REVIEW & OUTLOOK

Paxil Man

New York Attorney General Eliot Spitzer has sued so many people based on so little legal authority that it's almost hard to get worked up about it anymore. But it's worth making an exception for his recent lawsuit against GlaxoSmithKline, because it threatens to damage good science and public health.

How Eliot Spitzer is depressing the drug market.

Mr. Spitzer is going after British-based Glaxo for "concealing" information about its popular antidepressant medicine, Paxil. According to America's new self-anointed drug czar, Glaxo's crime is that it publicized one study showing Paxil had positive results in adolescents, but didn't advertise four studies that showed inconclusive results or suggested Paxil may increase the risk of suicidal thoughts. Mr. Spitzer alleges these "selective disclosures" robbed doctors of relevant information and constituted "fraud" under New York law.

Makers of antidepressants have also been the latest tort lawyer target, and Mr. Spitzer played to that constituency by weaving a tale of an industry that had routinely manipulated drug information with no real oversight. He added that far from usurping the Food & Drug Administration, he was simply stepping into an area that the federal agency lacked the authority to police. The press corps swallowed this verbatim, which means it missed a few facts.

The reality is that Mr. Spitzer has gatecrashed one of most regulated industries in the world. Though it may come as a surprise to the New York Attorney General, Congress has for better or worse given no little thought to drug regulation. It has amended the insanely detailed Food, Drug and Cosmetic Act some 100 times. Through it all one principle has remained intact: The only entity authorized to enforce federal drug law is the FDA.

And regardless of what state statute Mr. Spitzer pulls out if his magic hat, it is *federal law* that governs what drug information gets disclosed, to whom, and at what point in time. And for good reason. This country decided long ago that it was better to have a single agency distributing uniform drug info than to have 50 state attorneys general (and their tort-law retinue) with varied political agendas sending out conflicting safety messages.

Many clinical studies are badly designed or executed, and some of those are screened out in the publication process (the study that Glaxo publicized was published, while the other four weren't). As to the rest, the FDA has entire floors of experts whose only job is to inspect clinical drug trials and determine which are worth bringing to the attention of doctors.

The agency tries not to underwarn (so as not to encourage use in inappropriate situations) or to overwarn (so as not to discourage use in appropriate situations). The warnings also vary depending on whether there are five alternatives to the drug in question, or none. Somehow we doubt that even a smidgen of this thinking went into Mr. Spitzer's 18-page complaint berating Glaxo.

Mr. Spitzer also had the embarrassing luck to pick on a class of drugs that the FDA has made a top priority. The agency has been minutely examining studies for depression drugs, and that includes those for Paxil. Not only has the FDA scrutinized the studies Mr. Spitzer claims were "concealed," the agency has asked manufacturers to strengthen suicide warning labels and has provided a steady stream of guidance to doctors. The process is working exactly as it should.

Mr. Spitzer's second-guessing could do genuine public-health damage, as evident from a recent California case. A plaintiff sued to require manufacturers of nicotine replacement therapies to put stronger warnings for pregnant women on their California products than is federally required. The FDA made the case that such a move would dilute the FDA's message that smoking is still more harmful to pregnant women than nicotine. The court ultimately agreed with the FDA that California women deserve to know that just like everyone else.

All in all, there's something dangerous about a prosecutor making health-policy decisions for which he can't be held responsible. Whatever one thinks of the FDA, it is answerable both to the executive branch and Congress. Mr. Spitzer has to face the voters every four years, but will he take the blame for depressed kids who suffer because their doctors are scared out of prescribing Paxil?

Mr. Spitzer may have a constitutional hurdle to overcome as well. Last we looked, freedom of speech included the right to stay silent. Having informed regulators about the studies it performed, Glaxo had no duty to inform doctors or patients about trials the FDA itself takes responsibility for evaluating and passing along. Moreover, it's hardly a crime for a company to talk up its products; that's how many consumers learn about remedies in the first place.

Whatever good Mr. Spitzer has done by drawing attention to Wall Street's sins, it's clear his good press has gone to his head. He's now firing press releases and lawsuits in so many directions that he's hitting and harming innocent bystanders.

The Private Frontier

Perhaps it is only a coincidence that the world's first independent space mission is blasting off just a few days after a high-profile Presidential commission called on NASA to engage the private sector. But a more optimistic reading is that the U.S. is finally working out how to recapture the space momentum it lost 35 years ago when it stopped going to the moon.

