EUROPEAN ECONOMIC PERSPECTIVES

Centre for Economic Policy Research

Border Crossing

The advent of the euro is a significant event for investment managers. A new CEPR *Policy Paper* explores its impact on portfolio allocation and the structure of European securities markets.

Europe's financial markets are facing pressures for change from a number of sources, including new technologies, securitization, demand for pension reform and changing regulations. Economic and monetary union (EMU) is providing a further stimulus. The elimination of currency risk potentially creates a level playing field in that funding costs are becoming more transparent. This enhances competition within the financial industry and encourages the introduction of new investment strategies.

The latest CEPR *Policy Paper* examines the impact of the euro on the processes of security issuance and portfolio adjustment in Europe. The greatest changes are predicted to take place in the corporate bond market. The search for higher yields by investors, greater expertise in analysing credit risks by institutional investors, and reduced issuance by European governments is spurring growth in this market. Indeed, in the first nine months of 1999, the European corporate bond market outpaced the US and UK markets; and the average credit rating of European issuances fell, reflecting the increasing depth of the market.

But despite this strong growth, corporate bonds grew unevenly across sectors and countries. Growth came primarily from large companies in the telecoms sector and from the larger EMU countries: France, Germany, Italy and Spain. Given this sectoral concentration, investors are exposed to risks that cannot be diversified away within the corporate bond market alone.

Will the euro entail significant portfolio readjustments? The Paper's analysis of optimal portfolio allocation strategies before and after EMU – taking account of the possibility of investing within and outside Europe in several broad asset classes – suggests the disappearance of currency risk in itself is probably not a major event for investors. But at the same time, post-EMU changes in the correlation of equity returns are significant. EMU is associated with increased correlation between countries and, though less pronounced, between sectors.

The practical implications of this finding are that sectoral risk dominates country risk and no European country offers enough sectoral breadth to make it unnecessary to invest in another EMU country. More than ever before, this brings into question the common investment industry practice

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The disappearance of currency risk in itself is probably not a major event for investors

of allocating portfolios along geographical lines. The much-discussed impulse that the euro might give to portfolio allocations along sectoral lines thus appears warranted – provided that the benefits of geographical diversification are not forgotten in the process. The Paper confirms the superiority of a diversification approach that follows both countries and sectors.

The euro has undoubtedly made an important contribution to reducing the effective and psychological obstacles to international diversification. Yet obstacles to cross-border investment are still substantial, hindering the emergence of truly European capital markets and thus generating further barriers to international diversification in the form of underdeveloped and less liquid markets. The costs of cross-border investment and the related issue of the size and depth of European capital markets can have a major impact on the cost of capital for European firms and the opportunities for the average European portfolio investor.

Portfolio diversification under EMU should follow both countries and sectors

These are legitimate sources of concern for policy-makers. As the Paper notes, the euro was meant to launch a new era of cross-border financial trading and to end the maze of trading technologies that characterize Europe's financial markets. Yet Europe still has 15 stock exchanges, more than 20 derivatives markets and no national centre for bond trading.

Fragmented markets are costly to investors seeking pan-European assets. Consolidation would bring benefits to consumers in the form of better and more diverse financial services, more liquid markets and lower transactions costs. But the prospects for pan-European securities markets with centralized settlement remain uncertain. Although the structure of European markets is changing rapidly following widespread demutualization, mergers of exchanges within countries and various links between national exchanges, it appears unlikely that pan-European markets will evolve quickly. There are several obstacles that impede the transition.

The first barrier is the lack of any centralized settlement systems. This is primarily a technical problem of incompatible domestic systems or differences in trading platforms across exchanges. In many cases, they can be resolved through linkages and mergers. In others, where linked systems are constrained by weak or obsolete technology, new investment will be required.

Policy-makers should encourage the development of cross-border investment

If a centralized settlement system is agreed to be an important part of integrating securities markets, a tougher attitude by a European authority is essential. At the national level, this function is performed by the central bank, which can offer guidance and moral suasion in deriving a market-based solution or participate directly in forging the desired outcome. But at the European level, there is a vacuum since the European Central Bank does not currently have a legal mandate to address this issue.

