We’re only in it for the money
A research journey

A cooperative role model
Interview with Peter Nijkamp

Transformation of Europe
Macroeconomic research at Universiteit van Amsterdam

Letters from Alumni
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Beata Bierut

Roel Beetsma

Philip Hans Franses

Paul Frijters, Australian National University

Papers in journals

Discussion papers

Theses

Awards

References

Au revoir Carien de Ruiter

Carien de Ruiter has left Tinbergen Institute. Carien has been an important part of the Tinbergen Institute team since 1987. We thank her for her dedication during the past period and wish her all the best in her future endeavours.
A cooperative role model

Interview with Peter Nijkamp

You are the top Dutch economist in the recent ranking published by ESB (Ekonomisch-Statistische Berichten), based on your publications for the period 1998-2002. What is the key to this success?

Honestly speaking, I haven’t carefully studied the underlying statistics. But over the years I have consistently pursued new scientific endeavours. This is what I find so fascinating in science: exploring new pathways in research drives most of my efforts. Curiosity provides also the key to motivating young people. It is great to work with new and promising talent, to spend time supervising them, to help them to stand independently on their own and to become successful scholars. Personally, I have several ideals as a scientist, and if one of the signals of achievement is a ranked position, fine. But the real satisfaction in science stems from new discoveries.

Do you find such rankings useful?

Rankings can be useful as a benchmark, but for me they are just indicative of performance. They are based on various statistical measures that can all be questioned. But they do, of course, give some impression of one’s achievements. If for several years someone working at a senior level of research and of scholarly performance achieves top rankings of

Peter Nijkamp is professor of Regional Economics and Economic Geography at the Faculty of Economics, at the Vrije Universiteit Amsterdam since 1975. Since 2002, he is president of the governing board of the Netherlands Organisation for Scientific Research (NWO)
publications, then this is likely a sign of structurally good performance. Still, the ranking on a list is one thing and has its limitations; the creation of new knowledge and the education of a new generation of researchers is equally, if not more, important.

Let us for the moment continue to focus on the scientific recognition of your work. In 1996 you received the Spinoza Prize, which is seen as the Dutch Nobel prize. In your Spinoza lecture you sketched a vision of the way to spatial-economic meta-analysis. Could you please explain it briefly?

First, the Spinoza Prize was a big surprise for me. It enabled me to pursue work on an idea that I had been developing for some time. Essentially, within my own field (regional economics, and related fields such as transportation economics and environmental economics) many scholars have done extensive theoretical and applied work. They have accumulated a great deal of knowledge, but it all appears to be rather fragmented. Meta-analysis is an advanced statistical method designed to bring together applied results from all such empirical studies in a certain domain and to investigate under which conditions there is a similarity or a significant contrast in applied findings. The main strategic questions are then as follows: Does applied research help us to get better general insights? For example, if you have twenty different studies on a certain phenomena, what does it mean? Can you use them to form a broader general picture that will help in identifying different driving forces in the economy? For me, the grand idea was to get a synthesis in spatial-economic research by developing a methodology that transcends also the borders of my own field and can be used in other fields of economics as well. I am happy to say that it has been extremely successful, with hundreds of publications by a whole team all over the world. It has been the fulfilment of an old and long-cherished dream.

You have published three multiple-volume handbooks: on regional science, environmental analysis and transport analysis. In your Spinoza lecture you claimed that these three issues must be studied jointly. Why is that?

First, these volumes have to be interpreted within their own disciplinary domain. Second, they have to be linked together, simply because within the economics discipline these three fields are interconnected. We distinguish them in economic research for practical reasons, but in reality all spatial-economic markets are linked. The behaviour of people is interdependent: once you have a job, you need a house to live in, you have to commute, you cause environmental decay, etc. Clearly, after Adam Smith's path-breaking work we know that people are driven by self-interest. This recognition has contributed to enormous progress in economic research, but it has also led to a fragmentation in results. In my opinion, an extensive degree of specialisation may be detrimental for progress in economic thinking. Every now and then in the history of science you have to synthesise the field. Economics will otherwise lose its meaning, become fragmented. The use of meta-analysis and the publication of coherent handbooks represent a modest attempt from my side to work toward synthesising economics.

More specifically, now, does "Classics in transport analysis" provide any solution to Dutch problems with transport?

Oh yes. The economist's lesson is simple (since you always come back to good old economist Pigou's lesson): if there is a difference between social and private costs of benefits, use the market and let the market pay. Very simple; it holds for both the use of asphalt and the use of an airplane. The problem is that we have developed political judgment systems that were at odds with this wisdom, which consequently distorted market behaviour. Dutch researchers were almost the first in the world to look into the wisdom of simple economic thinking and to consider such solutions as road pricing and toll roads. We had, quite possibly, a first-mover disadvantage. When the Netherlands announced at the end of 1980s that it would pursue user-charge principles-- which is a sound economic message-- the Dutch population was unprepared to accept it. The idea was killed politically, and even led to the fall of the government at the time. Other countries have gradually progressed since that time: Germany has adopted road pricing to some extent, and London has toll roads for cars entering the city. Other countries that already had a system of toll roads (like France or Italy) extended their network. They managed to put in place-- without a fundamental debate about the freedom of mobility-- a right that is fundamental for every homo economicus.

Economists have rather fragmented ways of organising their views
What should then be changed to ensure support of sound economic messages?

An important message from the story I just told you is that economists have been unsuccessful in teaching society the basics of economics. That is true for the environment, for transportation, and for many other things as well. We have developed great theoretical ideas, but have not been very successful in convincingly explaining the implications. That is where economics should improve. In the past, great economists such as Jan Tinbergen were able to advocate their views in a political arena, not only in the scientific world. Nowadays, if an economist explains something (anything!) in a political debate, fellow economists immediately criticise it.

