** Firms that had invested in oil and gas during the boom faced writedowns. Some positions went to zero.

## Consumer Benefits

For the 95% of Americans who don't work in energy, the oil collapse was good news:

**Gasoline prices:** The national average fell from nearly \$4/gallon to below \$2. For a household driving 30,000 miles annually in a 25-mpg vehicle, this represented savings of \$2,400 per year—a meaningful boost to purchasing power.

**Transportation costs:** Airlines, trucking companies, and other transport-intensive businesses saw lower fuel costs. Some passed savings to consumers; others captured improved margins.

**Chemicals and plastics:** Industries using petroleum as feedstock benefited from lower input costs.

## Adjustment and Recovery

By 2018, the industry had adjusted:

**Productivity gains:** Surviving producers learned to operate profitably at \$50 oil instead of \$80. Breakeven costs in the Permian fell dramatically through better technology, improved completion techniques, and aggressive cost-cutting.

**Consolidation:** Weaker producers were acquired or liquidated. The industry emerged more concentrated and better capitalized.

**Capital discipline:** Investors who had funded growth-at-any-cost demanded returns. Companies shifted from maximizing production to maximizing cash flow.

**Structural employment loss:** Even as production recovered to record levels by 2019, employment didn't fully return. The industry had learned to produce more oil with fewer workers—a permanent productivity improvement that looked like a permanent job loss to the workers who never got called back.

## Comparative Analysis: Other Major Shocks

The oil shock illustrates the transmission framework, but other shocks activate different channels with different effects.

### The China Shock (2000-2010)

The China shock—the surge in imports following China's WTO accession—transmitted primarily through product market competition, with devastating effects on specific communities.

**Transmission mechanism:** Unlike oil, where prices adjusted to balance supply and demand, the China shock worked through quantities. American factories lost market

share to Chinese imports. Plants that couldn't match Chinese costs closed. Workers lost jobs.

**Geographic concentration:** The shock devastated communities specialized in the goods China produced: furniture in North Carolina, textiles across the Southeast, electronics assembly in multiple states. Research by Autor, Dorn, and Hanson documented that commuting zones with greater import exposure experienced larger employment losses, higher disability enrollment, and elevated mortality.

**Labor market response:** Displaced manufacturing workers largely didn't find equivalent employment elsewhere. The standard economic adjustment mechanisms—wage flexibility, geographic mobility, sectoral reallocation—failed to absorb workers at anything like the rate they were displaced. Many left the labor force entirely.

**Long-run effects:** Twenty years later, the affected communities still show the scars. Manufacturing employment never recovered. The skills and social capital embedded in factory work didn't transfer to other sectors. The China shock contributed to political realignment as affected voters shifted toward protectionist candidates.

## The Housing Bust (2006-2012)

The housing bust transmitted primarily through balance sheets—the wealth effect on households and the asset quality shock to financial institutions.

**Wealth destruction:** American homeowners lost roughly \$8 trillion in home equity between 2006 and 2009. For households whose homes represented their primary asset, this wealth destruction was catastrophic.

**Consumption collapse:** Mian and Sufi documented that zip codes with larger house price declines experienced larger drops in consumer spending. Households that felt poorer spent less—on cars, appliances, restaurants, and everything else.

**Financial contagion:** The housing bust became a financial crisis because mortgages had been securitized and distributed throughout the financial system. When housing prices fell and defaults rose, the securities backed by those mortgages fell in value. Banks holding these securities faced insolvency. The uncertainty about who held how much toxic paper froze interbank lending, transmitting a housing shock into a credit crisis affecting the entire economy.

**Geographic variation:** The “Sand States” (Arizona, California, Florida, Nevada) experienced the largest price declines—50-60% in some markets. Texas, which never had a boom, never had a bust. Supply-constrained coastal markets fell less and recovered faster.

## The 2022-2023 Monetary Policy Tightening

The Fed's rate increases transmitted through multiple channels simultaneously, demonstrating both intended and unintended effects of monetary policy.

**Mortgage rates:** The 30-year fixed rate doubled from 3% to 7%, crushing housing affordability and freezing the existing home market as locked-in borrowers refused to sell.

**Asset prices:** Rising rates mechanically reduce bond prices. Banks holding long-duration securities saw billions in unrealized losses, creating the fragility that ultimately sank Silicon Valley Bank.

**Credit conditions:** Banks tightened lending standards, particularly for commercial real estate and small business. The intended credit channel worked—but perhaps too abruptly.

**Sectoral variation:** Interest-rate-sensitive sectors (housing, autos) contracted sharply. Tech startups dependent on equity financing saw their funding environment collapse. Cash-rich companies faced minimal impact.

## Policy Responses and Their Transmission

Government responses to shocks themselves propagate through the economy. Understanding this transmission is essential for evaluating policy.

### Fiscal Policy: The CHIPS Act and IRA

The CHIPS and Science Act (\$52.7 billion for semiconductors) and Inflation Reduction Act (roughly \$370 billion for clean energy) represent deliberate positive shocks to specific sectors.

**Direct effects:** Semiconductor fabs are under construction in Arizona, Ohio, and Texas. Battery plants are rising across the “Battery Belt” from Georgia to Michigan.

**Geographic transmission:** These investments concentrate in specific regions—often politically targeted. The industrial policy explicitly aims to bring manufacturing to communities that lost it.

**Supply chain development:** The investments aim to catalyze domestic supply chains. Intel’s Ohio fab requires suppliers; suppliers need their own suppliers. The multiplier logic works in reverse—positive shocks should propagate through input-output linkages just as negative ones do.

**Limits:** Whether policy-driven investment achieves the same multipliers as market-driven investment remains debated. Government-directed capital may flow to politically favored rather than economically efficient locations.

### Monetary Policy: The Fed Response

The Federal Reserve’s response to shocks works through the financial transmission channels:

**Interest rate adjustments:** Lower rates stimulate borrowing and spending; higher rates cool them. But the transmission is imperfect—credit rationing means banks may not lend even when rates fall.

**Quantitative easing:** Asset purchases inject reserves into the banking system and lower long-term yields. The wealth effect from higher asset prices was the primary transmission mechanism.

**Emergency facilities:** During crises, the Fed becomes lender of last resort not just for banks but for the entire financial system. The 2008 and 2020 interventions prevented financial collapse from transmitting into complete economic shutdown.

## Trade Policy: Tariffs

Tariffs on Chinese goods, imposed starting in 2018, represent deliberate supply shocks intended to benefit domestic producers:

**Direct effects:** Higher prices for imported goods; some reshoring of production.

**Downstream transmission:** Tariffs on intermediate goods (steel, aluminum, components) raise costs for downstream manufacturers. The tariffs on Chinese steel may cost more jobs in steel-using industries than they save in steel-producing ones.

**Consumer effects:** Higher prices for tariffed goods effectively act as a tax on consumption. The incidence falls disproportionately on lower-income households who spend more of their income on goods.

## What Structure Tells Us About Vulnerability

The preceding chapters documented the American economy's structure. What does that structure tell us about vulnerability to future shocks?

### Concentrated Industries = Concentrated Risk

Industries with geographic concentration create communities whose fates rise and fall with a single sector:

- **Energy:** The Permian Basin, North Dakota, and Wyoming depend heavily on oil and gas. Price volatility directly translates to economic volatility.
- **Automotive:** Michigan and Ohio remain exposed to automotive disruption, whether from EV transition, trade policy, or demand shocks.
- **Tech:** The Bay Area's concentration in technology creates enormous wealth when tech booms and significant vulnerability when it busts.
- **Agriculture:** Rural communities dependent on commodity prices face boom-bust cycles tied to global markets and weather.

### Supply Chain Fragility

The 2021-2022 supply chain crisis revealed vulnerabilities in global production networks:

- **Single points of failure:** Concentration of semiconductor production in Taiwan, pharmaceutical ingredients in China, and container shipping through a few major ports creates systemic risk.
- **Just-in-time inventory:** Optimizing for efficiency left no buffer for disruption. The system that worked brilliantly in normal times failed spectacularly under stress.

- **Logistics bottlenecks:** The LA/Long Beach port complex handles 40% of containerized imports. When it congested, the entire country felt the effects.