The second barrier relates to policy and includes differences in tax regimes, accounting standards and regulatory frameworks, all of which heighten legal uncertainties about cross-border transactions. In several European countries, legal restrictions hinder pension funds from taking on a more diversified portfolio. And although there have been some efforts to foster harmonization, progress is slow. The reluctance of domestic authorities to create a level playing field in part reflects political motivations: these obstacles protect domestic institutions and markets from outside competition.

One contribution policy-makers could make to more integrated markets would be harmonizing the issuance of government bonds. A policy of stable and predictable issuances would improve liquidity and potentially generate interest rate savings, at least for issues that are perceived as perfect substitutes. It could also help reduce the liquidity premium that smaller EMU member countries are currently paying. As the correlation increases among European government bonds, the rationale for having different futures contracts corresponding to different national issuers would disappear. The emergence of a single futures contract would be an important step towards an integrated European government bond market.

The structural changes in securities markets also have implications for regulators. The Paper argues that the regulatory framework needs to encompass innovations in cross-border transactions, foster competition between all types of standards and enhance cooperation between national regulators.

On the one hand, European regulators should pursue a hands-off policy by allowing markets to evolve quickly in response to new technological advances. On the other hand, they need to establish a new harmonized code on norms, rules and procedures to ensure stable competitive markets for the profit-oriented exchanges. Until now, most exchanges have been self-regulated in that via club membership or shares, the listed companies held a vested interest in maintaining a well functioning exchange. Such a self-regulatory mechanism will not necessarily operate under demutualized exchanges.

This article summarizes 'EMU and Portfolio Adjustment', CEPR *Policy Paper* No. 5 by Kpate Adjaouté, Laura Bottazzi, Jean-Pierre Danthine, Andreas Fischer, Rony Hamaui, Richard Portes and Mike Wickens.

Imperfect Harmony

Must Europe harmonize taxes? Not according to new CEPR research by Richard Baldwin and Paul Krugman. Indeed, they argue, harmonization is likely to do more harm than good.

Conventional wisdom says that tax harmonization will prevent a 'race to the bottom'

Conventional wisdom says that in a world of high capital mobility, closer economic integration of European Union (EU) members requires tax harmonization. Failure to align taxes, it is argued, will result in destructive tax competition among members – a 'race to the bottom' that will undermine the foundations of Europe's welfare states. But this view assumes that producers will automatically move their capital to the country with the lowest taxes. The 'new economic geography' suggests a different outcome: rich countries with generous welfare states offer capital such attractive conditions – excellent infrastructure, established customer and supplier bases, accumulated experience and well-trained workforces – that they can afford to levy higher taxes.

In a recent CEPR *Discussion Paper*, Richard Baldwin and Paul Krugman explore these two views and their radically different implications for the desirability of tax harmonization. They begin by laying out the reasoning behind the traditional tax competition view, which is based on the analogy of competition among private sector firms. Such competition has two salient effects: fat-cutting – firms are forced to offer their goods at a price no higher than is necessary to cover costs and earn a reasonable return – and cost-cutting – firms must reduce their costs to a minimum.

Broadly speaking, both aspects of this competition are good for society, promoting efficiency and reasonable prices. The first aspect is also beneficial when applied to governments: when firms have a choice of locations, governments are forced to offer an attractive combination of good public services and taxes no higher than is necessary to pay for them. But the second aspect of competition may result in a level of public services that is too low, which implies that citizens in competing jurisdictions end up with a less inclusive society than they would wish.

In these circumstances, tax harmonization seems eminently reasonable. Competition to cut taxes has created a situation where governments cannot provide the level of public services their citizens want. But since everyone is cutting taxes, no one gains a competitive advantage from cutting taxes. This is like a crowd that stands up at a football match: no one sees any better but nor is anyone willing to sit down. So in this traditonal tax competition view, tax harmonization agreements among governments are like price-fixing cartels among firms – very attractive to all negotiating parties.