California's Mojave desert is today's launch site for SpaceShipOne, a craft underwritten by Microsoft co-founder Paul Allen. The group is one of 26 racing for the Ansari X-Prize, which will award $10 million to the first team that launches three people at least 62 miles into space twice within a period of two weeks. The competition has captivated the public's imagination—far more than did President Bush's return-to-the-moon promise—and no wonder.

Americans are at their best when they are handed a competitive challenge (the "space race" of the 1960s) or see a way to make a buck. In the early part of the 20th century, hundreds of aviation prizes (including the Orteig prize won by Charles Lindbergh) and the opportunity for commercial profit helped to drive breakthroughs in air travel. Today the X-Prize is a motivation for teams experimenting with launches from balloons and from the ocean, with new fuel systems, new computers, and new landing methods. Many teams are sponsored by companies trying out new technologies in hope of future profits.

Maybe this spectacle of new ideas and entrepreneurial risk-taking helped to inspire the NASA report of last week. Established by President Bush in January 2004 after decades of NASA struggles, the Commission's job was to create an entirely new vision for the U.S. space program. Its answer? The "commercialization of space." The authors understand that the only real way to reinvigorate NASA is to strip it of its bloated government monopoly and force it to compete against, and benefit from, the dynamism of the market.

The report offers many good ideas to accomplish this, including the removal of regulatory hurdles to private space launch and protecting private property rights in space. Let's hope President Bush and Congress are paying attention.

Taxpayer Air?

In healthy American industries the real drama takes place in the scramble for market share. So it says a lot about the airline industry that most of its excitement these days occurs in Washington, as with United's ongoing attempt to cadge a $1.6 billion taxpayer loan guarantee.

Flying the Beltway skies.

We say ongoing, because it's still impossible to tell if the Air Transportation Stabilization Board (ATSB) has actually turned down United's request for loan guarantees. The Board's letter of last week officially said no, but two of the three Board members later said they'd be open to one more United request. The ferocious lobbying continues.

This is what comes from Congress dumping the chronically ill airline industry into the lap of an ad-hoc bureaucracy such as the ATSB. Created in the bailout rush after September 11, the ATSB is now being asked to save carriers from such endemic problems as unionization and low-cost competitors. And while the Board has so far been appropriately stingy, the political pressure to show them the money has been intense, especially in this election year.

That much was obvious from the ATSB's carefully worded letter to United. The Board's official reasons for denying this second loan request were that it didn't believe a loan was necessary to maintain the commercial aviation system, and that it felt credit markets were receptive enough for United to succeed without government help. There was no focus on the obvious problem, namely that United's plans for recovery and cost-cutting clearly still hadn't met the Board's strict criteria. This Emily Post refusal, coupled with the offer for United to try yet again, suggests that some Board members, in particular Treasury representative Brian Roseboro, are feeling the heat to relent.

We hope he doesn't. Give United CEO Glenn Tilton full marks for tireless advocacy, as well as for winning notable union concessions. But the loan guarantees will only mask the fact that even coming out of bankruptcy United will remain a relatively high-cost carrier. Without the loans, United will either have to find further cost savings in order to attract more private cash, or sell its assets to another carrier. That's capitalism. Meanwhile, the experience of US Air, which is facing a possible second bankruptcy despite $900 million in ATSB loans, shows that the risks to taxpayers are genuine.

The biggest villain here is Congress. The Members would rather pass the buck to the ATSB than fix the regulatory and tax problems that have crippled U.S. airlines. It could amend the Railway Labor Act, which gives organized labor the whip hand in salary talks with management. Or let carriers attract foreign capital the way other American businesses can; or cut the federal taxes and fees that take 26% of every $200 air ticket, or get out of the gate-distribution business. It could even enact pension reform worth the name, allowing airlines to modernize their costly retirement plans.

We sympathize with United's plight, but the taxpayers shouldn't have to pay for Congress's failures.

The End of Power

By Niall Ferguson

We tend to assume that power, like nature, abhors a vacuum. In the history of world politics, it seems, someone is always bidding for hegemony. Today it is the United States; a century ago it was Britain. Before that, it was the French, the Spaniards and so on. The 19th-century German historian Leopold von Ranke, doyen of the study of statecraft, portrayed modern European history as an incessant struggle for mastery, in which a balance of power was possible only through recurrent conflict.

Power, in other words, is not a natural monopoly; the struggle for mastery is both perennial and universal. The "unipolarity" identified by commentators following the Soviet collapse cannot last much longer, for the simple reason that history hates a hyperpower. Sooner or later, challengers will arise, and back we must go to a multipolar, multipower world.