We have thus left the real decisions open to politicians. If economists disagree, politicians can use—or abuse—the controversy and the lack of a clear message, and take their own decisions. That hardly indicates mature economic science. In various other disciplines the situation is different. In the medical sciences, for instance, if an advisory medical council provides advice on a certain medical treatment to the minister, the minister listens carefully. Such issues involve human life, and a minister cannot afford to take any risks. Medical science is thus able to create a common perspective, while economists have rather fragmented ways of organising their views. In the natural and medical sciences, scientists are working in a more standardised way (and hence also in a more comparative way), so that one can base a decision on a comparable (risk) analysis. Some of these things would help to improve the profile of economists in a societal discussion. Consider the Tinbergen Institute, for example, which does very well in the scientific world. From a global perspective, it is even an absolute success story—with its great international recognition. If I look at Tinbergen Institute from a societal point of view, however, I am slightly more hesitant; it would be great if Tinbergen Institute would take the lead in national strategic debates. I think we have to take a step forward here. If economics is isolated from society, it will be less respected.

So you’re saying we should go out and make our voices heard—once we’re sure that we have one message.

Exactly. It doesn’t make sense to speak with ten voices. We will have to work much more in terms of evaluation of common and standardised policies, mapping of new developments, joint protocols... within a consistent analytical framework. At present, a commonly accepted framework, especially for political and industrial debate, is missing.

Is your project the first step in that direction?

I would hope so, in all modesty. But this is a mission applying to the entire economics discipline. Economists must come together and work much more along similar lines. That will lead to greater progress in economic thinking.

Curiosity provides the key to motivating young people

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Curiosity provides the key to motivating young people
I like numbers, so I ran a search for your name in EconLit. It came back with 335 hits. Since we obviously cannot discuss all of your publications, I have decided to ask you about one of the main themes: home and job location and commuting. What is your conclusion at this point, considering our earlier discussion about transport? What if we, for example, moved every worker to the place where his or her job is; would that help, even without paid roads?

These are fascinating, but also complex, issues. If life would be so easy–that a given person would always live in one given home and commute every day back to the same given place–then we could easily sort out the optimal pattern. But consider the additional complications of a person with flexible employment, working one day in Utrecht and the next in The Hague. It is even more complicated if that person has a partner, and they want to live together, and they work in different locations. You then have three solutions: partner 1 commutes, partner 2 commutes, or they live in-between and they both commute. I am almost back now at Adam Smith, and looking at all these millions of people who take decisions every day and arrive at their destinations without any central planner. I would say: leave it to the market. Individuals know what is best for them; let them take their individual decisions. Clearly, external costs would have to be charged in all cases.

What you can do from an economic perspective is to ascertain the driving forces of these individuals. Why does one couple decide that the woman should not commute, while the other decides that the man should not? Is this merely inertia, or does this couple have children? Do they want to live close to their family? Here, economics can learn from experimental sciences, for example. An important tool in dealing with externalities from a micro-economic perspective is contingent valuation analysis. We often, mistakenly, think that the concept of contingent valuation is an economics invention, and that stated- and revealed-preference methods are economic inventions. These concepts were invented much earlier, however, by experimental psychologists. They were documented already in the 1950s. A few economists have used them; others have re-invented the wheel. I think we sometimes work too much in isolation.

A final question: What do you want to achieve now?

That is an intriguing question. The way I started this interview may guide my answer. What I would like to achieve is good economic science, from a professional perspective. I would like to work toward a situation in which young talent has access to the intellectual possibilities to do things they would like to do, and I would like to ensure that they are able to do these things better than I ever would or could. How can this be achieved? I would like to provide a cooperative role model for young scientists. A good supervisor is characterised by a sense of openness and tenacity, and believes in his ideals– as I do.

Thank you.

Selected Publications
This article highlights an area of economic research that has been receiving dwindling attention over the past ten to fifteen years in the Netherlands. Although macroeconomic research is internationally more active than ever, and substantial scientific progress has been made, research attention in the Netherlands has traditionally focused on econometrics and, in recent years, increasingly on industrial organisation and game theory. The latter development is hardly entirely surprising, given that important policy questions are related to market structure, competition policy, pricing in networks, and the like. While the analysis of such micro-economic issues is of great importance, one should realise that the (industrialised) world and the Netherlands, in particular, face urgent macroeconomic problems that demand careful analysis. Examples include population ageing, fiscal profligacy and fiscal stabilisation, sluggish European growth, the transition dynamics of the newcomers to the European Union, trade imbalances and the danger that the dollar at some moment could be dumped.
A selection of current research
At the University of Amsterdam, research in macro-, international and monetary economics is bundled into the research program “Transformation of Europe” (ToE). This active research group interacts by working on joint projects. It has a bright future, given the low average age of the group. Since the space available here is too limited to discuss all the research conducted by ToE members, I will sketch the depth and breadth of modern macroeconomic research by describing my recent research.

Loosely speaking, most macroeconomic research can be divided into short-run and long-run analysis. The latter typically focuses on economic growth, where it tries to explain its determinants and to formulate policies that promote long-run growth. This is important not only for developing countries, but also for the industrialised countries, with their ageing populations and potentially shrinking bases on which taxes and premia can be levied.

Ageing is a major theme in ToE’s research. Several members of the program are involved in Netspar, the new Tilburg-based centre for research on ageing and pensions. My own project for Netspar concentrates on two issues where monetary policy interacts with intergenerational welfare distribution. The first analyses the threat that the common monetary policy conducted in the EMU may result in a redistribution of wealth from countries that have large accumulated pension savings towards countries with a pay-as-you-go system, where current workers pay for the pensions of the retired. A looser monetary policy could erode the real value of the pension assets (to the extent that they are nominally denominated). In particular, when pension funds invest heavily in public debt, the governments that have issued that debt could put pressure on the ECB to relax its policy. The second issue concerns the distribution of the stabilisation gains from monetary policy across generations. Monetary policy is often viewed as the problem of making an appropriate trade-off between stabilising inflation versus stimulating economic activity. But demarcating the appropriate trade-off becomes difficult when one realises that generations may differ in their main sources of income. In particular, the young receive a relatively large share of their income as salaries, and would have a relatively strong preference for stabilising economic activity. Older people presumably obtain a relatively larger share of their income from their asset holdings, and would benefit most from stable prices.