## Financial Leverage

Leverage amplifies shocks. The 2008 crisis demonstrated how levered positions unwind catastrophically. The March 2023 bank stress showed that even “safe” assets can destabilize institutions through duration mismatch:

- **Household leverage:** Mortgage debt exposes households to housing price declines and interest rate increases.
- **Corporate leverage:** Private credit and leveraged loans have grown rapidly. A recession would test this exposure.
- **Bank leverage:** Capital requirements have increased since 2008, but SVB showed that regulatory frameworks don’t capture all risks.

## Low-Diversity Metros

Metropolitan areas with concentrated industry bases are more vulnerable than diversified ones:

- **High vulnerability:** Midland (oil), Flint (autos), Atlantic City (gaming) face existential risk from single-sector decline.
- **Lower vulnerability:** New York, Los Angeles, and Chicago have diversified economies where no single sector dominates.
- **Moderate vulnerability:** Houston illustrates the middle case—heavily tilted toward energy but diversified enough within the sector to partially buffer shocks.

## Policy Can Redirect But Not Eliminate Shocks

Policy can shift who bears the burden of shocks but rarely eliminates the burden entirely:

- **Trade protection** shifts costs from domestic producers to domestic consumers and foreign exporters.
- **Bailouts** shift costs from current stakeholders to future taxpayers.
- **Monetary policy** shifts costs across time (higher inflation now vs. slower growth later).

The question is never whether to eliminate shocks but how to allocate their costs—across sectors, regions, income groups, and generations.

## Conclusion: Structure as Destiny

Understanding the American economy’s structure—its sectors, geography, institutions, and linkages—provides the foundation for understanding how it responds to shocks. The input-output linkages determine which industries feel indirect effects. The geographic distribution determines which communities bear concentrated pain or gain. The financial architecture determines whether shocks amplify or dampen

as they propagate. The labor market structure determines whether workers adjust smoothly or suffer prolonged displacement.

The shocks examined in this chapter—oil prices, Chinese imports, housing busts, monetary tightening—are not anomalies. They are the normal way an economy evolves. The question is not whether shocks will occur but how the economy's structure will shape their transmission and ultimate impact.

This returns us to the book's central premise: the American economy is not an abstraction of supply and demand curves but a concrete structure of industries, firms, workers, and institutions, located in specific places and connected through specific channels. That structure matters—for understanding how the economy works, and for understanding what happens when something changes.

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- Federal Reserve Bank regional research on local economic shocks
- Brookings Institution, "The Geography of Prosperity"
- Economic Innovation Group, "Distressed Communities Index"

## **Exercises**

### **Review Questions**

1. The chapter identifies four primary channels of shock transmission: input-output linkages, geographic transmission, financial transmission, and labor market transmission. For each channel, provide a one-sentence definition and a concrete example from the chapter. Then explain why understanding all four channels simultaneously is necessary—that is, why analyzing only one channel in isolation would produce a misleading picture of how a shock propagates.
2. Distinguish among direct effects, indirect effects, and induced effects in the input-output framework. Using the 2014–2016 oil price collapse as the example, trace each type of effect: the direct employment losses in oil and gas extraction, the indirect impact on steel pipe manufacturers and oilfield equipment companies, and the induced spending reductions by laid-off energy workers. Why is the combined “multiplier effect” larger for highly connected sectors than for peripheral ones?
3. The chapter describes the 2014–2016 oil price collapse as “simultaneously a negative supply shock (devastating energy-producing regions) and a positive demand shock (benefiting consumers everywhere else).” Explain this duality. Why was the net effect roughly neutral for national GDP even though the geographic distribution was “anything but neutral”? What does this case reveal about the limitations of aggregate national statistics for understanding the real impact of economic shocks?
4. Compare the transmission mechanisms of the China shock (2000–2010) and the housing bust (2006–2012). The chapter argues that the China shock transmitted primarily through “product market competition” and “quantities,” while the housing bust transmitted through “balance sheets” and “wealth effects.” Explain this distinction. Why did the China shock produce persistent, geographically concentrated damage to specific communities, while the housing bust produced a broader but in some ways more recoverable national recession?
5. The chapter introduces the concept of “hysteresis”—the idea that some shocks leave permanent marks. Using the China shock example, explain why the “standard economic adjustment mechanisms—wage flexibility, geographic mobility, sectoral reallocation—failed to absorb workers at anything like the rate they were displaced.” What structural features of the American economy (housing lock-in, skills mismatch, declining geographic mobility) contribute to hysteresis? Why is this concept important for policy—that is, why does hysteresis change the cost-benefit analysis of allowing versus preventing economic disruptions?
6. The chapter argues that “policy can shift who bears the burden of shocks but rarely eliminates the burden entirely,” citing trade protection, bailouts, and monetary policy as examples. For each of these three policy tools, identify who gains and who loses when the policy is deployed. Why does the chapter frame the fundamental question as “not whether to eliminate shocks but how to allocate their costs—across sectors, regions, income groups, and generations”?

7. The section on vulnerability identifies concentrated industries, supply chain fragility, financial leverage, and low-diversity metros as key sources of economic risk. Using the framework developed in the chapter, assess the vulnerability of a single metropolitan area of your choice. What is its dominant industry? How geographically concentrated is that industry? What supply chain dependencies exist? How leveraged are households and firms? Based on this analysis, what type of shock would pose the greatest threat to this metro, and through which channels would the damage propagate?

## Data Exercises

- 1. Tracing an Oil Shock Through the Data.** Using FRED, retrieve the following series for the period 2013–2019: West Texas Intermediate crude oil price (DCOILWTICO), total nonfarm employment in Texas (TXNA), the unemployment rate in Midland, TX (MIDL448URN), and U.S. real personal consumption expenditures (PCEC96). Plot all four series on a common timeline. Identify the lag between the oil price decline (beginning mid-2014) and the employment response in Texas and Midland. Then compare the timing of the consumer spending response nationally. Write a one-page analysis using the chapter’s propagation framework to explain the sequence: Why do prices move first, employment second, and induced consumption effects last? How does the Midland-specific data illustrate the concept of geographic concentration of shocks?
- 2. Input-Output Multipliers.** Download the most recent BEA Input-Output “Use” table (available at <https://www.bea.gov/industry/input-output-accounts-data>) for the U.S. economy. Identify the top five industries that purchase the most from the “Oil and gas extraction” sector (NAICS 211). Then identify the top five industries that sell the most to oil and gas extraction. Using this data, explain why the oil price collapse’s indirect effects were concentrated in specific downstream and upstream industries. Compare the interconnectedness of oil and gas to that of a less connected sector (e.g., “Performing arts and spectator sports”). Which sector would produce a larger multiplier if shocked, and why?
- 3. Housing Bust Geographic Variation.** Using FRED, retrieve the S&P/Case-Shiller home price indices for four metro areas: Las Vegas (LVXRSA), Phoenix (PHXRSA), Dallas (DAXRSA), and San Francisco (SFXRSA). Plot all four from 2004 to 2015. Calculate the peak-to-trough decline for each metro. Then retrieve unemployment rate data for the same four metros over the same period. Write a brief analysis (500–750 words) explaining why the “Sand States” experienced larger price declines, why Texas “never had a boom” so “never had a bust,” and how the chapter’s framework of financial transmission (leverage, wealth effects) explains the variation. Discuss whether supply-constrained markets like San Francisco “fell less and recovered faster” as the chapter claims.

## Deeper Investigation

1. The chapter examines shocks that have already occurred—the oil collapse, the China shock, the housing bust, monetary tightening. Apply the chapter’s four-channel propagation framework to a shock that is currently unfolding or may

occur in the near future. Choose one of the following: (a) a major disruption to semiconductor supply chains (e.g., a Taiwan Strait crisis), (b) the rapid displacement of knowledge workers by AI systems, or (c) a sharp correction in commercial real estate values as remote work permanently reduces office demand. For your chosen shock, write a research paper (1,500–2,000 words) that traces its likely propagation through each of the four channels: input-output linkages (which industries would be directly and indirectly affected?), geographic transmission (which regions or metro areas are most exposed?), financial transmission (what balance sheet and credit effects would occur?), and labor market transmission (which workers would be displaced and what adjustment mechanisms would or would not operate?). Use specific data from BEA, BLS, FRED, and Census sources to support your analysis. Conclude by evaluating what policy responses could mitigate the damage and through which channels those policies would operate.

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Chapter 32 | How Shocks Move Through the Economy The American Economy: A Structural Geography Draft v1 — January 2026

# **Appendices**

# Appendix A: Data Sources Guide

This appendix provides an overview of the primary data sources used throughout this book, along with guidance on how to access and interpret them.