But what if this view is wrong? What if the world is heading for a period when there is no hegemon? What if, instead of a balance of power, there is an absence of power? Such a situation is not unknown in history. Though the chroniclers of the past have long been preoccupied with the achievements of great powers—whether civilizations, empires or nation states—they have not wholly overlooked eras when power has receded. Unfortunately, the world's experience with power vacuums is hardly encouraging. Anyone who dislikes U.S. hegemony should bear in mind that, instead of a multipolar world of competing great powers, a world with no hegemon at all may be the real alternative to it. This could turn out to mean a new Dark Age of waning empires and religious fanaticism; of endemic rapine in the world's no-go zones; of economic stagnation and a retreat by civilization into a few fortified enclaves.

Why might a power vacuum arise early in the 21st century? The reasons are not especially hard to imagine.

• *The clay feet of the colossus.* The U.S. suffers from at least three structural deficits that will limit the effectiveness and duration of its crypto-imperial role in the world. The first is the nation's growing dependence on foreign capital to finance excessive private and public consumption. It is difficult to recall any empire that has long endured after becoming so dependent on lending from abroad. The second deficit relates to manpower: The U.S. is a net importer of people and cannot therefore underpin its hegemonic aspirations with real colonization; at the same time, its relatively small volunteer army is already spread very thin as a result of recent military interventions in Afghanistan and Iraq. Finally, the U.S. is afflicted by what is best called an attention deficit. Its republican institutions make it difficult to establish a consensus for long-term "nation-building" projects.

• *"Old Europe" grows older.* Those who dream that the European Union might become a counterweight to the U.S. should continue slumbering. Impressive though the EU's enlargement has been, the reality is that demography likely condemns it to decline in international influence. With fertility rates dropping and life expectancies rising, European societies may, within less than 50 years, display median ages in the upper 40s. Indeed, "Old Europe" will soon be truly old. By 2050, one in every three Italians, Spaniards and Greeks will be 65 or over, even allowing for immigration. Europeans therefore face an agonizing choice between "Americanizing" their economies, i.e., opening their borders to much more immigration, with the cultural changes that would entail, or transforming their union into a fortified retirement community.

• *China's coming economic crisis.* Optimistic observers of China insist that the economic miracle of the past decade will not fade—that growth will continue at such a pace that within three or four decades China's GDP will surpass that of the U.S. Yet it is far from clear that the normal rules that apply to emerging markets have been suspended for Beijing's benefit. First, a fundamental incompatibility exists between the free-market economy, based inevitably on private property and the rule of law, and the persistence of the Communist monopoly on power, which breeds rent-seeking and corruption, and impedes the creation of transparent institutions. As usual in "Asian tiger" economies, production is running far ahead of domestic consumption—thus making the economy heavily dependent on exports. No one knows the full extent of the problems in the Chinese domestic banking sector. Western banks that are buying up bad debts with a view to establishing themselves in China must remember that this strategy was tried a century ago, in the era of the Open Door policy, when American and European firms rushed into China only to see their investments vanish in the smoke of war and revolution. Then, as now, hopes for China's development ran euphorically high, especially in the U.S. But those hopes were disappointed, and could be disappointed again. A Chinese currency or banking crisis could have earth-shaking ramifications, especially when foreign investors realize the difficulty of repatriating assets held in China.

An 'apolar' future would be the worst of all worlds.

• *The fragmentation of Islamic civilization.* With birthrates in Muslim societies more than double the European average, Islamic countries are bound to put pressure on Europe and the U.S. in the years ahead. If, as is forecast, the population of Yemen will exceed that of Russia by 2050, there must be either dramatic improvements in the Middle East's economic performance or substantial emigration from the Arab world to senescent Europe. Yet the subtle colonization of Europe's cities by Muslims does not necessarily portend the advent of a new and menacing "Eurabia." In fact, the Muslim world is as divided as it has ever been. This division is not merely between Sunni and Shiite. It is also between those seeking a peaceful modus vivendi with the West (embodied in Turkey's desire to join the EU) and those drawn to the Islamic Bolshevism of the likes of Osama bin Laden. Opinion polls from Morocco to Pakistan suggest high levels of anti-American sentiment, but not unanimity. In Europe, only a minority expresses overt sympathy for terrorist organizations; most young Muslims in England clearly prefer assimilation to jihad. We are a long way from a bipolar clash of civilizations, much less the rise of a new caliphate that might pose a geopolitical threat to the U.S.

David Klein

In short, each of the obvious 21st-century hegemons—the U.S., Europe, China—seems to contain within it the seeds of decline; while Islam remains a diffuse force in world politics, lacking the resources of a superpower.

