

EUROPEAN ECONOMIC PERSPECTIVES

Mirror, Mirror

One of the hopes for the single European market was that it would benefit consumers by enforcing the ‘law of one price’, where identical traded goods sell for the same price everywhere. New research on the comparative prices of a well-known furniture retailer reveals that there is still a long way to go.

International price comparisons have moved from the preserve of statisticians to headline news. Newspapers send correspondents around the world to discover that for anything from CDs to restaurant meals, the United States is a buyer’s paradise. Prices in the European Union, above all in the UK, always seem to be much higher. Indeed, it is rumoured that the UK is known as ‘Treasure Island’ by those who sell such goods as motor cars and food there.

These large price gaps have become a matter of growing public concern. The UK government, for example, has responded by commissioning a comparative price study. But international price differences matter not just because of what happens when the people of one country feel they are being swindled. As the Japanese know all too well, high prices reduce purchasing power, thereby reducing consumption – and imports – and so annoying a country’s trading partners.

In truly competitive market places, price differences create arbitrage opportunities that limit divergences – gold prices in London and New York, for example,

differ only marginally. So persistent price differences indicate a lack of effective competition, casting doubt on the much discussed globalization of product markets.

But making these price comparisons properly is a tricky business. You need a product that passes three key tests: first, the product has to be exactly the same everywhere; second, it must be tradable; and third, since discounts and special offers mean that prices vary *within* a country, it needs to be sold at the same price in all shops in each country. Restaurant meals and most services fail these tests, as do cars (due to emission and other standards), television sets (because of different standards) and a number of other manufactured goods. *The Economist’s* famous Big Mac index suffers from the fact that hamburgers differ, even if only slightly, across national boundaries. They also require inputs whose prices differ from country to country.

Is it possible to find goods that are identical, tradable and priced the same within a country? In a recent CEPR Discussion Paper, Jonathan Haskel and Holger Wolf suggest a simple answer: IKEA. The

'Double relative price' comparisons confirm differential pricing across countries

Swedish household furniture retailer now has stores in 25 countries. The traded goods it sells are identical and come from the same manufacturer. In Europe, the 1998 catalogues are *exactly* the same in each country aside from the language and local prices. And the goods are sold within each country at a single catalogue price.

Haskel and Wolf obtained an IKEA catalogue from a store in each country where the firm operates. They tabulated the prices of 119 basic non-designer goods, from chairs to kitchenware and converted those prices at contemporaneous exchange rates into US dollars. The table shows their findings on the price of mirrors for a selection of the countries. The *Guldros*, for example, a simple wood-framed round mirror, which sells for \$99 in the United States, is most expensive in Denmark, where it is priced at \$119. The UK too is relatively expensive, with the same mirror selling for \$115.

Are these price differences proof of a lack of competition? Not necessarily. Retail prices reflect not only the traded good itself, but local rents, wages, taxes, tariffs and other costs that competitors would have to bear. So local price differences can occur even in competitive markets. Herein lies the basic problem in using any international price comparisons for testing for market power.

Haskel and Wolf found a way of using their IKEA data to get round this difficulty. If high local prices were due only to high local costs, then the local prices of *all* goods sold by IKEA should be relatively higher. So the test for market power is to compare the relative price of *Guldros* mirrors with the relative price of other mirrors sold by IKEA – the 'double relative price'.

The second column of the table shows the prices of IKEA's *Alg* square mirror: Denmark, where the *Guldros* was most expensive, is now the least expensive; and in the UK, where the *Guldros* was more expensive than in the United States, the *Alg* is cheaper. This suggests that price differences are about more than just local costs; they also reflect local market power that enables IKEA to set different prices.

What determines the extent of these price differences? It is of course unlikely that consumers will travel to stores in other countries to find cheaper IKEA products. But inter-country price differences do signal the opportunity for other firms to compete. One would expect these pressures to increase the closer that countries are together, if they are members of the European Union, if they share a common language, and so on.

The dispersion of relative prices for the 119 goods Haskel and Wolf have analysed shows just this pattern. Price differences are smaller between adjacent countries and between countries with larger markets, where fixed costs of entry may be spread more easily.

These price differences are a snapshot, taken at one moment in time. Do they tend to persist? By looking at catalogues over a period of years, an interesting pattern emerges. When international prices are not too different, they converge but only very slowly. But when relative prices get wildly out of line – by about 150% – prices converge very rapidly. So market power does enable price differences to be maintained. Yet when they get too large, the discipline of competition undoes them.