Short-run analysis typically focuses on explaining business cycles and exploring the role of monetary and fiscal policies in stabilising the business cycle. Over the past ten to fifteen years, macroeconomics has made substantial progress in the analysis of short-run fluctuations. Much of the research has concentrated on the “New-Keynesian” framework, which combines the assumptions of imperfect competition, sticky prices and/or wages with rigorous micro-foundations in which the behaviour of economic agents is derived through optimisation. The New-Keynesian approach allows for a rigorous assessment of the welfare effects of public policies. Although monetary stabilisation policies usually feature prominently in New-Keynesian analysis, fiscal policy is notably absent. In joint work with Henrik Jensen (Copenhagen University), we introduce fiscal policy in a New-Keynesian model of a monetary union. Obviously, monetary policy can focus only on stabilising union-wide shocks. It turns out that an active (optimal) fiscal stabilisation policy in response to country-specific shocks leads to non-
negligible welfare gains. This is a relevant message in light of the debate about the appropriate degree of flexibility in the implementation of Europe’s Stability and Growth Pact, which limits deficits to a maximum of 3% of GDP.

In a joint project with Massimo Giuliodori and Franc Klaassen, we try to assess the potential scope for fiscal policy coordination in Europe. A typical example would be a joint (temporary) reduction of taxes by the EU member countries that are currently trapped in sluggish growth. In fact, Germany and France have lowered or are lowering income taxes. Also, not so long ago, Germany and France floated the idea to set up large European infrastructure projects in order to stimulate the European economy. Of course, coordination makes sense only if national policies result in substantial cross-border spillover effects. We explore the empirical relevance of spillovers of fiscal policy through intra-European trade. This is a question that has been largely overlooked in the literature. The idea is that a fiscal expansion in Germany, say, stimulates economic activity in Germany. This leads to more German imports from partner countries, thereby also raising their incomes. Indeed, we find that a fiscal expansion in a major European country can have a substantial positive short-run impact on the economies of partner countries. This suggests that joint fiscal expansions could be mutually beneficial under current circumstances. Such expansions should be short-lived, and compensated by a joint fiscal contraction when a large part of the EU economy shows signs of overheating.

In our work exploring the optimal implementation of the Stability and Growth pact, we have identified the benefits of a simple deficit rule that allows for flexibility under appropriate conditions.

In joint work with Xavier Debrun (IMF), we explore the optimal implementation of the Stability and Growth Pact. Recently, the Council of Economics and Finance (ECOFIN) ministers adopted a reform proposal of the Pact within the confines of the Treaty on the European Union. Yet many questions concerning its implementation remain on the table. For example, room has been created for some leniency of the Pact towards the short-run costs of implementing structural reforms. Distinguishing between reform-related costs and other costs has thus become an important issue. In particular, governments might unduly present politically motivated spending as reform-related spending. The additional flexibility of the implementation comes at the cost of intensified monitoring. As a result, it is important to design the implementation of the Pact in such a way that incentives for abuse are minimal. We find that a simple deficit rule that allows for flexibility under appropriate conditions can
simultaneously contain deficits, diminish politically motivated spending and stimulate high-quality spending geared towards implementing structural reform.

In another project, Alex Cukierman (Tel Aviv University), Massimo Giuliodori and I explore the implications of wars for US fiscal policy. This research centres around two hypotheses. First, we find that the increase in defence spending during World War I was associated with an increase in civilian public spending, while the opposite was true for World War II. This leads us to the hypothesis that the change in civilian spending as a result of an increase in war spending is determined by a trade-off between the complementarities of the two types of spending and the need to limit tax distortions. The complementarities argument dominates when the government sector is relatively small (at the start of World War I), while the other argument dominates when the government sector becomes larger (as was the case before World War II). The other hypothesis concerns the presence of a ratchet effect in spending on transfers (such as public pensions and unemployment benefits) around wars. While transfers fall at the start of World War II, the data suggest that they rise beyond their original level after the war. The question, then, is what explains this ratchet. Is it possible to explain the ratchet by amending an existing model in the literature, or do we need to devise a completely new model, possibly based on deviations from standard preference assumptions? This is the question that is now on our desk.

**Selected Publications**


Philip Hans Franses

Philip Hans Franses is professor of Econometrics at Erasmus Universiteit Rotterdam, and an amateur collector of rare notes, coins, records and books.

“We’re only in it for the money”, the title of an album recorded by Frank Zappa and his Mothers of Invention (which came out in 1967 under the Verve label; I have an original version in my modest collection), comes close to describing one of the reasons why I went to my office on the days when I was free to do research. Indeed, part of my research in the last few years has dealt with money— that is, with real coins and banknotes.

How did it start?
It all started with an intriguing message on NOS Teletext page 192 on May 31, 2002. By then, the euro had been in use for a few months, and the first fake euro note had already appeared. In Germany, at a gas station, someone paid a 50-euro charge with a phoney 300-euro banknote, and received 250 euros as change. A closer look at this note, which I managed to buy at a stamps and coins fair, reveals that it is obviously fake (as it contains adult pictures), but apparently the face value of 300 euros caused no alarm bells to ring. Consider: a fake note of 495 would most likely never have been accepted, but a 300-euro note was. So, 300 seemed plausible.

Apparentaly, a banknote with a face value of 300 euros caused no alarm bells to ring. A fake note of 495 would most likely never have been accepted, but a 300-euro note was.
This brings us to the theory of the optimal denominational range— that is, which values should coins and notes have, in some dimension, in order to represent an optimal range? Various studies have sought to establish which denominational range is optimal, at least in theory (see Van Hove (2001), Telser (1995) and Wynne (1997), among others). There are links with finding optimal sets of weights for a balance. The conclusion: discrete ranges of 1-2-5 and of 1-2\(\frac{1}{2}\)-5 come close to optimality, but various countries issue notes with face value 3.

This optimality concept takes as the starting point the issuer. Alternatively, one could also begin with the paying individual. Along these lines, Cramer (1983) defined an efficiency concept, using the “principle of least effort” to develop a behavioural model for cash payments, and defining efficient payments as those in which the number of notes and coins exchanged between payer and receiver is minimized. He also developed an algorithm that makes it possible to compute the number of ways people can pay certain amounts efficiently.

Back in 2001, we thought that these theories would have had received much empirical support in an abundance of studies. However (and greatly to our surprise), we discovered that there were no studies in which individuals were asked to literally open up their wallets when they were observed making cash payments. A study in 1998 by the Dutch Central Bank observed people making cash payments, but the bank was reluctant to ask them what they had in their wallets.