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Suppose, in a worst-case scenario, that U.S. neoconservativism meets its match in Iraq and that the Bush administration's project to democratize the Middle East at gunpoint ends in withdrawal: from empire to decolonization in 24 months. Suppose also that no rival power shows interest in filling the resulting vacuums—not only in Iraq but conceivably also Afghanistan, to say nothing of the Balkans and Haiti. What would an "apolar" future look like?

The answer is not easy, since there have been very few periods in history with no contenders for the role of global or at least regional hegemon. The nearest approximation might be the 1920s, when the U.S. walked away from Woodrow Wilson's project of global democracy and collective security. But that power vacuum was short-lived. The West Europeans quickly snapped up the leftovers of Ottoman rule in the Middle East, while the Bolsheviks reassembled the Tsarist empire.

Indeed, one must go back much further in history to find a period of true and enduring apolarity; as far back, in fact, as the ninth and 10th centuries, when the heirs of the Roman empire—Rome and Byzantium—had receded from the height of their power, when the Abbasid caliphate was also waning and when the Chinese empire was languishing between the Tang and Sung dynasties. In the absence of strong secular polities, it was religious institutions—the Papacy, the monastic orders, the Muslim *ulema*—that often set the political agenda. That helps explain why the period culminated with the holy war known as the Crusades. Yet this clash of civilizations was in many ways just one more example of the apolar world's susceptibility to long-distance military raids directed at urban centers by more backward peoples. The Vikings were perhaps the principal beneficiaries of an anarchic age. Small wonder that the future seemed to lie in creating small defensible entities like the Venetian republic or the Anglo-Saxon kingdom of England.

Could an apolar world today produce an era reminiscent of that troubled time? Certainly, one can imagine the world's established powers retreating into their own regional spheres of influence. But what of the growing pretensions to autonomy of the supranational bodies created under U.S. leadership after World War II? The U.N., the IMF, the World Bank and the WTO each regards itself as in some way representing the "international community." Surely their aspirations to global governance are fundamentally different from the spirit of the Dark Ages?

Yet universal claims were an integral part of the rhetoric of that era. All the empires claimed to rule the world; some, unaware of the existence of other civilizations, maybe even believed that they did. The reality, however, was political fragmentation. And that remains true today. The defining characteristic of our age is not a shift of power upward to supranational institutions, but downward. If free flows of information and factors of production have empowered multinational corporations and NGOs (to say nothing of evangelistic cults of all denominations), the free flow of destructive technology has empowered criminal organizations and terrorist cells, the Viking raiders of our time. These can operate wherever they choose, from Hamburg to Gaza. By contrast, the writ of the international community is not global. It is, in fact, increasingly confined to a few strategic cities such as Kabul and Sarajevo.

Waning empires. Religious revivals. Incipient anarchy. A coming retreat into fortified cities. These are the Dark Age experiences that a world without a hyperpower might find itself reliving. The trouble is, of course, that this Dark Age would be an altogether more dangerous one than the one of the ninth century. For the world is roughly 25 times more populous, so that friction between the world's "tribes" is bound to be greater. Technology has transformed production; now societies depend not merely on freshwater and the harvest but also on supplies of mineral oil that are known to be finite. Technology has changed destruction, too: Now it is possible not just to sack a city, but to obliterate it.

For more than two decades, globalization has been raising living standards, except where countries have shut themselves off from the process through tyranny or civil war. Deglobalization—which is what a new Dark Age would amount to—would lead to economic depression. As the U.S. sought to protect itself after a second 9/11 devastated Houston, say, it would inevitably become a less open society. And as Europe's Muslim enclaves grow, infiltration of the EU by Islamist extremists could become irreversible, increasing trans-Atlantic tensions over the Middle East to breaking point. Meanwhile, an economic crisis in China could plunge the Communist system into crisis, unleashing the centrifugal forces that have undermined previous Chinese empires. Western investors would lose out, and conclude that lower returns at home are preferable to the risks of default abroad.

The worst effects of the Dark Age would be felt on the margins of the waning great powers. With ease, the terrorists could disrupt the freedom of the seas, targeting oil tankers and cruise liners while we concentrate our efforts on making airports secure. Meanwhile, limited nuclear wars could devastate numerous regions, beginning in Korea and Kashmir; perhaps ending catastrophically in the Middle East.

The prospect of an apolar world should frighten us a great deal more than it frightened the heirs of Charlemagne. If the U.S. is to retreat from the role of global hegemon—its fragile self-belief dented by minor reversals—its critics must not pretend that they are ushering in a new era of multipolar harmony. The alternative to unpolarity may not be multipolarity at all. It may be a global vacuum of power. Be careful what you wish for.