## Bureau of Economic Analysis (BEA)

The BEA, housed within the Department of Commerce, produces the foundational measures of the U.S. economy.

### Key Products

**Gross Domestic Product (GDP)** - Quarterly and annual estimates of U.S. economic output - Released monthly (advance, second, and third estimates) - Access: [bea.gov/data/gdp](http://bea.gov/data/gdp)

**Industry Accounts** - GDP by industry (NAICS-based) - Input-output tables showing inter-industry flows - Annual and benchmark tables - Access: [bea.gov/industry](http://bea.gov/industry)

**Regional Economic Accounts** - State GDP (quarterly and annual) - Metropolitan area GDP (annual) - Personal income by state and county - Access: [bea.gov/regional](http://bea.gov/regional)

**International Transactions** - Balance of payments - Trade in goods and services - Foreign direct investment - Access: [bea.gov/international](http://bea.gov/international)

### How to Access

- **Interactive Tables:** BEA's website offers customizable data retrieval
  - **API:** Free API access for programmatic retrieval (registration required)
  - **FRED:** Many BEA series available through Federal Reserve Economic Data
- 

## Bureau of Labor Statistics (BLS)

The BLS, within the Department of Labor, produces employment and price statistics.

## Key Products

**Current Employment Statistics (CES)** - Monthly employment by industry (nonfarm payrolls) - Average hourly earnings - Hours worked - The “jobs report” released first Friday of each month - Access: [bls.gov/ces](http://bls.gov/ces)

**Quarterly Census of Employment and Wages (QCEW)** - Employment and wages by industry and geography - Derived from unemployment insurance records - Covers 95%+ of jobs - Access: [bls.gov/qcew](http://bls.gov/qcew)

**Occupational Employment and Wage Statistics (OEWS)** - Employment and wages by detailed occupation - Metropolitan area detail - Access: [bls.gov/oes](http://bls.gov/oes)

**Consumer Price Index (CPI)** - Monthly inflation measure - Multiple series (all items, core, by region) - Access: [bls.gov/cpi](http://bls.gov/cpi)

**Producer Price Index (PPI)** - Wholesale/producer-level prices by industry - Access: [bls.gov/ppi](http://bls.gov/ppi)

**Productivity and Costs** - Labor productivity by sector - Unit labor costs - Access: [bls.gov/lpc](http://bls.gov/lpc)

## How to Access

- **Data Retrieval Tools:** BLS offers customizable series selection
  - **API:** Free API access for bulk retrieval
  - **FRED:** Most major BLS series available through FRED
- 

## Census Bureau

The Census Bureau, within the Commerce Department, conducts surveys and the decennial census.

## Key Products

**Economic Census** (every 5 years) - Comprehensive establishment-level data by industry - Employment, payroll, revenue by NAICS code - Geographic detail to county level - Access: [census.gov/econ](http://census.gov/econ)

**Annual Business Survey** - Annual updates between Economic Censuses - Business characteristics and innovation

**County Business Patterns** - Annual employment and establishments by industry and county - Access: [census.gov/programs-surveys/cbp](http://census.gov/programs-surveys/cbp)

**American Community Survey (ACS)** - Annual demographic, housing, and economic characteristics - 1-year and 5-year estimates - Access: [census.gov/acs](http://census.gov/acs)

**Trade Data** - USA Trade Online: Detailed imports and exports - Access: [us-atrade.census.gov](http://us-atrade.census.gov)

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## Federal Reserve

The Federal Reserve System produces financial and monetary data.

### Key Products

**Financial Accounts of the United States (Z.1)** - Flow of funds, balance sheets - Sectoral balances (households, corporations, government) - Quarterly release - Access: [federalreserve.gov/releases/z1](http://federalreserve.gov/releases/z1)

**H.4.1 Release** - Federal Reserve balance sheet - Weekly

**H.8 Release (Assets and Liabilities of Commercial Banks)** - Weekly data on bank credit, loans, and securities holdings - Key for tracking lending conditions and bank balance sheets - Access: [federalreserve.gov/releases/h8](http://federalreserve.gov/releases/h8)

**Industrial Production and Capacity Utilization** - Monthly output by industry - Capacity utilization rates - Access: [federalreserve.gov/releases/g17](http://federalreserve.gov/releases/g17)

**Survey of Consumer Finances** - Triennial household wealth and debt survey - Access: [federalreserve.gov/econres/scfindex.htm](http://federalreserve.gov/econres/scfindex.htm)

**FRED (Federal Reserve Economic Data)** - Aggregates data from BEA, BLS, Census, and many other sources - Easy-to-use interface, API access - Access: [fred.stlouisfed.org](http://fred.stlouisfed.org)

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## Agency-Specific Sources

### Energy

**Energy Information Administration (EIA)** - Comprehensive energy production, consumption, prices - State Energy Data System (SEDS) - Access: [eia.gov](http://eia.gov)

### Healthcare

**Centers for Medicare & Medicaid Services (CMS)** - National Health Expenditure Accounts - Medicare and Medicaid data - Access: [cms.gov/data-research](http://cms.gov/data-research)

### Agriculture

**USDA Economic Research Service** - Farm income, food expenditure, rural statistics - Access: [ers.usda.gov](http://ers.usda.gov)

**USDA National Agricultural Statistics Service (NASS)** - Crop production, prices, farm counts - Access: [nass.usda.gov](http://nass.usda.gov)

## **Finance**

**FDIC** - Bank financial data, deposit data - Access: [fdic.gov/bank/statistical](http://fdic.gov/bank/statistical)

**SEC EDGAR** - Public company filings (10-K, 10-Q, proxy statements) - Access: [sec.gov/edgar](http://sec.gov/edgar)

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## **Transportation**

**Bureau of Transportation Statistics (BTS)** - Freight, passenger, infrastructure data - Access: [bts.gov](http://bts.gov)

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## **International and Comparative Data**

**World Bank Open Data** - Cross-country economic indicators - Access: [data.worldbank.org](http://data.worldbank.org)

**OECD Statistics** - Developed economy comparisons - Access: [stats.oecd.org](http://stats.oecd.org)

**UN Comtrade** - Detailed international trade data - Access: [comtrade.un.org](http://comtrade.un.org)

**IMF Data** - Balance of payments, financial statistics - Access: [data.imf.org](http://data.imf.org)

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## **Tips for Using Government Data**

1. **Check Vintage:** Economic data is revised frequently. The first release differs from final estimates.
  2. **Understand Seasonal Adjustment:** Most monthly/quarterly data is seasonally adjusted. Use adjusted figures for trend analysis, unadjusted for specific period comparisons.
  3. **Note Geographic Coverage:** Some series cover all establishments; others sample. Coverage affects precision at detailed levels.
  4. **Mind NAICS Changes:** The NAICS classification system is revised every 5 years. Historical comparisons may require concordances.
  5. **Use APIs for Reproducibility:** Programmatic access via APIs ensures your analysis can be replicated and updated.
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## **Further Resources**

- **Data.gov:** Central portal for federal open data
- **USA Facts:** Non-profit aggregating government data
- **IPUMS:** Harmonized Census and survey microdata

- **ICPSR**: Academic data archive with many government series

# Appendix B: BEA Industry Accounts Reference

This appendix provides reference tables for interpreting BEA industry data, which underpins much of the analysis in this book.

## GDP by Industry (2023)

The following table shows value added (GDP contribution) by major industry, sorted by size.