Haskel and Wolf's study sends a message about the value of international price comparisons. First, because of variations in local costs, simple relative price differences do not say very much about competition or the lack of it. Studies should look at double relative prices, that is to say, relative prices for similar goods. Second, static studies can be misleading since they ignore the process of relative price adjustment. Competition tends to work its magic but can do it only slowly.

This article discusses research reported in 'Why Does the Law of One Price Fail? A Case Study' by Jonathan Haskel and Holger Wolf, CEPR *Discussion Paper* No. 2187 (July 1999). Haskel is at Queen Mary and Westfield College, London and a Research Fellow in CEPR's Labour Economics programme; Wolf is at Georgetown University, Washington.

Price differences are smaller in adjacent countries and those with larger markets

International prices converge slowly when not too different, but rapidly when wildly out of line

Prices of Round and Square Mirrors at IKEA in 1998 US dollars

The *Guldros* is a round mirror, 59x78cm, with bevelled glass; the *Alg* is a two-pack of square mirror tiles, 45x60cm.

	Guldros (round mirror)	Alg (square mirror)
United States	99	40
Denmark	119	13
Sweden	115	15
UK	115	25
Belgium	111	22
France	100	21
Canada	98	49
Germany	97	22
Italy	79	23

Source: IKEA catalogues

Independence Day

How should the IMF respond to financial crises in emerging markets? A new Report recommends ways to improve crisis prevention and crisis management, and strengthen the legitimacy and accountability of the Fund.

Increasingly severe financial crises in emerging markets have punctuated the final years of the twentieth century. A new Report, published jointly with the International Centre for Monetary and Banking Studies in Geneva, draws lessons from the recent turbulence, with particular attention to the role of the IMF. It concludes that making the Fund truly independent and accountable would give it a far greater chance of success in predicting, averting and managing the volatility associated with open, liquid and internationally integrated financial markets.

Mexico, Asia, Russia and Brazil have all endured severe crises during the 1990s. Sometimes referred to as 'the first financial crises of the twenty-first century', these episodes have become more violent, disruptive and difficult to predict and manage because they are now centred in the capital account of developing countries' balance of payments. This contrasts with earlier crises, which were rooted in imbalances in the current account. But the IMF has yet to integrate this evolution into its diagnoses, procedures and conditions.

To date, the Fund's response to crisis has been to rely on larger and more heavily front-loaded loans, disbursed more rapidly and accompanied by conditionality that mixes old-fashioned macroeconomic adjustment with deep structural interventions. Whether this approach is appropriate to today's new circumstances remains open to question. Also at issue is whether the Fund has adapted its staff and governance structure so as to cope with the new challenges.

The Report welcomes the new IMF emphasis on data dissemination and transparency. But the belief that this will strengthen market discipline sufficiently to head off crises before they start is naive, the Report argues. There are also good reasons to doubt whether the Fund can identify reliable early warning signals of impending crises.

The Fund must rethink both its traditional recommendation that crisis countries impose tough monetary and fiscal policies and its recent tendency to provide ever-larger balance of payments financing. Restarting an economy that is the victim of a severe credit crunch may require a wholly different approach, including restructuring foreign currency debts – both public and private – and the adoption of reflationary measures.

There is a strong economic case for the IMF to continue to play a major international role, the Report argues. Yet its governance structure and the

representation of its member countries are anachronistic and must be reformed. In particular, the role of the Executive Board is unsatisfactory. Directors are often overwhelmed by the IMF staff and its considerable agenda-setting power. What is more, their decision-making is often driven by national agendas, specifically those of the principal shareholders.

To address these problems, the Report makes the following proposals:

- The IMF should be made truly independent and accountable. Insulating the Executive Board from the politically driven agendas of national governments would permit it to focus more efficiently on surveillance and conditionality. This requires amending the Articles of Agreement on which the Fund is founded.
- But independence would be counterproductive without adequate accountability and transparency. The Interim Committee is the logical body to provide oversight of the Fund and hold the Executive Directors accountable for their decisions. If it were given the power to remove Directors who pursue private agendas, the Interim Committee could fulfil these roles. The power of both the Board and the Interim Committee would be strengthened while at the same time creating a clear separation of roles and responsibilities.
- The Board should be accountable not only to governments but also to the public at large. Publishing detailed minutes of Board meetings, requiring decisions through voting rather than consensus, and publishing voting records of the Executive Directors would move the Fund into the modern era of transparency.
- The perception of excessive influence from the US Treasury – unavoidable given its geographical and intellectual proximity to the Fund – would be lessened by reducing from 85% to 80% of votes the current 'supermajority' needed for the most important IMF decisions. Then no one country would have a veto.