Our projects
This gap in research opened the way for our project, which focuses on what individuals do when they look into their wallets and have to make a cash payment. The first order of business, of course, was to ask people to open up their wallets. And so we did. Next, we needed to extend the Cramer model in order to allow for wallets that would not contain all notes and coins. Furthermore, we needed an econometric model that could summarize the observations. The last few years have thus been spent collecting data and summarizing these with a useful and reliable econometric model. This process turned out to be relevant for an abundance of research questions.

We started in 2001 with an analysis of Dutch Central Bank data involving the payments of 40,000 individuals who used the guilder. The data include the amount to be paid, the notes and coins used, and the notes...
and coins received as change. The fact that there was no wallet content was solved by using an interview, which helped us to establish “typical” wallets. Theory predicts that no preference should exist for (not) using certain coins and notes; that is, if a note or coin is in a person’s wallet, the person should use it as needed. Interestingly, our empirical analysis in Kippers et al. (2003) shows that there were preferences for not using the 2½-guilder coin (the “rijksdaalder”) and the 50-guilder note (the beautifully designed note with the sunflower). Thus, even though theory predicts that the 1-2½-5 range is close to optimal, the guilder range was not efficient.

In October 2002, we collected the same type of data for the euro. We used the same model as in Kippers et al. (2003), but before collecting the data, we examined the performance of the model (size and power of tests and the reliability of estimators). This helped us to see that no more than 250 observations were needed. The results, reported in Kippers and Franses (2005), imply that no preferences exist for certain euro coins or notes. It seems that the euro range implies efficient payments in practice, in contrast to the guilder.

The next question: would omission of certain notes and coins affect payment behaviour? This question sprang from our own experience of almost never getting 20-euro notes from the bank. Thus, what would happen if, say, the 20-euro note would be unavailable for a while? Theoretical derivations using the Cramer algorithm show that omitting the 1-eurocent and 2-eurocent leads to more efficient cash payment behaviour. We have also been able to show that having no access to 100-euro notes and 10-euro notes is less harmful than having no 50-euro notes. It would be nice, but not at all easy, to verify this result using empirical data. We therefore decided to collect data using games of Monopoly. We had over 50 people play games of Monopoly, and each time we deleted one note. Because the Monopoly game does not have 200-euro notes, we had them made ourselves. An example of this fake note appears in Figure 1. The end result of this experimental study was that we found support for the theoretical prediction concerning the 50-euro note.

Finally, what can we say about the 1- and 2-eurocent coins? Interestingly, we faced a change on September 1, 2004, as from this date onwards stores were allowed to round off at 5 eurocents. To understand the consequences, we collected samples of 250 wallet contents before that date, and twice after that date. Again, using Cramer’s algorithm, we were able to compute which fractions of which coins and notes should be in an average wallet in order to be able to make any kind of cash payment between 1 cent and 100 euros. Comparing these fractions with the observed fractions, we conclude that rounding-off leads to fewer coins in the wallets, although there seems to be rather an overabundance of 5-eurocent coins.

In sum, money has kept us busy during the last few years, and we are not yet done. At present, we are collecting data in Turkey, where they have deleted six zeroes from the notes and coins. We also trying to understand why people claim that the euro causes us to spend too much, and much more. One could say that, at present, money makes our world go ‘round.

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A tale from Down Under

Paul Frijters®
Australian National University

I've been working in Canberra for the last two years on a research-only position, with five more years to go. It's the kind of deal whereby there are no explicit pressures to achieve anything, but given the limited time horizon of the contracts one nevertheless has full incentives to publish and be academically active.

My research here consists of various tracks. One track is an extension of my PhD work with Bernard van Praag and concerns itself with measuring utility. The “bad old days” in economics, when we just assumed we knew what the utility function looked like, but refused to empirically measure it, are ending. We're starting to use self-reported happiness measures and measures specific to domains of life as additional sources of information to cheap introspection. Much of my research fits into that vein: finding out how responsive happiness is to income; exploring to what extent tastes concerning the ethnicity of co-workers is reflected in job-satisfaction and wages; using health satisfaction to determine the health effects of various life shocks; etc.

Another track of my research is a continuation of the work I started just after my PhD at the VU, where Gerard vd Berg gave me a job. This track includes structural labour-supply models (with Bas vd Klaauw, who is a TI fellow!); duration analyses of the transitions of UK nurses and teachers; reduced-form models of the various search channels used by ethnic minorities in the UK; etc.

A third track, an offshoot of activities started during my PhD, concerns economic development and individual psychology issues using dynamic models. These issues are less suitable for academic papers, but are more the sort of thing you shove in books— so that's what I'm doing in my spare time.

All in all, hence, everything I'm currently researching is related in some way to what I was busy with as a PhD student at Tinbergen Institute. All that's been added to my activities in the meantime is more money and more co-authors. During my PhD studies, I found the institute to be full of people interested in issues and willing to cooperate on zany projects that had low expected pay-offs, but were fun to pursue— even if they failed. I found Dutch academia to be full of professors willing to subsidise such activities on the off chance that long shots might actually be successful. I hope they haven't scared the new generation of TI students into doing only safe projects....

Let me end by advertising the place I work at now. The main advantage of working at the Australian National University is the work environment. There is a laid-back Australian atmosphere in this place: morning coffee; long lunches; afternoon tea; and a beer in the Fellow's garden when it is warm (which is about six months a year). This easy-going mentality is coupled, however, with a brutally competitive undertone in which the ‘Fellows' have to maintain their worthiness. The old idea of Academia is thus alive and well here. We have plenty of guests with which to work and to exchange information about the real world. Plenty of seminars and conferences keep us up-to-date with the world. Come and visit us one day, but bring your own research money if possible!
thoughts—say, reject
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problem.

Such vanity may lead to reputational concerns—the consequences of vanity (or mainly the negative Economistss have stressed report in 2000. appeared in Ahold’s annual reality; the bottom one had sunset. The top picture was exactly the same meeting but now against the backdrop of the New York skyline lit by sunset. The top picture was reality; the bottom one had appeared in Ahold’s annual report in 2000.