But since the mid-1960s, as integration has increased, average EU taxes have risen

To assess the validity of this view, Baldwin and Krugman examine how tax rates have reacted to closer economic integration in the past. After all, European trade barriers have been falling more or less continuously since the late 1940s and barriers to capital mobility have also come down. But comparing the aggregate tax rate – total tax revenue divided by GDP – in two groups of countries – a 'core' of Benelux, France, Germany and Italy; and 'periphery' of Greece, Ireland, Portugal and Spain – indicates that there has been nothing like a race to the bottom. Instead, since the mid-1960s, as European integration has steadily increased, the average tax rate has risen.

And there has not been a uniform narrowing of tax differentials across countries

Even more surprisingly, it is by no means uniformly the case that integration has led to a narrowing of tax differentials. Tax rates have always been higher in the core than in the periphery; and the gap between them actually widened until the late 1970s, narrowing only more recently. Only since 1978 have some faint signs of tax competition begun to appear as the difference between core and periphery tax rates has narrowed significantly. But this narrowing is more like a 'race to the top' with tax rates in the core levelling off while periphery rates converge upwards.

These trends suggest that what is happening is more complex than the traditional view suggests. Baldwin and Krugman offer an economic geography view as a way to make sense of this. Like the traditional view, this can best be presented using an analogy between private and

Economic geography suggests that tax harmonization is potentially damaging

public competition. But instead of competition being between evenly matched firms, here competition is unbalanced – more like the competition between Microsoft and any number of start-up firms.

Microsoft charges a relatively high price for Windows so it might be thought that a start-up could steal customers by producing a Windows-like system at a cheap price. The problem is that Microsoft has the best people in the industry and can afford to buy or produce the best technology. Windows is therefore very attractive despite its price and this allows it to capture about 90% of the market. And how can Microsoft afford the best people and technology? Well, because it captures 90% of the market. There is a circular causality that makes success self-sustaining.

The circularity also means that start-ups have little chance against Windows, allowing Microsoft to charge high prices. Indeed, most software firms have completely abandoned attempts to compete, choosing instead to focus on other forms of software, which they can price without regard to competition from Windows. This means that competition in the market for operating systems is one-sided – but not in the way most people would think. Microsoft worries about competition from firms that might enter the market if the price of Windows gets too high. But the start-up firms set prices without regard to competition from Windows since they have chosen not to compete head-to-head in the operating system market.

A single 'split-the-difference' tax rate would make all countries worse off

This circularity (or 'agglomeration force') is at the heart of the economic geography view. The concentration of economic activity – particularly of industry and high-end services – in core countries creates forces that encourage continued concentration. And the implications for tax competition are clear. In principle, periphery countries could try to vie for the core's industrial bases by charging low taxes. But since the core has an agglomeration advantage, even a zero tax rate might not be enough to induce firms to move. Moreover, just as with Microsoft, the core can meet almost any tax-cutting challenge by lowering rates, so any challenge is likely to be ultimately futile. Periphery countries are thus likely to abandon attempts to compete, choosing instead to set their tax rates on criteria unrelated to tax competition.

No wonder the European Union has a hard time harmonizing tax rates

How does the economic geography view explain the fact that increasing European integration led first to a widening of tax differentials and then to a narrowing? The answer lies in a particularity of agglomeration forces: that they are strongest at intermediate levels of trade costs – when very high barriers divide markets, agglomeration is not feasible, and when barriers are low, it is not necessary. So the explanation is that up to the late 1970s, greater integration increased agglomeration forces, allowing the core to raise tax rates faster than the periphery. More recently, the advantage of being in the core has eroded. Cheap transportation, communications and liberalization have made it less important to be located where everyone else is. In response, core governments moderated their rate of tax increases. At the same time, liberalization raised incomes in periphery countries, encouraging their citizens to demand better, more expensive public services while at the same time boosting their ability to pay higher taxes. In response, periphery governments accelerated tax hikes.

So what does all this mean for tax harmonization schemes, such as the proposal that EU members 'split the difference' by converging on a common tax rate somewhere between high core rates and low periphery rates? The traditional view argues that it is good for everyone. But economic geography suggests quite the opposite since a common rate would maintain the core–periphery divide. With identical tax rates, firms' preferences for concentrating where other firms are already concentrated would not change. Indeed, 'one-tax-fits-all' harmonization might even worsen the distribution of industry by neutralizing the periphery's tax advantage for economic activities that are not subject to agglomeration forces.