This article summarizes 'An Independent and Accountable IMF', the first Geneva Report on the World Economy (CEPR, 1999) by José De Gregorio (Universidad de Chile), Barry Eichengreen (University of California, Berkeley, and CEPR), Takatoshi Ito (Hitotsubashi University) and Charles Wyplosz (Graduate Institute of International Studies, Geneva, and CEPR).

The IMF Executive Board must be insulated from the politics of national governments

The Interim Committee should hold Executive Directors accountable for their decisions

The Fund must move into the modern era of transparency, accountable to the public and member governments

So Far, So Good...



An Update to Monitoring the European Central Bank (MECB)

Since the launch of the euro in January, the ECB's policies have proved remarkably pragmatic and the Bank has served as an important force for stability in Europe, the latest *MECB* Update concludes. In particular, the ECB responded sensibly, both to the upturn in unemployment in the large EU economies and to the decline in the value of the euro – in the first case by cutting interest rates and in the second by doing nothing.

Average inflation in Euroland countries fell from 1.6% in 1997 to 1.1% in 1998, largely because of lower energy prices. Real GDP growth increased from 2.5% in 1997 to 3.0% in 1998. This was little cause for optimism, however, given the size of the adverse global shock in 1998. The coordinated reduction of interest rates in December 1998 was, therefore, a shrewd move. It signalled the *de facto* existence of monetary union ahead of its *de jure* start-up. More importantly, it dispelled fears that the ESCB might be unable to respond to worsening macroeconomic conditions.

Early statements by President Duisenberg and other Council members indicated that the ECB wanted to avoid interest rate activism. For three months, the ECB maintained the interest rate at 3% despite increasing evidence that the slowdown was indeed materializing – particularly in Germany and Italy, which together constitute half of Euroland's GDP. From the outset, however, there have been asymmetries: GDP has been growing strongly in Spain and Portugal and especially in Ireland.

On 8 April 1999, the ECB cut the interest rate to 2.5%, a further step in an already long period of decline. Nominal interest rates are now at their lowest point this decade and real interest rates are not high in historical perspective. But the April decision to cut interest rates was not uncontroversial. The move thus provides an early signal about the ECB's preferences. Three lessons can be drawn, according to the *MECB* authors:

- First, while the ECB had repeatedly stated that it cannot do much to deal with unemployment, it clearly responded to the risk of a cyclical increase in some countries. It thus demonstrated that in the absence of any inflationary pressure, it can support counter-cyclical policies rather than hide behind its frequently stated goal of medium-term price stability.
- Second, the decision was taken at a time when the euro was declining against the dollar. The ECB thus indicated that it is prepared to treat the exchange rate with benign neglect. Greater benign neglect of the external exchange rate may, of course, be a perfectly appropriate response to monetary union since Euroland is much less open to external trade than were its individual members. Yet discussions of ECB policy within Euroland countries are still dominated by the small open-economy perspective, which is, the *MECB* Update stresses, now clearly inappropriate. In any case, it was not the euro that declined but the dollar that was strengthening, owing to the continuing remarkable performance of the US economy. So the ECB should not be criticized for apparently neglecting the decline of the external value of the euro.
- Third, although the ECB has vowed not to look at national situations, the interest rate cut is easier to understand in light of the economic situation in the weaker member countries rather than in light of the aggregate data in Euroland.

These three messages show that the monetary strategy of the ECB is evolving, maturing and gradually stepping out of the shadow of the Bundesbank. The ECB could have opted for a narrower interpretation of its mandate, repeating the argument that growth and unemployment are the concerns of national authorities. That would have been the easy way. By eschewing this approach, the ECB has demonstrated that it will follow a more balanced approach.

The ECB has worked hard to resolve the early problems of being central banker to Euroland. As emphasized in the inaugural *MECB* report published in the autumn of 1998, time was not on its side, global conditions were less favourable than might have been the case, and reconciling disparate interests and traditions is never easy. The ECB should be congratulated both for avoiding some of the dogmatic positions into which it might easily have fallen, and for its continuing openness to ideas and discussion.