Economists have stressed mainly the negative consequences of vanity (or reputational concerns)—the desire of an individual or entity to come across as a competent decision maker. Such vanity may lead to

Can reputational concerns be a social blessing? This paper shows that they can. Imagine an agent who can exert effort to become informed about the uncertain benefits of a project—say, a dedicated freight line connecting the port of Rotterdam to the German hinterland. He cares about the project and about coming across as a well-informed decision maker. If he is intelligent, then exerting effort makes him better informed; if he is not, then any effort is to no avail. In the latter case, he exerts no effort, and ideally should take decisions in line with his a priori thoughts—say, reject the project. After all, the rivers and roads have served well for decades, and isn’t trade electronic these days? If he is intelligent, however, he collects information; should this prove favourable, he implements the project. The temptation for a stupid agent is clear: to come across as intelligent, he mimics the probable behaviour of an intelligent agent, and sometimes implements the project. This is harmful for society. As a result of this situation, however, an intelligent agent exerts more effort in order not to be mistaken as stupid. This is beneficial, as greater effort implies a more accurate prediction of the project’s value. On the whole, the private vice of vanity may prove to be a public virtue.


On the Bad Reputation of Reputational Concerns

Two years ago, the Dutch newspaper De Volkskrant published two pictures of Ahold senior executives. The top picture showed them gathered in a boardroom somewhere in an anonymous building in grey and dreary Zaandam, where the Ahold headquarters are located. The bottom picture showed exactly the same meeting but now against the backdrop of the New York skyline lit by sunset. The top picture was reality; the bottom one had appeared in Ahold’s annual report in 2000.

Specific investments, hold up, and the outside-option principle

Consider the relation between two parties in which one party can make an investment that is valuable only within the relationship. If future payoffs cannot be conditioned on the level of investment, the investor is predicted to invest less than the efficient level. The reason is that the investor anticipates that the non-investor will capture part of the return on investment during the bargaining stage, which diminishes return on the investment. This is the hold-up problem.

In similar cases, making the investor the residual claimant of the remaining surplus solves the hold-up problem. One way of doing this is to structure post-investment bargaining such that the non-investor has a binding outside option. According to the outside-option principle, the surplus up for renegotiation is divided in proportion to the parties’ bargaining power—unless this yields the non-investor less than his outside option. In the latter case, the non-investor simply obtains the value of his binding outside option and the investor reaps the full return. Theory therefore predicts that the level of investment will increase when the non-investor’s outside option increases from a non-binding low level to a binding high level. In the latter case, the investment level is efficient.

This study tested these predictions using laboratory experiments. Subjects play an alternating-offer bargaining game that is preceded by an investment stage. As experimental treatments, the non-investor has either a low- or high outside option.

No support was found for the theoretical relationship between investment incentives and the outside option being binding or not. Moreover, average investment levels are always below the optimal level. This suggests that contractual solutions that rely on the outside-option principle are unlikely to solve the hold-up problem.

Overeducation, wages and promotions within the firm

Does it pay off to be better educated than is required for your job? Why would you work below the level of the education you attained? Does it perhaps pay off later in your career?

This is exactly what human capital theory states: individuals who are overeducated for their job have made a deliberate investment decision. An individual thus chooses such a job because it provides him with better-than-average learning opportunities, which enhances his career opportunities. To test this claim, this study analysed data from personnel records of a
large firm operating in the energy and telecommunication markets. In this firm, overeducation significantly enhances an individual’s career development— but at a decreasing rate. Both the probability of job promotion and of excess wage growth is higher for the overeducated, but mainly so at young ages. Hence, the claim made by human capital proponents holds only for career development at a young age. The literature about overeducation shows that returns to a year of overeducation, while positive, are smaller than on a year of required education. It’s conceivable that the results are due, at least to some extent, to selective matching of workers and firms, as suggested by Gautier et al. (2002). In their view, the wage effects of overeducation are mainly due to overeducated workers selecting high-wage firms. By considering data for a single firm (as was done in the study featured in this article), researchers can discard this effect as the sole explanation for the findings. The study established unequivocal support for a wage function extended with the effects of over- and undereducation, with required education measured from the firm’s hiring standards. The usual wage effects of required education were also found for this single firm.

Reference: Gautier et al. (2002), Worker turnover at the firm level and crowding out of lower educated workers, European Economic Review, 46, 523-538.

By Sandra Groeneveld (VU) and Joop Hartog (UvA), 2004, Overeducation, wages and promotions within the firm, Labour Economics, Special Issue Dec. 2004, v. 11, iss. 6, pp. 701-14.

First-mover advantage has been studied for many years. The vast majority of empirical studies find that market pioneers have substantially higher market shares than later entrants. This paper studies whether early entrants in the European mobile telephony sector benefited from their pioneering activities and obtained in the long term a larger market share. This is the first paper to study the consequences of the order of entry using data from one particular sector where consumers buy infrequently. It provides the first empirical investigation of the success or failure of the policies of competition authorities to ensure the interests of entrants. The paper, which estimates whether systematic differences exist between the ways market shares of entrants develop in different European countries, can thus answer the question in which countries it is more (or less) difficult for entrants to enter the mobile telephony market.

The analysis is based on a unique dataset containing monthly data about market shares in all Western European countries. The study explores how the order of entry co-determined the evolution of the market shares of firms over time in different countries. A clear early-mover advantage is found, caused mainly by the influence of the penetration rate: it pays to enter when still only a few people have acquired a mobile telephone. Another important determining factor is the market power at the moment of entry: it is significantly easier to enter a highly concentrated industry. Finally, important differences exist between countries—indicating, perhaps, the relative strength of the national regulators. For example, it seems to be relatively difficult to enter the mobile telephony sector and to gain market share in the Scandinavian countries.

By Govert E. Bijwaard, Maarten C.W. Janssen and Emiel Maasland (EUR), Early-mover advantages TIOS-007/1

Dumping in a Global World

While less than a decade ago only major industrial countries employed anti-dumping actions, they are now the preferred trade policy of developing and transition economies as well. For example, in terms of cases per dollar of imports, India’s intensity of anti-dumping use is seven times the US figure; Argentina’s intensity is 20 times the US figure. Differences in product quality are particularly important in international trade between developing and transition economies and the Western World. In this context, this paper explores the strategic incentives of oligopolistic exporting firms to undertake dumping, and attempts to understand why developing and transition economies have increasingly applied anti-dumping laws.