In these circumstances, higher rates would be unambiguously bad for periphery countries. Their initially lower rates were freely chosen, so a scheme that forced them to raise taxes without affecting the location of industry would make no sense. Similarly, the core countries – which are continually concerned about potential tax competition – are only interested in raising rates. A scheme that forced them to lower taxes and the quality of their public services would be a move in the wrong direction. Baldwin and Krugman conclude that a single 'split-the-difference' tax rate would make both core and periphery countries worse off. No wonder the EU has a hard time harmonizing tax rates.

This article discusses research reported in 'Agglomeration, Integration and Tax Harmonization', CEPR *Discussion Paper* No. 2630 (November 2000) by Richard Baldwin and Paul Krugman. Baldwin is at the Graduate Institute of International Studies, Geneva, and Co-Director of CEPR's International Trade programme; Krugman is at Princeton University and a Research Fellow in CEPR's International Macroeconomics and International Trade programmes.

Creative Accounting

Changes in relative corporate tax levels across countries may conceivably affect the location of production. But as new CEPR research reveals, they almost certainly have an impact on where multinational firms declare their profits.

Raising corporate tax rates by one percentage point does not increase tax revenues

As the previous article indicates, policy-makers in industrialized countries have to balance their need for tax revenues and the attractiveness of their jurisdiction for economic activity – and they react to each other's corporate tax policies in finding the appropriate balance. But international differences in tax rates can affect revenues not only through shifts in economic activity: they can also alter revenues more directly through shifts in firms' cross-country allocation of accounting profits. A recent CEPR *Discussion Paper* by Eric Bartelsman and Roel Beetsma examines the effects of tax differences on profit shifts that occur purely on paper and finds evidence that they have a significant impact on where profits are declared.

All things being equal, multinational firms try to allocate costs to countries with high corporate tax rates and revenues to countries with low tax rates. The potential gains from such shifts are largest if the firm is resident in countries like France and the Netherlands, which use the exemption system – profits taxed elsewhere are tax-exempt in the country of residence. Other countries, including the United Kingdom and the United States, use the credit system, which gives a tax credit for corporate taxes already paid elsewhere. Here, the gains from profit shifting arise primarily from deferring the repatriation of profits to a residence country with higher taxes.

There are essentially two ways in which pure profit shifting can take place. One is through the capital structure: a firm might finance new subsidiaries in high-tax countries by establishing debt contracts with branches in low-tax countries. The other is through incorrectly pricing intra-firm deliveries of goods and services. Although the OECD's guidelines on tax and transfer pricing call for the use of the 'arm's length principle' whereby internal transfers are made at market prices, there are various problems in applying this principle. With many intra-firm transactions, for example, there is no comparable outside market, most notably with intellectual property developed by one branch of the company and used by other branches in other countries.

The extensive misuse of transfer pricing between industrialized countries and tax havens receives considerable attention in a recent OECD report, *Towards Global Tax Competition: Progress in Identifying and Eliminating Harmful Tax Practices*. Less attention has been paid to transfer pricing within the industrialized world, where the focus has been more on the effects of tax competition on real activity. Yet Bartelsman and Beetsma's results suggest that the effects of changes in corporate tax rates on transfer pricing between industrialized countries are substantial.

The tax rate increase is more than offset by the decline in the profits companies report

The researchers estimate the extent of this kind of profit shifting by examining the relationship between the ratio of nominal value added to labour compensation and differences in corporate tax rates between individual countries and the OECD average. The idea is that pure profit shifting resulting from high taxes will lead to a reduction in reported value added, conditional on the scale of a firm's operations. (Taking account of labour compensation controls for the scale of operations and thus filters out the effect of tax rate changes on shifts in real activity.) Hence, the ratio of nominal value added to labour compensation should decline if firms misuse transfer prices to counteract a rise in tax rates.