The first *MECB* Report, published in October 1998, identified many challenges for the ECB. The Update does not discuss them all in detail, but argues that it is useful to keep score and take stock. At the time of the issue of the ECB's first Annual Report in April 1999, the *MECB* team's assessment can be summarized as follows:

Problems resolved:

- Price stability defined
- Benign neglect of exchange rates largely established
- Monetary policy already dedicated to wider objectives than mere pursuit of price stability
- Importance of banking supervision recognized
- European mode of thinking within the Council established
- Early credibility with financial markets
- Adequate reporting of Euro-aggregate numbers
- Establishment of a smoothly working payments system

Challenges remaining:

- Transparency still inadequate
- Monetary policy strategy still too vague
- Monetary actions need to match the declared strategy
- Inflation forecasts and their relevance need to be clearly discussed
- Differences across regions and their relevance need to be assessed
- Centralization of authority within ESCB needs to progress further
- Further coordination with supervisory bodies is desirable
- The linkages between the various payments systems need to work more smoothly

The full text of *MECB* Update is available from CEPR. The first full report was published by CEPR in October 1998: 'The ECB: Safe at Any Speed? *Monitoring the European Central Bank* No.1' by David Begg, Paul De Grauwe, Francesco Giavazzi, Harald Uhlig and Charles Wyplosz.

Alice's Adventures

Should the European Central Bank be more transparent and accountable? Willem Buiter and Otmar Issing conduct a vigorous debate in the first two CEPR *Policy Papers*.

According to Buiter, the ECB should not try to create a culture of collective responsibility

The adoption of a common currency by 11 of the 15 members of the European Union is an act without precedent, which Willem Buiter describes as ‘a bold step into the unknown, not unlike Alice’s fall down the rabbit hole’. Although an enthusiastic supporter of monetary union, Buiter sees serious flaws in the legal framework, institutional arrangements and emerging operating practices of the European Central Bank (ECB) and the European System of Central Banks (ESCB).

In the first of CEPR’s new *Policy Paper* series, Buiter urges a number of changes to the Eurosystem, which he argues are necessary to ensure the survival of the common currency. Some require major constitutional change while others relate to the ECB’s own procedures and so could be made at the discretion of the Governing Council. In CEPR *Policy Paper* No. 2, Otmar Issing, an ECB Executive Board Member and a former member of CEPR’s Executive Committee, responds to Buiter’s critique, arguing in particular that, in some respects, the ECB can already be regarded as *the* most transparent and accountable central bank in the world.

In terms of constitutional changes, which require amendments to the Maastricht Treaty, Buiter proposes:

- Abolishing the ‘one-country-one-seat-on-the-Governing-Council’ rule; and restricting the size of the Governing Council to no more than nine members and the size of the Executive Board to no more than four members.
- Abolishing the clause in Article 109 giving the Council of Ministers the power to formulate ‘general orientations’ for exchange rate policy, because this clause creates doubts about the ECB’s operational independence.
- Charging the ECB explicitly with responsibility for systemic financial stability in Euroland, with the phrase ‘lender of last resort’ entering the revised Treaty.
- Creating a body that has the power to examine and make binding recommendations about the ECB’s procedures. This supervisory body could consist of MEPs and members of the European Court of Justice.

A second set of changes that Buiter recommends does not require Treaty amendments, but neither can they be implemented at the sole discretion of the Governing Council:

- Striving for institutional arrangements and practices that allow better coordination of monetary and budgetary policy in Euroland.
- Fleshing out the ECB’s lender of last resort function prior to formal recognition of this role in an amended Treaty.
- Spreading the message that authority in the ECB/ESCB is centralized. National central banks are useful conduits for national information and their research departments provide safeguards against intellectual ‘democratic centralism’. Beyond that they have no substantive authority. Yet there remains unnecessary uncertainty in the markets and among the public about their role, according to Buiter.
- Strengthen the role of the European Parliament as an interlocutor of the ECB.