The determination of dumping relies on three main principles. First, domestic and export goods must be “like” products: this means alike in all respects, or having characteristics closely resembling those of the product under consideration. Second, a local firm may petition the government for relief if dumped imports materially injure the local industry. Third, a product is considered to be dumped if its export price to a particular country is less than a “normal value”. The latter is a crucial concept, and different proxies for the normal value lead to distinct outcomes regarding dumping.

One definition of dumping considers the competing local price as a proxy for the normal value. This simple measure leads to unilateral dumping by low-quality producers, often located in developing and transition
economies. A second definition, the one advanced by the WTO, is when a company exports a product at a price lower than the price it normally charges in its own home market. This definition may lead to reciprocal dumping by all firms if the cross-country difference in incomes falls within a range of values defined by the exchange rate and the domestic and foreign tariff rates. A strong depreciation of the developing economy’s currency shifts this range in such a way that only unilateral dumping by the high-quality firm in the developing country occurs.

By José Luis Moraga-González and Jean-Marie Viaene (EUR), Dumping in a global world T104-128/2

Marriage and the City

Do people move to cities because of marriage-market considerations? In cities, singles are able to meet more potential partners than in rural areas. Singles are therefore prepared to pay a premium in terms of higher housing prices. Once married, individuals no longer need the marriage-market benefits, while the housing premium remains.

This study extends the model of Burdett and Coles (1997) by making a distinction between efficient (city) and less efficient (non-city) search markets. One implication of the model is that singles are more likely to move from rural areas to cities, while married couples are more likely to do the reverse. A second prediction of the model is that attractive singles benefit most from a dense market (i.e. from being choosy) because they have more “marriage-market endowments”.

These predictions are tested with a unique Danish dataset that follows a cohort of singles over a period of 15 years. The study assumes that the attractiveness of an individual is a function of all relevant personal and family background characteristics (education, income, labour-market status, father’s education, father’s income). The weights of these factors are determined such that they maximize the correlation between male and female attractiveness.

The results suggest that the probability of moving from rural areas to cities is greater for singles and is particularly large for attractive singles. This cannot be explained by moving costs, because the probability of leaving the city is greater for couples. The results are robust to both non-student populations and individuals who remain childless. Finally, the probability of an individual moving to the city within two years after divorce is found to be substantially greater than the reverse movement.

Reference

By Pieter A. Gautier (VU), Michael Svarer (University of Arhus), and Coen N. Teulings (UvA, SEO), Marriage and the city T105-015/3

Why frequency matters for unit root testing

The validity of economic equilibrium relations is often analysed by testing for a unit root in the time series of deviations from equilibrium. For example, if purchasing-power parity holds in the long run, then real exchange rates should display mean reversion; a unit root in this series should thus be rejected.

The main problem with unit-root tests is their low power against alternatives with slow mean reversion. The usual way to increase power is to obtain more data. This may be accomplished by increasing either the time span (e.g., from the post-war period to the entire 20th century) or the observation frequency (e.g., from monthly to daily data). It is generally believed that increasing the data frequency (keeping the time span constant) has a negligible effect on the power substantially when analysing financial data. This claim is based on two results. First, recent research indicates that the typical features of financial data (such as fat tails and volatility clustering) imply that a likelihood ratio test in a model that includes these effects can be considerably more powerful than the conventional Dickey-Fuller test. Secondly, these features are more pronounced in daily data than in lower-frequency data. In this sense, frequency does matter.

A Monte Carlo experiment illustrates that the power gains from increasing the frequency from monthly to daily observations can be substantial (up to 50 percent). In an empirical application to real exchange rates, this study finds that accounting for volatility clustering and fat tails in daily data leads to significant evidence in favour of purchasing-power parity in the case of the Japanese Yen-US dollar real exchange rate.

By H. Peter Boswijk and Franc Klaassen (UvA), Why Frequency Matters for Unit Root Testing T104-119/4
Humans show concern for others. We may not always be as nice to each other as we wish we were— we may, in fact, even be mean and evil from time to time—but we are at least not indifferent to the fate of others. Behaviour for which the interest of someone else makes a difference can be labelled with terms such as altruism, fairness and morality. The first task in this thesis is to categorize the range of possibilities that could be summarised by the term “other-regarding behaviour”. The result is a set of definitions of altruism, fairness and morality that makes it possible to discern the different ingredients.

In the light of evolution, this other-regarding behaviour poses something of a puzzle, for one can easily imagine that ‘survival of the fittest’ would imply that the selfish would always win. Yet, one observes that these deviations from straightforward selfishness are very common in humans. We even seem to have specialized in caring for others, given that we have the neurological circuitry that is needed for empathy and for the weighting of our own interests against the interests of others. The main question of the thesis is therefore the following: can models be devised that explain how these different aspects of our other-regarding behaviour have evolved? To answer that question, the thesis critically evaluates a range of existing models and introduces a few new ones. Although the main focus of the thesis is on evolutionary game theory, models of kin-, group- and sexual selection are also discussed. In general, one can say that many claims about the explanatory power of models are too strong. Because of the presence of different selection processes, the whole of our other-regarding behaviour cannot be explained by any one of them alone, and the varied facets of our behaviour require different models.

Thesis: ‘Survival of the Fair; Modelling the evolution of altruism, fairness and morality’ by Matthijs van Veelen. Published in the Tinbergen Institute Research Series # 333.

Book by: Han T.J. Smit (EUR) and Lenos Trigeorgis, Strategic Investment: Real Options and Games, published by Princeton University Press, was awarded the Professional and Scholarly Publishing Award of the Association of American Publishers in the category Business, Management & Accounting.


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The TI PhD Thesis # 336 of Mauro Mastrogiacomo, ‘Retirement, Expectations and Realizations. Essays of the Netherlands and Italy’ (summary in TI Magazine, Fall 2004), was the 2005 Honourable Mention Winner of the John Heinz dissertation competition sponsored by the National Academy of Social Insurance in Washington DC.
Theses


345 VITALY PRUZHANSKY (02/03/2005), Topics in Game Theory.

346 PEDRO CARDOSO (07/12/2004), The future of old-age pensions: Its explosion and implosion.

347 CARIN BOSSINK (02/12/2004), To go or not to go...? International relocation willingness of dual-career couples.

348 RUTGER VAN OEST (03/02/2005), Essays on Quantitative Marketing Models and Monte Carlo Integration Methods.

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351 REZA ANGLINGKUSUMO (08/03/2005), Preparatory studies for inflation targeting in post crisis Indonesia.