Industry	GDP (\$ billions)	Share of GDP	NAICS
Real estate, rental, leasing	\$2,843	10.4%	53
Professional, scientific, technical services	\$2,426	8.9%	54
Government	\$2,217	8.1%	—
Finance and insurance	\$2,191	8.0%	52
Health care and social assistance	\$2,074	7.6%	62
Manufacturing	\$2,041	7.5%	31-33
Retail trade	\$1,573	5.8%	44-45
Information	\$1,471	5.4%	51
Wholesale trade	\$1,433	5.2%	42
Construction	\$1,184	4.3%	23
Transportation and warehousing	\$926	3.4%	48-49
Other services	\$640	2.3%	81
Accommodation and food services	\$622	2.3%	72
Administrative and waste services	\$552	2.0%	56
Utilities	\$391	1.4%	22
Management of companies	\$384	1.4%	55
Educational services	\$375	1.4%	61
Arts, entertainment, recreation	\$303	1.1%	71
Mining	\$290	1.1%	21
Agriculture, forestry, fishing	\$243	0.9%	11

Source: BEA Industry Accounts, 2023 data

## Manufacturing Subsectors

Subsector	Value Added (\$ billions)	NAICS
Chemical products	\$382	325
Computer and electronic products	\$291	334
Food, beverage, tobacco	\$251	311-312
Motor vehicles and parts	\$195	336
Petroleum and coal products	\$176	324
Machinery	\$153	333
Miscellaneous manufacturing	\$133	339
Fabricated metal products	\$127	332
Plastics and rubber products	\$87	326
Electrical equipment, appliances	\$74	335
Primary metals	\$59	331
Nonmetallic mineral products	\$58	327
Paper products	\$52	322
Printing and support activities	\$33	323
Furniture and related products	\$30	337
Textile mills and products	\$21	313-314
Wood products	\$38	321
Apparel and leather	\$11	315-316

Source: BEA Industry Accounts, 2023 data

## State GDP Rankings (2023)

Rank	State	GDP (\$ billions)	Share of U.S.
1	California	\$4,080	14.6%
2	Texas	\$2,356	8.4%
3	New York	\$2,140	7.7%
4	Florida	\$1,523	5.5%
5	Illinois	\$1,050	3.8%
6	Pennsylvania	\$931	3.3%
7	Ohio	\$800	2.9%
8	Georgia	\$788	2.8%
9	New Jersey	\$752	2.7%
10	Washington	\$741	2.7%

Source: BEA Regional Accounts, 2023 data

## Metropolitan Area GDP (Top 20, 2023)

Rank	Metro Area	GDP (\$ billions)
1	New York-Newark-Jersey City	\$2,160
2	Los Angeles-Long Beach-Anaheim	\$1,105
3	Chicago-Naperville-Elgin	\$886
4	San Francisco-Oakland-Berkeley	\$696
5	Washington-Arlington-Alexandria	\$715
6	Dallas-Fort Worth-Arlington	\$613
7	Houston-The Woodlands-Sugar Land	\$558
8	Boston-Cambridge-Newton	\$641
9	Philadelphia-Camden-Wilmington	\$558
10	Seattle-Tacoma-Bellevue	\$450
11	Atlanta-Sandy Springs-Alpharetta	\$449
12	San Jose-Sunnyvale-Santa Clara	\$467
13	Miami-Fort Lauderdale-Pompano Beach	\$415
14	Phoenix-Mesa-Chandler	\$310
15	Detroit-Warren-Dearborn	\$280
16	Minneapolis-St. Paul-Bloomington	\$278
17	Denver-Aurora-Lakewood	\$255
18	San Diego-Chula Vista-Carlsbad	\$283
19	Tampa-St. Petersburg-Clearwater	\$204
20	Baltimore-Columbia-Towson	\$225

Source: BEA Metropolitan Area Accounts, 2023 data

## How to Read BEA Industry Tables

### Value Added vs. Gross Output

- **Value added (GDP):** The contribution to final output. Value added = Gross output minus intermediate inputs. This is what appears in the GDP tables.
- **Gross output:** Total production, including intermediate goods. Gross output counts all sales, including business-to-business transactions.

Example: A steel mill sells \$100 million in steel to an auto plant. The auto plant uses that steel to make cars worth \$200 million. - Gross output: \$300 million (\$100M steel + \$200M cars) - Value added: \$200 million (only the final product counts)

### Real vs. Nominal

- **Nominal** (current dollars): Values at prices of the measurement year
- **Real** (constant/chained dollars): Values adjusted for inflation, typically using 2017 as base year

Use real values for growth comparisons over time; nominal for current-period analysis.

## **Industry Classification**

BEA uses NAICS (North American Industry Classification System). Key features: - Two-digit codes: Broad sectors (e.g., 31-33 = Manufacturing) - Three-digit codes: Subsectors (e.g., 334 = Computer and electronic products) - Four-digit codes: Industry groups - Five/six-digit codes: Detailed industries

NAICS is revised every five years. Historical comparisons may require concordance tables when industry definitions change.

## **Input-Output Tables**

BEA produces input-output tables showing inter-industry purchases. Two main types:

**Use Table:** Shows which industries purchase which commodities - Rows: Commodities (products) - Columns: Industries (producers)

**Make Table:** Shows which industries produce which commodities - Rows: Industries - Columns: Commodities

The symmetric industry-by-industry table (derived from Use and Make tables) shows direct purchases between industries.

## **Reading the I-O Tables**

A cell showing \$50 billion at the intersection of “Automotive” row and “Steel” column means the automotive industry purchased \$50 billion worth of steel products.

## **Multipliers**

BEA calculates economic multipliers showing total impact (direct + indirect + induced) of changes in final demand. Type I multipliers capture direct and indirect effects; Type II adds induced effects from household spending.

## **Data Vintage Notes**

BEA revises data through a predictable schedule: - GDP: Three monthly estimates (advance, second, third), then annual and comprehensive revisions - Industry accounts: Annual revisions, quinquennial benchmark revisions - Regional accounts: Quarterly for states, annual for metros

Always note the vintage of data used in analysis. Current estimates may differ from figures cited in this book.

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For current data, visit [bea.gov](http://bea.gov)

# **Appendix C: NAICS Codes Quick Reference**

The North American Industry Classification System (NAICS) is the standard framework for classifying economic activity. This appendix maps NAICS codes to the chapters in this book.

## **Two-Digit NAICS Sectors**

Code	Sector	Book Chapter
11	Agriculture, Forestry, Fishing and Hunting	Ch. 25 (Rural America)
21	Mining, Quarrying, and Oil and Gas Extraction	Ch. 14 (Energy), Ch. 25 (Rural)
22	Utilities	Ch. 14 (Energy)
23	Construction	Ch. 13 (Construction)
31-33	Manufacturing	Ch. 9 (Manufacturing)
42	Wholesale Trade	Ch. 10 (Retail and Wholesale)
44-45	Retail Trade	Ch. 10 (Retail and Wholesale)
48-49	Transportation and Warehousing	Ch. 12 (Transportation)
51	Information	Ch. 11 (Tech/Media)
52	Finance and Insurance	Ch. 8, 16, 17, 18 (Finance chapters)
53	Real Estate and Rental and Leasing	Ch. 5 (Real Estate)
54	Professional, Scientific, and Technical Services	Ch. 7 (Professional Services)
55	Management of Companies and Enterprises	Ch. 7 (Professional Services)
56	Administrative and Support and Waste Management	Ch. 7 (Professional Services)
61	Educational Services	Ch. 15 (Education)

Code	Sector	Book Chapter
62	Health Care and Social Assistance	Ch. 6 (Healthcare)
71	Arts, Entertainment, and Recreation	Ch. 11 (Tech/Media)
72	Accommodation and Food Services	Ch. 10 (Retail and Wholesale)
81	Other Services (except Public Administration)	Various
92	Public Administration	Ch. 4 (Government)

## Key Three-Digit Subsectors

### Manufacturing (31-33)

Code	Subsector	Notable Products
311	Food Manufacturing	Processed foods, beverages
312	Beverage and Tobacco Products	Soft drinks, beer, wine
321	Wood Products	Lumber, plywood
322	Paper Manufacturing	Paper, paperboard
323	Printing and Related Support	Commercial printing
324	Petroleum and Coal Products	Refineries
325	Chemical Manufacturing	Pharmaceuticals, petrochemicals
326	Plastics and Rubber Products	Packaging, tires
327	Nonmetallic Mineral Products	Cement, glass
331	Primary Metal Manufacturing	Steel, aluminum
332	Fabricated Metal Products	Structural metal, hardware
333	Machinery Manufacturing	Industrial equipment
334	Computer and Electronic Products	Semiconductors, computers
335	Electrical Equipment and Appliances	Batteries, appliances
336	Transportation Equipment	Vehicles, aerospace
337	Furniture and Related Products	Household furniture
339	Miscellaneous Manufacturing	Medical devices, toys

### Information (51)

Code	Subsector	Key Industries
511	Publishing Industries	Newspapers, software
512	Motion Picture and Sound Recording	Film studios, streaming
515	Broadcasting	TV, radio
517	Telecommunications	Wireless carriers, ISPs
518	Data Processing, Hosting	Cloud computing, data centers
519	Other Information Services	Search engines, portals