The third set of changes Buiter proposes could be made by the Governing Council itself:

- Abandoning attempts to create a culture of ‘collective responsibility’. The presentation of a united front to the outside world adds to uncertainty about the likely future stance of monetary policy, Buiter argues.
- Publishing the minutes of meetings of the Governing Council and its relevant committees and sub-committees.
- Publishing the individual voting records of Governing Council members.
- Clarifying the operational inflation target.
- Publishing the inflation forecast.

Otmar Issing responds to these proposals by noting that in order to make sense of reality, monetary policy-makers – like anybody else – must filter, process and structure relevant information and interpret it on the basis of a coherent frame of reasoning. This is the purpose of adopting a monetary policy strategy that

The ECB should also publish minutes of Governing Council meetings, including individual voting records

And it should clarify the operational inflation target and publish the inflation forecast

Issing notes that a monetary policy strategy must guide both internal decision-making and communication with the public

serves as a guide both for *internal* decision-making and for *external* communication with the public.

Transparency and accountability, he argues, need to be discussed against the background of the stability-oriented monetary policy strategy that the ECB has actually adopted and not as if it were pursuing some other strategy, such as direct inflation targeting.

Issing stresses the need to distinguish accountability and transparency, while recognizing that both are crucial for the effectiveness of monetary policy and the success of the monetary union over the longer term. He suggests thinking of accountability as related primarily to the ECB's fulfilment of its Treaty mandate and its quantitative definition of price stability. Ultimately, the ECB's performance will have to be judged by 'deeds' – observable policy outcomes.

By contrast, transparency is primarily to do with 'words' – the attempt to communicate clearly the reasoning behind policy decisions to the wider public. Complete transparency is impossible to achieve in practice, and the effort to achieve it must balance the public's 'right to know' with its 'need to understand', Issing argues. It is not simply a question of making available the maximum amount of information. Clarity is also required to help policy-makers and the public make sense of monetary policy.

Issing believes that in order to foster both accountability and transparency, the ECB has gone far beyond the already exacting reporting requirements of the Treaty. This reflects the conviction that in a democratic society, accountability is the 'reverse side' of central bank independence and that transparency, to the extent that it helps the public clearly understand monetary policy, will enhance policy effectiveness and reduce uncertainty.

Issing also responds to Buiters' specific proposals to enhance ECB transparency and accountability:

- *Abandon attempts to create a culture of collective responsibility?* There are inherent limits to individual accountability of members of a collective decision-making body. Moreover, a balance has to be struck between providing adequate individual incentives and the need for effective collective decision-making. Excessive focus on individuals, rather than on the institution as a whole, may render the policy signals more and not less difficult to interpret. Developing a common culture and speaking a common 'language' for external communication is especially important for a new institution in a multi-country monetary union.

- *Publish minutes?* The ECB President's monthly press conferences immediately after Governing Council meetings plus the comprehensive information provided by the ECB's Monthly Bulletins come very close to providing 'summary minutes'. They represent a quite unprecedented degree of instant 'hands-on' accountability, where the arguments underlying the decisions of the Governing Council (but not individual 'opinions') are explained and exposed to public scrutiny. Issing argues that this may well be preferable to publishing carefully edited official

minutes, which are usually provided with considerable delay.

- *Publish individual voting records?* This would not be sufficient for substantive individual accountability, which would also require revealing the arguments underlying individual votes. Few people go as far as advocating the publication of attributed minutes or verbatim transcripts, since the effectiveness and coherence of internal discussions would suffer. In any event, the validity of dissenting views can never be verified conclusively even *ex post*. So the potential benefits of publishing votes are limited, even under the questionable model of individual accountability, while the risk of confusing policy signals is not negligible. Moreover, the perception of policy will inevitably continue to be coloured by national frames of reference. Issing concludes that publishing votes would impose an unbearable asymmetry in the burden of proof on individual decision-makers seeking to demonstrate that a particular vote had *not* been influenced by national considerations.

- *Clarify the operational inflation target?* The ECB, Issing notes, simply does not have the sort of operational inflation target used in strategies of direct inflation targeting. The quantitative definition of price stability should serve as a basis for accountability. The stability-oriented strategy used to achieve the ECB's objective over the medium term rests on two pillars: a prominent role for money – captured by a reference value for money growth – and a broadly based assessment of the outlook for price developments and the risks to price stability.