352 ANDREA GALEOTTI (11/03/2005), On Social and Economic Networks.

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Discussion papers
Institutions and Decision Processes

04-113/1
Hendrik P. van Dalen, Erasmus Universiteit Rotterdam, Kéne Henkens, Netherlands Interdisciplinary Demographic Institute, The Hague, Signals in Science – On the Importance of Signaling in Gaining Attention in Science

04-115/1
Robert Dur, Erasmus Universiteit Rotterdam, Amihai Glazer, University of California, Irvine, The Desire for Impact

04-117/1
Jeroen Hinloopen, Universiteit van Amsterdam, The Pro-collusive Effect of Increased Cartel Detection Probabilities

04-121/1
Gerard van der Laan and Vitaly Pruzhansky, Vrije Universiteit Amsterdam, Demand Adjustment in Coalitional Games

04-127/1
René van den Brink, Vrije Universiteit Amsterdam, Null or Zero Players: The Difference between the Shapley Value and the Egalitarian Solution

04-133/1
Silvia Dominguez Martinez, Otto H. Swank, Erasmus Universiteit Rotterdam, Does Electoral Competition create incentives for Political Parties to collect Information about the Pros and Cons of Alternative Policies?

04-136/1
René van den Brink, Vrije Universiteit Amsterdam, Yukihiko Funaki, Waseda University, Tokyo, Axiomatizations of a Class of Equal Surplus Sharing Solutions for Cooperative Games with Transferable Utility

05-004/1
Jean-Jacques Herings, Maastricht University, Gerard van der Laan, Vrije Universiteit Amsterdam, Dolf Talman, Tilburg University, Zaifu Yang, Yokohama National University, A Fixed Point Theorem for Discontinuous Functions

05-005/1
Hendrik P. van Dalen, Erasmus Universiteit Rotterdam, NIDI, The Hague, Arjo Klamer, Erasmus Universiteit Rotterdam, Is There such a Thing called Scientific Waste?

05-006/1
Gerard van der Laan, Vrije Universiteit Amsterdam, Dolf Talman, Tilburg University, Zaifu Yang, Yokohama National University, Computing Integral Solutions of Complementarity Problems

05-007/1
Govert E. Bijwaard, Maarten C.W. Janssen, Emiel Maasland, Erasmus Universiteit Rotterdam, Early Mover Advantages

05-010/1
Robert Dur, Erasmus Universiteit Rotterdam, and CESifo, Munich, Amihai Glazer, University of California, Irvine, Subsidizing Enjoyable Education

05-014/1
Erneste Reuben, Frans van Winden, Universiteit van Amsterdam, Negative Reciprocity and the Interaction of Emotions and Fairness Norms

05-020/1
René van den Brink, Vrije Universiteit Amsterdam, Pieter H.M. Ruys, CentER, TILEC, Tilburg University, Positional Wages, Market Wages and Firm Size

05-022/1
Maarten C.W. Janssen, Mariëlle C. Non, Erasmus Universiteit Rotterdam, Advertising and Consumer Search in a Duopoly Model

05-025/1
Maarten C.W. Janssen, Vladimir A. Karamychev, Erasmus Universiteit Rotterdam, Auctions, Market Prices and the Risk Attitude Effect

05-026/1
Randolph Sloof, Mirjam van Praag, Universiteit van Amsterdam, Performance Measurement, Expectancy and Agency Theory: An Experimental Study

05-027/1
Josse Delfgaauw, Erasmus Universiteit Rotterdam, Where To Go? Workers’ Reasons to Quit and Intra-versus Interindustry Job Mobility

05-028/1
Bauke Visser, Erasmus Universiteit Rotterdam, On Committees of Experts

05-030/1
Hendrik P. van Dalen, Erasmus Universiteit Rotterdam, and NIDI, The Hague, George Groenewold and Tineke Fokkema, NIDI, Remittances and their Effect on Emigration Intentions in Egypt, Morocco and Turkey

05-034/1
Vjollca Sadiraj, Economic Science Laboratory, University of Arizona, Tucson, US, Jan Tuinstra, CeNDEF, and Frans van Winden, CREED, Universiteit van Amsterdam, On the Size of the Winning Set in the Presence of Interest Groups
Financial & International Markets

04-120/2
Jan Marc Berk, De Nederlandsche Bank, Beata Bierut, Erasmus Universiteit Rotterdam, *On the Optimality of Decisions*

04-124/2
José Luis Moraga-González, Jean-Marie Viaene, Erasmus Universiteit Rotterdam, *Anti-dumping, Intra-industry Trade and Quality Reversals*

04-125/2
José Luis Moraga-González, Jean-Marie Viaene, Erasmus Universiteit Rotterdam, *Dumping in Developing and Transition Economies*

04-128/2
José Luis Moraga-González, Jean-Marie Viaene, Erasmus Universiteit Rotterdam, *Dumping in a Global World*

04-131/2
Miriam Manchin, Erasmus Universiteit Rotterdam, *The Economic Effects of a Russia-EU FTA*

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Miriam Manchin, Erasmus Universiteit Rotterdam, *Preference Utilisation and Tariff Reduction in EU Imports from ACP Countries*

05-008/2
Namwon Hyung, Seoul City University; Casper G. de Vries, Erasmus Universiteit Rotterdam, *Portfolio Diversification Effects of Downside Risk*

05-009/2
Namwon Hyung, Seoul City University; Casper G. de Vries, Erasmus Universiteit Rotterdam, *Portfolio Selection with Heavy Tails*

05-012/2
Manjira Datta, Kevin L. Reffett, Arizona State University, *Isotone Recursive Methods: the Case of Homogeneous Agents*

05-013/2
Manjira Datta, Arizona State University; Leonard J. Mirman, University of Virginia; Olivier F. Morand, University of Connecticut; Kevin L. Reffett, Arizona State University, *Markovian Equilibrium in Infinite Horizon Economies with Incomplete Markets and Public Policy*