## **Finance and Insurance (52)**

Code	Subsector	Key Industries
521	Monetary Authorities	Federal Reserve
522	Credit Intermediation	Banks, credit unions
523	Securities, Commodities, Investment	Brokerages, exchanges
524	Insurance Carriers and Related	Life, health, P&C insurance
525	Funds, Trusts, Financial Vehicles	Pension funds, REITs

## **Professional Services (54)**

Code	Subsector	Key Industries
541	Professional, Scientific, Technical	Law, accounting, consulting
5411	Legal Services	Law firms
5412	Accounting, Tax Preparation	CPA firms
5413	Architectural, Engineering	A&E firms
5414	Specialized Design Services	Interior, industrial design
5415	Computer Systems Design	IT services, software dev
5416	Management Consulting	Strategy, operations consulting
5417	Scientific Research	R&D services
5418	Advertising, PR	Ad agencies, PR firms

## **Healthcare (62)**

Code	Subsector	Key Industries
621	Ambulatory Health Care	Physician offices, clinics
622	Hospitals	Acute care hospitals
623	Nursing and Residential Care	Nursing homes, assisted living
624	Social Assistance	Child care, social services

## **Transportation (48-49)**

Code	Subsector	Key Industries
481	Air Transportation	Airlines
482	Rail Transportation	Freight and passenger rail
483	Water Transportation	Shipping
484	Truck Transportation	Trucking companies
485	Transit and Ground Passenger	Public transit, taxis
486	Pipeline Transportation	Oil and gas pipelines
487	Scenic and Sightseeing	Tour operators
488	Support Activities	Ports, airports
491	Postal Service	USPS

Code	Subsector	Key Industries
492	Couriers and Messengers	FedEx, UPS
493	Warehousing and Storage	Logistics facilities

## NAICS vs. SIC

NAICS replaced the Standard Industrial Classification (SIC) system in 1997. Key differences:

- **Service sector detail:** NAICS provides much more detailed service industry classification
- **Information sector:** NAICS created a dedicated Information sector (51) that did not exist in SIC
- **Production-based:** NAICS classifies by production process; SIC was more product-oriented
- **North American coverage:** NAICS is harmonized with Canada and Mexico; SIC was U.S.-only

Historical data before 1997 uses SIC codes. Concordance tables are available from Census Bureau for converting between systems.

## NAICS Revisions

NAICS is revised every five years (2007, 2012, 2017, 2022). Major recent changes:

**2022 Revision:** - New industries for renewable electricity generation (wind, solar, geothermal) - Expanded detail for cannabis industry - New industries for online retailers - Updated data processing and hosting categories

When comparing data across time, check whether NAICS codes remained consistent or whether industries were reclassified.

## Using NAICS for Research

### Data Sources by NAICS

Source	Geographic Detail	Time Frequency
BEA GDP by Industry	National	Annual
BEA Regional	State, Metro	Annual
BLS QCEW	County	Quarterly
BLS OES	Metro, State	Annual
Census CBP	County	Annual
Census Economic Census	County	5-year

## Common Pitfalls

1. **Holding companies:** Large conglomerates may be classified in NAICS 55 (Management) rather than their operating industries
2. **Auxiliary establishments:** Corporate headquarters may be classified separately from operating facilities
3. **Primary activity:** Establishments are classified by primary activity; secondary activities are not captured
4. **Suppression:** Data for small cells may be suppressed to protect confidentiality
5. **Revisions:** Be aware of when NAICS definitions changed for any longitudinal analysis

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For the complete NAICS manual and concordances, visit [census.gov/naics](https://census.gov/naics)

# Appendix D: Glossary of Key Terms

This glossary compiles key economic, financial, and policy terms used throughout *The American Economy: A Structural Geography*. Definitions are written for an undergraduate audience. Where a term is discussed in depth in a particular chapter, a cross-reference is provided.

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## A

**Agglomeration effects** — The economic benefits that firms and workers gain from being located near one another. Clustering reduces transportation costs, deepens labor pools, and accelerates knowledge spillovers. Agglomeration helps explain why industries concentrate in specific cities and regions. See Chapter 3.

**Antitrust** — The body of federal and state law designed to promote competition and prevent monopolistic behavior. Key statutes include the Sherman Act (1890), the Clayton Act (1914), and the Federal Trade Commission Act. Antitrust enforcement is relevant across many sectors, from technology to healthcare. See Chapter 28.

**At-will employment** — The default employment doctrine in most U.S. states, under which either the employer or the employee may end the relationship at any time, for any lawful reason, without advance notice. This distinguishes the U.S. labor market from most other advanced economies. See Chapter 30.

## B

**Balance of payments** — A comprehensive accounting of all economic transactions between a country's residents and the rest of the world over a given period. It includes the current account (trade in goods and services, income, transfers) and the capital and financial account (investment flows). See Chapter 21.

**Basis points** — A unit of measurement equal to one-hundredth of a percentage point (0.01%). Used widely in finance and monetary policy to describe changes in interest rates, bond yields, and other rates. A move from 4.50% to 4.75% is an increase of 25 basis points. See Chapter 18.

**Bond market** — The market in which debt securities are issued and traded. Bonds are IOUs: an investor lends money to a government or corporation in exchange for periodic interest payments and the return of principal at maturity. The U.S. bond market is the largest in the world and is central to how the government and corporations finance themselves. See Chapter 19.

**Bureau of Economic Analysis (BEA)** — The agency within the U.S. Department of Commerce responsible for producing national, regional, and industry economic accounts, including GDP estimates, personal income data, and input-output tables. See Appendix A and Appendix B.

**Bureau of Labor Statistics (BLS)** — The principal federal agency responsible for measuring labor market activity, working conditions, and price changes in the economy. The BLS produces the Consumer Price Index, the unemployment rate, and the Employment Situation report, among other data series. See Appendix A.

## C

**Capital-intensive** — Describing an industry or production process that requires a relatively large amount of physical capital (machinery, equipment, facilities) per unit of output or per worker. Oil refining, semiconductor fabrication, and electric power generation are examples. See Chapter 9.

**Capacity utilization** — The percentage of an economy's or industry's productive capacity that is actually being used at a given time. The Federal Reserve publishes a monthly capacity utilization index for manufacturing, mining, and utilities. Low capacity utilization can signal economic slack. See Chapter 9.

**Carbon pricing (cap-and-trade)** — A market-based policy mechanism for reducing greenhouse gas emissions. Under a cap-and-trade system, a government sets an overall emissions cap, issues a limited number of permits, and allows firms to buy and sell them. Firms that can reduce emissions cheaply sell permits to those for whom reduction is more expensive. See Chapter 14.

**CHIPS Act** — The CHIPS and Science Act of 2022, a federal law that provides roughly \$53 billion in subsidies and tax credits to encourage domestic semiconductor manufacturing and research. It represents a major exercise in industrial policy aimed at reducing U.S. dependence on foreign chip fabrication. See Chapters 9 and 28.

**Circular flow** — A simplified model of the economy showing how money, goods, and services move between households, firms, government, and the rest of the world. The circular flow diagram is a foundational tool for understanding how GDP is generated and how the major sectors of the economy interact. See Chapter 2.

**Comparative advantage** — The principle, originating with David Ricardo, that a country benefits from specializing in the production of goods and services for which it has the lowest opportunity cost, even if it can produce everything more efficiently than its trading partners. Comparative advantage is the theoretical foundation of international trade. See Chapter 21.

**Consumer Price Index (CPI)** — A measure of the average change over time in the

prices paid by urban consumers for a representative basket of goods and services. Published monthly by the BLS, the CPI is the most widely cited measure of inflation in the United States. See Chapter 1.

**Cost disease** — A phenomenon, identified by economists William Baumol and William Bowen, in which wages in labor-intensive sectors (such as education and healthcare) rise over time even without corresponding productivity gains, because those sectors must compete for workers with sectors where productivity is growing. Also called Baumol's cost disease. See Chapters 6 and 15.

**Cross-subsidy** — An arrangement in which revenues from one product, service, or customer group are used to offset losses or below-cost pricing for another. Cross-subsidies are common in regulated industries, such as when profitable urban postal routes help fund rural delivery. See Chapter 14.

**Current account** — The component of the balance of payments that records a country's trade in goods and services, net income from abroad (such as investment returns), and net transfer payments. The United States has run a persistent current account deficit since the early 1980s. See Chapter 21.