- *Publish the inflation forecast?* Issing notes that in contrast to direct inflation targeting, the ECB strategy does *not* attempt to condense and present all relevant information through a single inflation forecast. Direct inflation targeting, moreover, does not by itself solve the transparency problem. A single forecast can never represent a full summary statistic of all relevant information, nor does it obviate the difficult task of explaining how the forecast was arrived at and how it is joined with further judgement in determining actual policy decisions. The role of forecasts under the ECB's stability-oriented monetary policy strategy is quite different and much less ambitious. To pretend otherwise would be a disservice to clarity, transparency and accountability, Issing concludes.

This article discusses the first two CEPR *Policy Papers*: 'Alice in Euroland' by Willem Buiters (No. 1); and 'The Eurosystem: Transparent and Accountable (or "Willem in Euroland")' by Otmar Issing (No. 2). Buiters is at the University of Cambridge, a member of the Bank of England's Monetary Policy Committee and a Research Fellow in CEPR's International Macroeconomics programme; Issing is an Executive Board Member of the European Central Bank and a former member of CEPR's Executive Committee.

Publishing votes would impose an unbearable asymmetry in the burden of proof on individual decision-makers

Operational inflation targets are not part of the ECB's stability-oriented strategy

Protection Rackets

Who provides protection when the state breaks down? New CEPR research uses the tools of modern economics to explain the emergence of organized crime.

Many societies face enormous difficulties in establishing even the most basic level of protection of life and material goods. From Colombia to Sierra Leone, Somalia, Russia, Albania, even in the inner cities of the United States, there is an apparent shortage of the good variously known as security, order, protection of property rights – or simply protection. This good is the quintessential collective good provided by the state. It is also a precondition for the provision of ordinary infrastructural public goods and, more generally, for facilitating trade and economic development.

When protection is not provided effectively by state institutions, it is typically provided by organized crime – mafias, gangs and similar groups. But why do such groups emerge in a power vacuum? And why are they autocratically organized, run for the benefit of their leaders in the same way that most states in history have been run?

To put it differently, why is the provision of protection by self-governing, democratic community groups and states so difficult? Is competition in the provision of protection as beneficial as it is in the provision of other goods and services? Or is a monopoly preferable? These are some of the questions examined by Kai Konrad and Stergios Skaperdas in a recent CEPR Discussion Paper.

In thinking about the market for protection, it is important to take account of a characteristic that makes protection very different from other goods and services: the inputs used in its production – soldiers and policemen, swords and guns – contain the seeds of the good's own destruction. At times, these seeds can sprout very fast: by virtue of their positions, policemen and soldiers can extract from the people who employ them even more than the robbers and bandits against whom they are supposed to guard.

Rulers who provide protection against internal and external threats can use their powers of extraction on an even grander scale. Army generals and colonels, ostensibly at the service of democratic governments, can – and regularly do – topple such governments. Clearly, protection is not an ordinary economic good.

The analysis developed by Konrad and Skaperdas to explore these phenomena goes through a series of scenarios. It begins with a simple and fragmented economy without a state or any other form of organized protection. Some individuals become

producers – ‘peasants’ – who spend part of their initial resources to protect their own production. Others become full-time bandits who prey on the peasants. The overall outcome is highly inefficient since the bandits contribute nothing to material production while the peasants spend much of their resources and time protecting themselves against bandits.

The researchers next consider a scenario in which peasants form small self-governed groups in which protection for the whole group is provided by voluntary contributions to collective protection. Compared to the first scenario, welfare is higher under self-governance. But the incentives to ‘free-ride’ in such groups – to enjoy the benefits without contributing – lead to underprovision of protection.

In the next scenario, a ‘for-profit’ protection agency – Leviathan, the tribal chief or the mafia don – arrives and monopolizes protection. The result is that the agency uses the machinery of protection to keep its subjects in conditions that are no better than in the absence of a state. But because of the efficiency of collective protection that Leviathan employs, output can be much higher than in the absence of the state, with all the surplus appropriated by Leviathan.

In the final scenario, the profits earned by Leviathan attract competitors – ‘competing lords’ – who attempt to set up their own protection businesses. What happens here is that in the long run, the number of protection agencies reaches a level where no further entry to the protection market is profitable, implying that all lords who are abstaining from entry obtain the same net income as agents who did enter and now run a protection agency. This outcome is called the ‘competing lords’ regime.