05-014/2
Ernesto Reuben, Frans van Winden, Universiteit van Amsterdam, *Negative Reciprocity and the Interaction of Emotions and Fairness Norms*

05-017/2
Wendy Janssens, Vrije Universiteit Amsterdam, *Measuring Externalities in Program Evaluation*

05-018/2
Charles van Marrewijk, Erasmus Universiteit Rotterdam, *Geographical Economics and the Role of Pollution on Location*

05-019/2
Mario Larch, University of Innsbruck, Austria, *The Multinationalization of the Transport Sector*

05-021/2
Leon Bettendorf, Erasmus Universiteit Rotterdam, and Ben Heijdra, University of Groningen, *Population Ageing and Pension Reform in a Small Open Economy with Non-Traded Goods*

05-024/2
Charles van Marrewijk, Erasmus Universiteit Rotterdam, *Basic Exchange Rate Theories*

05-031/2
Silvia Caserta, Casper G. de Vries, Erasmus Universiteit Rotterdam, *Auctions with Numerous Bidders*

05-033/2
Paul A. de Hek, Erasmus Universiteit Rotterdam, *Uncertain Technological Change under Capital Mobility*

Labour, Region & Environment

04-114/3
Eric J. Bartelsman, Vrije Universiteit Amsterdam, John Haltiwanger, University of Maryland, US Census Bureau and NBER and Stefano Scarpetta, World Bank, *Microeconomic Evidence of Creative Destruction in Industrial and Developing Countries*

04-116/3
Peter Nijkamp, Vrije Universiteit Amsterdam, Katrin Oltmer, Agricultural Economics Research Institute (LEI), The Hague, *The Regional Self-Organizing Potential in Sustainable Agriculture: An Analysis of Co-operative Agreements on Nitrate Pollution by means of Rough Set Methods*

04-118/3
Laura A. Schintler, Sean P. Gorman, George Mason University; Aura Reggiani, University of Bologna; Roberto Patuelli, George Mason University; Andy Gillespie, University of Newcastle; Peter Nijkamp, Vrije Universiteit Amsterdam; Jonathan Rutherford, University of Newcastle, *Complex Network Phenomena in Telecommunication Systems*

04-123/3
James Allrech and Susan Vroman, Georgetown University; Aico van Vuuren, Vrije Universiteit Amsterdam, *Decomposing the Gender Wage Gap in the Netherlands with Sample Selection Adjustments*

04-126/3
Piet Rietveld, Vrije Universiteit Amsterdam, *Urban Transport Policies: The Dutch Struggle with Market Failures and Policy Failures*
04-129/3
Maria Abreu, Henri L.F. de Groot, Raymond J.G.M. Florax, Vrije Universiteit Amsterdam, *Space and Growth*

04-130/3
C. Mirjam van Praag and Justen van der Sluis, Universiteit van Amsterdam; Arjen van Witteloostuijn, University of Groningen, and University of Durham, *The Impact of the Locus-of-Control Personality Trait on the Earnings of Entrepreneurs vis-à-vis Employees*

04-134/3
Simonetta Longhi and Peter Nijkamp, Vrije Universiteit Amsterdam; Jacques Poot, University of Waikato, Hamilton - New Zealand, *A Meta-Analytic Assessment of the Effect of Immigration on Wages*

05-001/3
Maria Abreu and Henri L.F. de Groot, Vrije Universiteit Amsterdam; Raymond J.G.M. Florax, Vrije Universiteit Amsterdam, and Purdue University, *A Meta-Analysis of Beta-Convergence: The Legendary Two-Percent*

05-011/3
Mark Lijesen, CPB Netherlands Bureau for Economic Policy Analysis; Peter Nijkamp and Eric Pels, Vrije Universiteit Amsterdam, *The Home Carrier Advantage in Civil Aviation*

05-015/3
Pieter A. Gautier, Vrije Universiteit Amsterdam; Michael Svarer, University of Arhus; Coen N. Teulings, Universiteit van Amsterdam, SEO, *Marriage and the City*

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Gert-Jan M. Linders, Henri L.F. de Groot, Piet Rietveld, Vrije Universiteit Amsterdam, *Institutional Determinants of Bilateral Trade: An Analysis according to Product Type*

05-029/3
Mark J. Koetse and Raymond J.G.M. Florax, Vrije Universiteit Amsterdam, and Purdue University; Henri L.F. de Groot, Vrije Universiteit Amsterdam, *Correcting for Primary Study Misspecifications in Meta-Analysis*

05-032/3
Andrea Galeotti, University of Essex, Gerrit Müller, Erasmus Universiteit Rotterdam, *Friendship Relations in the School Class and Adult Economic Attainment*

05-035/3
Bas Jacobs, Universiteit van Amsterdam and European University Institute; A. Lans Bovenberg, CentreER, Tilburg University, CEPR, Erasmus Universiteit Rotterdam and Tilburg University, *Human Capital and Optimal Positive Taxation of Capital Income*

04-129/3
A. Lans Bovenberg, CentreER, Tilburg University, CEPR, Erasmus Universiteit Rotterdam and Tilburg University; Bas Jacobs, Universiteit van Amsterdam and European University Institute, *Redistribution and Education Subsidies are Siamese Twins*

05-037/3
Bas Jacobs, Universiteit van Amsterdam and European University Institute; Sweder J.G. van Wijnbergen, Universiteit van Amsterdam and CEPR, *Capital Market Failure, Adverse Selection and Equity Financing of Higher Education*

**Econometrics**

04-119/4
H. Peter Boswijk, Franc Klaassen, Universiteit van Amsterdam, *Why Frequency matters for Unit Root Testing*

04-135/4
Siem Jan Koopman, Marius Ooms, Vrije Universiteit Amsterdam, *Forecasting Daily Time Series using Periodic Unobserved Components Time Series Models*

05-002/4

05-003/4
Ad Ridder, Vrije Universiteit Amsterdam, Adam Shwartz, Electrical Engineering Technion, Israel Institute of Technology, *Large Deviations without Principle: Join the Shortest Queue*
Colophon

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In this issue

- We’re only in it for the money
- A research journey
- A cooperative role model
  Interview with Peter Nijkamp
- Transformation of Europe
  Macroeconomic research at Universiteit van Amsterdam
- Letters from Alumni
- Publications, awards and references