## D

**De minimis exemption** — A customs rule that allows imported goods valued below a certain threshold to enter a country duty-free and with minimal paperwork. In the United States, the de minimis threshold has historically been \$800 per shipment. This exemption has become controversial with the rise of direct-to-consumer shipping from overseas sellers. See Chapter 21.

**Default search agreement** — A contract in which a technology company pays a device manufacturer or browser maker to be the pre-installed, default search engine. Google's default search agreements with Apple and others have been the subject of major antitrust litigation. See Chapter 11.

**Deficit spending** — Government spending that exceeds government revenue in a given period, financed by borrowing. Deficit spending is a tool of fiscal policy, often used to stimulate demand during recessions, and a recurring feature of U.S. federal budgets. See Chapters 4 and 28.

**Disintermediation** — The removal of intermediaries (middlemen) from a supply chain or financial transaction, allowing producers and consumers to deal with each other more directly. The internet and fintech have accelerated disintermediation across many industries, from retail to banking. See Chapters 10 and 18.

**Dodd-Frank Act** — The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the most significant overhaul of U.S. financial regulation since the 1930s. Enacted in response to the 2007-2009 financial crisis, it created the Consumer Financial Protection Bureau, imposed new rules on derivatives trading, and established a framework for identifying systemically important financial institutions. See Chapter 8.

**Dutch disease** — A phenomenon in which a boom in one sector of the economy (typically natural resources) causes a real appreciation of the currency or a reallocation of resources that harms other sectors, particularly manufacturing. The term originates from the Netherlands' experience after discovering natural gas in the 1960s. See Chapter 14.

## E

**Economies of scale** — The cost advantages that a firm obtains by increasing its scale of production. As output rises, fixed costs are spread over more units, reducing the average cost per unit. Economies of scale are a key driver of industry structure across sectors from manufacturing to technology. See Chapter 9.

**Employer-tied insurance** — The predominant system of health insurance provision in the United States, in which most working-age Americans obtain coverage through their employer. This system originated during World War II wage controls and is reinforced by favorable tax treatment of employer-provided health benefits. See Chapter 6.

**ERISA** — The Employee Retirement Income Security Act of 1974, a federal law that sets minimum standards for most voluntarily established retirement and health plans in private industry. ERISA preempts state regulation of employer-sponsored benefit plans, which has significant implications for health insurance policy. See Chapters 6 and 30.

**Exchange-traded fund (ETF)** — An investment fund that trades on a stock exchange, much like an individual stock. ETFs typically track an index, a commodity, or a basket of assets and offer investors diversification at low cost. The growth of ETFs has transformed the asset management industry. See Chapter 19.

**Externality** — A cost or benefit of an economic activity that falls on a third party who did not choose to incur it. Pollution is a classic negative externality; a neighbor's well-kept garden producing higher property values is a positive externality. Externalities are a primary rationale for government intervention in markets. See Chapters 4 and 14.

## F

**FDIC insurance** — Deposit insurance provided by the Federal Deposit Insurance Corporation, a U.S. government agency created in 1933. The FDIC insures individual bank deposits up to \$250,000, which stabilizes the banking system by reducing the incentive for depositors to engage in bank runs. See Chapter 8.

**Federal funds rate** — The interest rate at which depository institutions lend reserve balances to each other overnight. The Federal Open Market Committee (FOMC) sets a target range for the federal funds rate as its primary tool of monetary policy. Changes in this rate ripple through the entire economy. See Chapter 18.

**Federal Reserve** — The central bank of the United States, established by the Federal Reserve Act of 1913. The Fed conducts monetary policy, supervises and regulates banks, maintains financial stability, and provides financial services to the banking system. It is structured as a system of twelve regional Federal Reserve Banks governed by a Board of Governors in Washington, D.C. See Chapter 18.

**Financialization** — The long-term trend in which financial markets, financial institutions, and financial motives play an increasingly dominant role in the operation of the economy. Indicators include the growing share of GDP attributable to the financial sector, the rise in financial assets relative to real assets, and the increasing orientation of nonfinancial corporations toward shareholder value. See Chapters 8 and 18.

**FIRE economy** — An acronym for Finance, Insurance, and Real Estate, used to describe the cluster of industries that together constitute one of the largest segments of the U.S. economy by GDP. The FIRE sectors are deeply intertwined: real estate depends on mortgage finance, which depends on insurance and securitization. See Chapters 5 and 8.

**Fiscal policy** — The use of government spending and taxation to influence the economy. Expansionary fiscal policy (more spending or lower taxes) stimulates demand; contractionary fiscal policy (less spending or higher taxes) restrains it. In the United States, fiscal policy is set by Congress and the President. See Chapter 4.

**Foreign direct investment (FDI)** — Investment by a firm or individual in one country in business interests in another country, typically involving either establishing operations or acquiring tangible assets such as factories, real estate, or controlling stakes in companies. FDI is distinct from portfolio investment, which involves purchasing financial assets like stocks and bonds. See Chapter 21.

**Franchise model** — A business arrangement in which a franchisor licenses its brand, business methods, and operational systems to independent franchisees in exchange for fees and royalties. Franchising is prevalent in fast food, hospitality, and retail, and raises important questions about labor relations and business risk. See Chapter 17.

**FRED** — Federal Reserve Economic Data, a free online database maintained by the Federal Reserve Bank of St. Louis. FRED provides access to hundreds of thousands of economic time series from dozens of sources and is one of the most valuable research tools available to students and analysts. See Appendix A.

## G

**GDP (Gross Domestic Product)** — The total market value of all final goods and services produced within a country's borders in a given period, typically a year or a quarter. GDP is the single most widely used measure of the size and health of an economy. It can be measured by production, income, or expenditure. See Chapter 1.

**Gig economy** — The segment of the labor market composed of short-term, flexible, freelance, or independent contractor work, often mediated by digital platforms. Ride-hailing drivers, food delivery workers, and freelance designers are common examples.

The gig economy raises questions about worker classification and benefits. See Chapter 30.

**Gini coefficient** — A statistical measure of inequality within a distribution, ranging from 0 (perfect equality) to 1 (perfect inequality). It is most commonly used to measure income or wealth inequality within a country. The U.S. Gini coefficient for household income has risen substantially since the late 1970s. See Interlude.

**GSE (Government-sponsored enterprise)** — A financial services corporation created by Congress to improve the flow of credit to specific sectors of the economy. Fannie Mae and Freddie Mac, which purchase and securitize residential mortgages, are the most prominent GSEs. They occupy an unusual position between public and private institutions. See Chapters 5 and 8.

## H

**H-1B visa** — A nonimmigrant visa category that allows U.S. employers to temporarily employ foreign workers in specialty occupations requiring at least a bachelor's degree. The program is heavily used by the technology and professional services sectors and is subject to annual numerical caps. See Chapters 11 and 30.

**Horizontal drilling** — A drilling technique in which a well is initially drilled vertically and then gradually turned to extend horizontally through a rock formation. When combined with hydraulic fracturing, horizontal drilling makes it economically viable to extract oil and gas from shale formations that were previously inaccessible. See Chapter 14.

**Hydraulic fracturing (fracking)** — A well stimulation technique in which fluid is injected at high pressure into underground rock formations to create fractures through which oil or natural gas can flow. Fracking, combined with horizontal drilling, enabled the U.S. shale revolution and transformed global energy markets. See Chapter 14.

## I

**Independent System Operator (ISO)** — A nonprofit organization that coordinates, controls, and monitors the operation of the electrical power system within a defined region. ISOs (and their close relatives, Regional Transmission Organizations or RTOs) operate wholesale electricity markets and ensure grid reliability in restructured electricity markets. See Chapter 14.

**Industrial policy** — Government actions intended to shape the structure of the economy by promoting specific industries, technologies, or economic activities. Tools include subsidies, tax credits, tariffs, procurement preferences, and direct investment. The CHIPS Act and the Inflation Reduction Act represent major recent exercises in U.S. industrial policy. See Chapter 28.

**Inflation Reduction Act (IRA)** — A 2022 federal law that includes approximately \$370 billion in energy and climate spending, primarily through tax credits for re-

newable energy, electric vehicles, and domestic manufacturing of clean energy components. The IRA also allows Medicare to negotiate prices for certain prescription drugs. See Chapters 14 and 28.