Konrad and Skaperdas compare these different scenarios and conclude that the most likely outcome is one of competing lords without further entry. Whether this outcome means higher or lower welfare than in the absence of a state depends on the lords’ power to extract revenue. If their power is similar to that of bandits in the absence of a state, then everyone earns the same net income as in the absence of a state. But although the lords’ protection technology is superior to what exists in the absence of a state, this does not translate into higher welfare. All the savings from the provision of collective protection are dissipated in contests between lords, and welfare can be as low or lower than in the absence of a state. This is called the ‘tragedy of coercion’.

Protection is the quintessential collective good provided by the state: a precondition for trade and economic development.

In a world of peasants and bandits, resources are wasted on protection

In a world of self-governing groups, there are incentives to ‘free-ride’

The competing lords of organized crime lead to the 'tragedy of coercion'

The environments the authors describe are very abstract and not, of course, intended to serve as models of the political organization of modern industrialized states. But the approach does illuminate the nature of power in many developing and transition economies – and in those parts of modern states where power vacuums allow gangs and mafias to emerge.

The scenario with the peasants and bandits, for example, helps to explain interactions between shopkeepers and robbers in Moscow, inner-city Los Angeles or Lagos. In such cases, genuine community

policing is very difficult. Instead, hierarchical gangs come in to fill the gap vacated by the modern state, supplanting legitimate government and creating a near-monopoly of force.

This article discusses research reported in 'The Market for Protection and the Origin of the State' by Kai Konrad and Stergios Skaperdas, CEPR *Discussion Paper* No. 2173 (June 1999). Konrad is at Freie Universität Berlin and a Research Fellow in CEPR's Public Policy programme; Skaperdas is at the University of California, Irvine.

Unemployment Policy - Think Big

A recent CEPR *Discussion Paper* ('Anatomy of Policy Complementarities' – No. 1963) by Mike Orszag and Dennis Snower, provides a new explanation for two problems at the heart of European unemployment policy: the disappointingly small effect of many past reform measures on unemployment, and the political difficulties of implementing more extensive reform programmes. These researchers argue that reform has frequently been unsuccessful because governments have failed to exploit economic and political complementarities among policy measures.

Economic complementarities arise when the effectiveness of one policy depends on the implementation of other policies. For example, since it is impossible for people to find more work when firms provide no new jobs, and since it is impossible for firms to fill their vacancies when there is no one looking for them, supply-side labour market policies – such as job counselling to promote job search – are complementary with demand-side policies – such as measures to stimulate investment demand.

Similarly, tax breaks for hiring the long-term unemployed – as in France or Germany – may be ineffective in the presence of generous unemployment benefits, since the latter discourage the unemployed from taking advantage of the former. Giving employers greater latitude in negotiating fixed-term contracts – as in Spain – may do little to stimulate employment unless the job security provisions associated with the incumbent employees are relaxed. And reducing the magnitude and duration of unemployment benefits may have only a limited effect on the employment rate when there are large incapacity benefits – as in the Netherlands – or high minimum wages – as in France.

In the presence of economic complementarities, individual unemployment policy measures might appear ineffective, but they would not be if they were implemented as part of a broad-based reform package. What is more, the exploitation of complementarities would address the apparent trade-off between unemployment and inequality by giving the unemployed greater incentives to work.

Unemployment policies are also characterized by political complementarities, when the ability to gain political consent for one policy depends on the implementation of other policies. For example, the political feasibility of unemployment benefit reform – such as reducing the magnitude and duration of benefits – depends on tax reform – such as reducing payroll and income taxes – and employment promotion policies – such as hiring subsidies.

The reason is that 'single-handed reforms' – such as reducing unemployment benefits without changing any other policy instrument – may improve economic efficiency, but they often pit the interests of the employed against those of the unemployed, creating political deadlock. In contrast, 'broad (many-handed) reforms' enable the government to use the efficiency gains from one reform to compensate the losers from another reform – and *vice versa* – thereby breaking the political deadlock.

Complementary policies call for a distinctive approach to policy-making. When only a small number of unemployment policies is under consideration, it may be politically impossible to implement them and their impact on unemployment would be small. It is only when a broader range of policies are implemented simultaneously that they become politically feasible and economically effective.

The Orszag-Snower analysis suggests that the timid approach to policy-making in most European countries over the past two decades may simply not be an option in future. Incremental, small-scale adjustments of existing policy packages may be doomed to failure. They conclude that perhaps the only way to tackle Europe's unemployment problem is to have the courage to think big.

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