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Bubble Act Redux

By Lawrence B. Lindsey
And Marc Sumerlin

The Financial Accounting Standards Board is about to change the way employee stock options are treated for accounting purposes. Faced with the collapse of the stock market bubble and the accounting scandals of the anything-goes 1990s, FASB is responding to the new political environment in which a premium is placed on any changes that appear to be "tough" on corporate America. With politicians and the media looking for targets, change is good because moving targets are harder to hit.

This is a cycle as old as financial markets. After the collapse of the South Sea Bubble of the 1720s, Parliament passed the Bubble Act, which banned the creation of any new joint-stock companies without Parliament's express approval. The ban stayed on the books for 105 years. The prosecution of wrongdoing is essential to the clean-up process, but history suggests that when political institutions run out of wrong doers, they often turn to ill-conceived systemic changes. These changes, like the Bubble Act, undermine sound economic activity with little impact on wrongdoers.

FASB's proposed change is no exception. To begin with, it undermines a key principle of accounting: the link between the balance sheet and the income statement. FASB proposes requiring that firms treat stock options as a current expense. A true expense reduces the net asset value of the firm. But no such reduction in net asset value occurs when a stock option is granted. Granting an option does dilute the value of shares of existing shareholders by effectively increasing the number of potential shares outstanding. But the total value of the firm and its profits remains unchanged; they are merely spread among more shares.

FASB has been searching for a way to credit owners' equity to hold the balance sheet harmless from mandating fictitiously reduced income. But no elegant solution exists for fixing a fundamental violation of accounting principles. FASB's jury-rigged proposal would distort the earnings per share calculations by changing both the numerator and the denominator, causing a double counting of the impact of options on earnings per share. Moreover, if the stock options expired and were never exercised, the stock option expense would stay on the books, and the profits of the firm would be permanently reduced, even though no economic transaction occurred.

FASB's proposal is not only conceptually wrong, it is also technically wrong. The primary methods used to calculate the value of stock options, like Black-Scholes, are valid only for tradable options that are readily converted into cash. Employee stock options are long term and non-transferable. The fact that they cannot be sold means they cannot be measured by market-based option calculators. FASB is violating its own Statement of Financial Accounting Concepts No. 5, which states that "revenues and gains are realizable when related assets received or held are readily convertible into known amounts of cash or claims to cash."

There is no question that shareholders need better information on the effect of stock options on the value of their shares than they got during the bubble years of the 1990s. Under current accounting rules, the dilution effect of stock options is appropriately shown in the diluted earnings per share calculation. This dilution effect is both important and variable, and so is shown on a quarterly basis so that shareholders are aware of its evolving impact. This should be upgraded to include the disclosure of vested and unvested options for both in-the-money and out-of-the-money options and should also include more disclosure on employee purchase plans and other claims on equity. The FASB plan does none of this.

But the adverse effect of FASB's plan is not just on accounting principles; its effect on the high-growth sector of the American economy is even greater. Options give an employee a stake in the firm and a concern for its future. This is particularly vital in high-technology industries where a good portion of the firm's capital is human capital that can walk out the door at any time. It is also a way of conserving scarce cash for high return investments.

If the FASB plan is implemented, credible estimates suggest the average technology rich Nasdaq 100 firm would suffer a 44% drop in reported profits. Some high growth firms that use their cash for investment will appear to be underwater. These firms are hit hardest because they have both the highest price/earnings ratios and the highest volatility. In the complex formulae used to calculate the value of options, higher projected volatility leads to a higher assigned value to the option.

The adverse effect on high-tech firms can be 20 times as great as a percent of net income compared with traditional companies. Hence, more mature firms like Coca Cola are more inclined to accept expensing of stock options. By double-counting the effect of options on earnings per share, the net effect of FASB's proposal would be to reallocate capital from cutting-edge firms to more mature and slower-growing companies. It would be particularly devastating on start-up firms with emerging technologies.

This protection of the well entrenched is one of the more ironic aspects of the history of political responses to the collapse of bubbles. Back in the 1720s, the South Sea Company was one of the behind-the-scenes supporters of the Bubble Act, even though it was at the center of the controversy. It reasoned that if new joint-stock companies could not be formed, its own access to capital would be enhanced. It is hard to see how having fewer investment opportunities helped the shareholders of the day. It is similarly hard to see how today's shareholders or workers will benefit from a one-size-fits-all formula that restricts innovation and will reduce the public offering of shares in the high technology firms that will form the base of America's economic future.

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