**Input-output analysis** — An economic framework, developed by Wassily Leontief, that quantifies the interdependencies among industries in an economy. Input-output tables show how the output of one industry becomes an input to another, enabling analysts to trace how a change in one sector ripples through the rest of the economy. See Chapter 2.

**Institutional investor** — An organization that invests large sums of money on behalf of others. Examples include pension funds, mutual fund companies, insurance companies, endowments, and sovereign wealth funds. Institutional investors are the dominant players in U.S. capital markets and wield significant corporate governance power. See Chapter 19.

**Interest rate risk** — The risk that changes in interest rates will adversely affect the value of a financial asset or the cost of a liability. Bond prices, for example, fall when interest rates rise. Interest rate risk is a central concern for banks, insurers, and anyone holding long-duration fixed-income securities. See Chapter 19.

## J

**Job lock** — A situation in which workers remain in their current job primarily because they fear losing employer-provided health insurance or other benefits, rather than because the job is the best match for their skills. Job lock reduces labor market fluidity and is a consequence of the employer-tied insurance system. See Chapters 6 and 30.

**Just transition** — A framework for ensuring that the social and economic costs of shifting away from fossil fuels are shared equitably, particularly by providing support for workers and communities that depend on carbon-intensive industries. Just transition policies may include retraining programs, economic diversification investments, and transitional income support. See Chapter 14.

## K

No terms in this section.

## L

**Labor force participation rate** — The percentage of the civilian noninstitutional population aged 16 and older that is either employed or actively looking for work. The U.S. labor force participation rate peaked in the late 1990s and has declined since, reflecting demographic shifts, educational enrollment, disability trends, and changing social norms. See Chapter 30.

**Leverage** — The use of borrowed money to amplify potential returns (or losses) from an investment. A firm or individual is highly leveraged when debt is large relative to equity. Leverage is a central concept in corporate finance and played a major role in the 2007-2009 financial crisis. See Chapter 20.

**Locational marginal pricing (LMP)** — A pricing mechanism used in restructured electricity markets in which the price of electricity varies by location and time, reflecting the cost of generating and delivering an additional megawatt-hour to a specific node on the grid. LMP accounts for generation costs, congestion, and transmission losses. See Chapter 14.

**Lock-in effect** — A situation in which users of a product or service face high switching costs that discourage them from moving to a competitor, even if alternatives might be preferable. Lock-in effects are especially strong in technology markets, where proprietary standards, data formats, and network effects create barriers to switching. See Chapter 11.

## M

**Market capitalization** — The total market value of a company's outstanding shares of stock, calculated by multiplying the share price by the number of shares outstanding. Market capitalization is a common measure of company size and is used to classify companies as large-cap, mid-cap, or small-cap. See Chapter 19.

**Medicaid** — A joint federal-state program that provides health insurance coverage to low-income individuals and families, pregnant women, children, elderly adults, and people with disabilities. Medicaid is the single largest source of health coverage in the United States, covering more than 90 million people. See Chapter 6.

**Medicare** — A federal health insurance program for Americans aged 65 and older and certain younger people with disabilities. Medicare is divided into parts covering hospital care (Part A), outpatient services (Part B), private plan alternatives (Part C/Medicare Advantage), and prescription drugs (Part D). See Chapter 6.

**Monetary policy** — The actions taken by a central bank to manage the money supply and interest rates in order to achieve macroeconomic objectives such as price stability, full employment, and moderate long-term interest rates. In the United States, monetary policy is conducted by the Federal Reserve. See Chapter 18.

**Monopsony** — A market structure in which there is only one buyer (or a dominant buyer) for a good or service. In labor economics, monopsony power allows an employer to pay wages below what a competitive market would yield. Hospital systems in rural areas and dominant employers in small towns are common examples. See Chapter 30.

**Moral hazard** — The tendency of a party that is insulated from risk to behave differently than it would if fully exposed to the risk. In insurance, moral hazard arises when the insured party takes greater risks because someone else bears the cost of those risks. The concept is central to understanding both health insurance and financial regulation. See Chapters 6 and 8.

**Mortgage-backed security (MBS)** — A type of asset-backed security that is secured by a collection (pool) of mortgages. Investors in MBS receive periodic payments derived from the underlying mortgage payments. The securitization of mortgages vastly expanded the availability of housing credit but also contributed to the 2007–2009 financial crisis. See Chapters 5 and 19.

## N

**NAICS codes** — The North American Industry Classification System, a standardized system used by the United States, Canada, and Mexico to classify business establishments by their primary type of economic activity. NAICS codes are the backbone of federal economic statistics and are essential for analyzing industry-level data. See Appendix C.

**Natural monopoly** — An industry in which the most efficient number of firms is one, typically because of very high fixed costs and declining average costs over the relevant range of output. Electric transmission, water distribution, and local telephone service are classic examples. Natural monopolies are typically subject to government regulation. See Chapter 14.

**Nearshoring** — The practice of relocating business operations or supply chains from distant countries to nearby ones, often to reduce transportation costs, shorten lead times, and mitigate geopolitical risk. For the United States, nearshoring often means shifting production from East Asia to Mexico or other parts of Latin America. See Chapter 22.

**Net metering** — A billing arrangement in which customers who generate their own electricity (typically from rooftop solar panels) receive a credit on their utility bill for any excess power they send back to the grid. Net metering policies vary significantly by state and are a contentious issue in electricity regulation. See Chapter 14.

**Network effects (direct and indirect)** — The phenomenon in which a product or service becomes more valuable as more people use it. Direct network effects occur when the value increases for all users (as with a telephone network). Indirect network effects occur when more users attract complementary products or services (as when more smartphone users attract more app developers). See Chapter 11.

**Noncompete agreement** — A contractual clause in which an employee agrees not to work for a competitor or start a competing business for a specified period after leaving a job. Noncompetes have become widespread across the U.S. labor market, including in low-wage occupations, and have drawn regulatory scrutiny for their effects on worker mobility and wages. See Chapter 30.

## O

**OECD** — The Organisation for Economic Co-operation and Development, an intergovernmental organization of 38 member countries, mostly advanced economies, that promotes policies to improve economic and social well-being. OECD data and re-

ports are frequently used for international comparisons of economic performance. See Chapter 31.

**Oligopoly** — A market structure in which a small number of firms dominate an industry. Oligopolistic markets are characterized by interdependent decision-making, barriers to entry, and the potential for both competition and tacit coordination. Airlines, wireless carriers, and meatpacking are U.S. examples. See Chapters 9 and 12.

## P

**Platform economics** — The study of multi-sided platforms that create value by facilitating interactions between two or more user groups. Platforms such as Amazon, Uber, and app stores exhibit network effects, often leading to winner-take-all dynamics. Understanding platform economics is essential for analyzing the modern technology sector. See Chapter 11.

**Private equity** — An asset class consisting of equity investments in companies that are not publicly traded on a stock exchange. Private equity firms typically raise capital from institutional investors, acquire companies using significant leverage, restructure them to improve profitability, and sell them at a gain. See Chapter 20.

**Productivity** — The efficiency with which inputs are converted into outputs. Labor productivity, the most commonly cited measure, is output per hour worked. Productivity growth is the primary driver of long-run improvements in living standards and is tracked closely by the BLS. See Chapters 1 and 31.

**Public utility commission (PUC)** — A state-level regulatory body that oversees the rates, services, and operations of investor-owned utilities, including electric, gas, water, and telecommunications companies. PUCs set the rates that utilities are allowed to charge and approve major capital investments. Also called a public service commission (PSC) in some states. See Chapter 14.

## Q

**Quantitative easing** — An unconventional monetary policy tool in which a central bank purchases large quantities of financial assets, typically government bonds and mortgage-backed securities, to inject money into the economy and lower long-term interest rates. The Federal Reserve employed quantitative easing extensively after the 2007-2009 financial crisis and again during the COVID-19 pandemic. See Chapter 18.

## R

**Rate base** — The total value of assets on which a regulated utility is allowed to earn a return. When a PUC approves a new power plant or transmission line, the investment

is added to the rate base, and the utility earns a regulated rate of return on that investment, funded by customer rates. See Chapter 14.

**Rate case** — A formal regulatory proceeding before a public utility commission in which a utility requests approval to change its rates. During a rate case, the utility must justify its costs, proposed capital investments, and requested return on equity. Intervenors, including consumer advocates and industrial customers, may challenge the utility's proposals. See Chapter 14.

**Real estate investment trust (REIT)** — A company that owns, operates, or finances income-producing real estate. REITs are required by law to distribute at least 90% of their taxable income to shareholders as dividends, making them a popular vehicle for investing in real estate without directly owning property. See Chapter 5.

**Renewable portfolio standard (RPS)** — A state-level regulation that requires electric utilities to source a minimum percentage of their electricity from renewable energy sources by a specified date. RPS policies have been a major driver of wind and solar energy deployment in the United States. See Chapter 14.

**Reserve currency** — A currency held in large quantities by central banks and other institutions as part of their foreign exchange reserves. The U.S. dollar is the world's dominant reserve currency, which gives the United States significant economic advantages, including lower borrowing costs and the ability to run persistent trade deficits. See Chapter 21.

**Restructured electricity market** — An electricity market in which generation has been separated from transmission and distribution, and wholesale electricity prices are determined by competitive bidding among generators rather than by cost-of-service regulation. About two-thirds of U.S. electricity customers are served in restructured markets. See Chapter 14.

**Risk-adjusted return** — A measure of investment performance that accounts for the amount of risk taken to achieve a return. Two investments may have the same nominal return, but the one achieved with less risk is considered superior on a risk-adjusted basis. Common risk-adjusted metrics include the Sharpe ratio and alpha. See Chapter 19.

## S

**Section 230** — Section 230 of the Communications Decency Act of 1996, which provides internet platforms with broad immunity from liability for content posted by their users. Often called the law that created the modern internet, Section 230 has become the subject of intense political debate from both sides of the aisle. See Chapter 11.

**Section 301/232** — Provisions of U.S. trade law that authorize the President to impose tariffs or other trade barriers. Section 301 of the Trade Act of 1974 addresses unfair trade practices by foreign governments, while Section 232 of the Trade Expansion Act of 1962 allows tariffs on national security grounds. Both were used extensively to impose tariffs on Chinese goods and on steel and aluminum imports. See Chapter 21.

**Securitization** — The financial process of pooling various types of contractual debt (such as mortgages, auto loans, or credit card receivables) and selling the consolidated cash flows to investors as tradable securities. Securitization was a major financial innovation of the late twentieth century and vastly expanded the availability of credit. See Chapter 19.

**Shale revolution** — The dramatic increase in U.S. oil and natural gas production that began in the mid-2000s, driven by the combined application of hydraulic fracturing and horizontal drilling to previously inaccessible shale rock formations. The shale revolution transformed the United States from a major energy importer into the world's largest producer of oil and natural gas. See Chapter 14.

**Smoot-Hawley** — The Smoot-Hawley Tariff Act of 1930, which raised tariffs on more than 20,000 imported goods. It is widely regarded as having worsened the Great Depression by provoking retaliatory tariffs from trading partners and collapsing international trade. Smoot-Hawley is frequently invoked as a cautionary example in trade policy debates. See Chapter 21.

**Sovereign wealth fund** — A state-owned investment fund financed by revenues from natural resources, trade surpluses, or other government income. Sovereign wealth funds are major institutional investors in global markets. The Alaska Permanent Fund is the primary U.S. example. See Chapter 19.

**Special purpose vehicle (SPV)** — A legal entity, usually a subsidiary, created for a specific financial purpose such as isolating financial risk. SPVs are central to the securitization process: a bank might transfer loans to an SPV, which then issues securities backed by those loans. This structure is designed to protect investors if the originating bank fails. See Chapter 19.

**Stranded asset** — An asset that has suffered an unexpected or premature write-down, devaluation, or conversion to a liability, often due to regulatory changes, technological disruption, or shifts in market conditions. In the context of the energy transition, stranded assets typically refer to fossil fuel reserves or power plants that may become uneconomic before the end of their expected useful life. See Chapter 14.

**Structural unemployment** — Unemployment that arises from a mismatch between the skills or locations of workers and the requirements or locations of available jobs. Unlike cyclical unemployment, which rises and falls with the business cycle, structural unemployment persists even when the economy is strong and often requires retraining or relocation to resolve. See Chapter 30.

**Supply chain** — The entire network of organizations, people, activities, information, and resources involved in moving a product or service from raw materials to the end consumer. Modern supply chains are global, complex, and increasingly vulnerable to disruption, as demonstrated during the COVID-19 pandemic. See Chapter 22.

**Systemically important financial institution (SIFI)** — A bank, insurance company, or other financial institution whose failure could trigger a broader financial crisis due to its size, interconnectedness, complexity, or the lack of readily available substitutes for its services. The Dodd-Frank Act established a framework for designating and subjecting SIFIs to enhanced regulatory scrutiny. See Chapter 8.

## T

**Tariff** — A tax imposed by a government on imported goods. Tariffs raise revenue, protect domestic industries from foreign competition, and can be used as leverage in trade negotiations. They also raise prices for domestic consumers and downstream industries that use imported inputs. See Chapter 21.

**Tax expenditure** — A reduction in government revenue resulting from a provision of the tax code that provides a special exclusion, exemption, deduction, credit, or preferential rate. Examples include the mortgage interest deduction, the exclusion of employer-provided health insurance from taxable income, and the earned income tax credit. Tax expenditures are a form of government spending conducted through the tax system. See Chapter 4.

**TEU (Twenty-foot Equivalent Unit)** — A standard unit of measurement for container shipping capacity, based on the volume of a 20-foot-long intermodal shipping container. Port throughput, vessel capacity, and trade volumes are commonly expressed in TEUs. The Port of Los Angeles and the Port of Long Beach are the largest U.S. container ports by TEU volume. See Chapter 12.

**Too big to fail** — The notion that certain financial institutions are so large and interconnected that their failure would cause catastrophic damage to the broader economy, compelling the government to intervene to prevent their collapse. The concept became central to public debate during the 2007-2009 financial crisis and motivated key provisions of the Dodd-Frank Act. See Chapters 8 and 18.

**Trade deficit** — The amount by which a country's imports of goods and services exceed its exports. The United States has run a persistent trade deficit since the 1970s, reflecting strong domestic consumption, the dollar's role as the world's reserve currency, and structural features of the global economy. See Chapter 21.

**Trade-weighted average** — An average tariff rate calculated by weighting each tariff line by the value of imports in that category, so that tariffs on heavily traded goods count more than tariffs on rarely traded goods. Trade-weighted averages provide a more accurate picture of tariff burdens than simple (unweighted) averages. See Chapter 21.

## U

**USMCA** — The United States-Mexico-Canada Agreement, a trade agreement that took effect on July 1, 2020, replacing NAFTA. The USMCA updated rules of origin for automobiles, expanded digital trade provisions, strengthened labor and environmental standards, and maintained the trilateral framework for North American trade. See Chapter 21.

## V

**Value added** — The increase in the value of a good or service at each stage of production, calculated as the difference between the value of a firm's output and the cost of

its intermediate inputs. GDP can be understood as the sum of value added across all firms in the economy. Value added is the conceptual foundation of the BEA's industry accounts. See Chapter 1 and Appendix B.

**Venture capital** — A form of private equity financing provided to early-stage, high-growth companies in exchange for equity ownership. Venture capital has been a critical funding mechanism for the U.S. technology sector, backing companies such as Apple, Google, and Amazon in their early years. See Chapter 20.

**Vertical integration** — A business strategy in which a firm controls multiple stages of the production or distribution process, from raw materials to final sale. Vertical integration can reduce transaction costs and secure supply chains but may also raise antitrust concerns. See Chapters 9 and 16.

**Vibecession** — An informal term describing a situation in which public sentiment about the economy is significantly more negative than traditional economic indicators (such as GDP growth, unemployment, and job creation) would suggest. The term gained currency in 2022-2023 when consumer confidence diverged sharply from objective economic performance. See Chapter 31.

## W

No terms in this section.

## X

No terms in this section.

## Y

**Yield curve** — A graph plotting the interest rates (yields) of bonds with equal credit quality but different maturity dates, typically U.S. Treasury securities. A normal yield curve slopes upward, reflecting higher yields for longer maturities. An inverted yield curve, in which short-term yields exceed long-term yields, has historically been a reliable predictor of recessions. See Chapter 19.

## Z

**Zoning** — Local government regulations that divide land into zones and specify the permitted uses (residential, commercial, industrial, etc.) and development standards for each zone. Zoning profoundly shapes the built environment, housing affordability, and the spatial distribution of economic activity in the United States. See Chapters 5 and 13.