To assess whether this does indeed happen, the researchers combine data on corporate tax rates with the OECD's STAN database, which contains information on a large number of industrial sectors for most OECD countries over the period 1970-97. The results confirm that there are significant effects of tax rate differences on the value added/labour compensation ratio.

The rewards of stricter enforcement of the rules on transfer pricing might be quite high

So what exactly is the effect of a tax increase on corporate tax revenues? Bartelsman and Beetsma's baseline estimate suggests that, on average, a unilateral one percentage point increase in the corporate tax rate does not lead to an increase in corporate tax revenues, owing to a more than offsetting decline in *reported* profits. The countries for which the estimated effects are

Enforcement of transfer pricing rules would benefit from international policy coordination

largest are Japan, Portugal and Spain, followed by Denmark, Germany and the Netherlands. The sectors with the strongest effects are 'Industrial Chemicals', 'Other Chemicals', 'Iron and Steel' and 'Non-Ferrous Metals'. 'Other Chemicals' includes pharmaceutical products, for which research and development and hence intellectual property are relatively important.

Since the analysis focuses on only one type of profit shifting – transfer pricing – it seems likely that the results constitute a lower bound on the effect of tax rate changes on reported profits. This suggests that the rewards of stricter enforcement of the rules on transfer pricing might be quite high. Yet the scope for transfer pricing, and profit shifting in general, within a multinational is tightly linked to the scale at which it operates. Tighter enforcement of the rules in a high-tax country means that the net return on investment would fall, hence carrying the risk that real activity is shifted to other countries with lower taxes or more lenient enforcement. In these circumstances, enforcement of transfer pricing rules would probably benefit from international policy coordination, such as exchange of information about multinationals' activities and agreements about minimum enforcement standards or common transfer prices.

Transfer pricing may distort cross-national growth comparisons

The analysis also has lessons for productivity measurement and comparisons of growth rates across countries, suggesting, for example, that observed growth spurts in countries that have lowered their tax rates – such as Ireland – may be related, at least partly, to mismeasurement. It is possible that the reduction in the corporate tax rate has boosted measured value added by more than the increase in real activity.

This article discusses research reported in 'Why Pay More? Corporate Tax Avoidance through Transfer Pricing in OECD Countries', CEPR *Discussion Paper* No. 2543 (August 2000) by Eric Bartelsman and Roel Beetsma. Bartelsman is at the Vrije Universiteit Amsterdam; Beetsma is at the Universiteit van Amsterdam and a Research Affiliate in CEPR's International Macroeconomics programme.

Brave New World?

With human cloning seemingly just around the corner, to what extent will market forces create an incentive to use this new reproductive technology and what are the likely economic consequences? Gilles Saint-Paul speculates about these issues in CEPR *Discussion Paper* No. 2674 (January 2001). He suggests that there will be strong incentives to clone people of exceptional labour market value – top entrepreneurs, surgeons and scientists. But the extent to which the market 'internalizes' this economic value will depend on how much of the return to the clone's genes can be appropriated by the people who invest in creating the clone, notably the clone's original model.

If clones are treated as products, they could be patented, effectively enslaved. Those who fund production of the clones could then reap all the returns to their genes by forcing them into high return occupations and expropriating their income. But as human beings, clones are likely to have the same civil rights as other individuals. They could then appropriate all the returns to their genes, reducing the incentives for cloning.

But as Saint-Paul points out, there are alternative mechanisms for appropriating the value of clones. One is 'information retention': a cloning firm could buy some DNA from a top ability individual and produce a clone about which the model knows nothing. Then when the clone reaches his legal majority, the firm would sell him information about the model. Learning that he is the clone of a top ability worker, he would be willing to pay substantial amounts to know whether he is the clone of a violinist or a surgeon.

Clearly, such mechanisms are far weaker than slavery and they imply a level of cloning much lower than if clones were granted fewer rights than original human beings. But if clones' expected incomes are very large, they may make cloning a profitable operation even at relatively low levels of appropriability, thus creating a market. Saint-Paul analyses the likely outcomes once that market has emerged. His results suggest that only the most talented people will be cloned, while women at the bottom of the ability distribution could increase their income by acting as surrogate mothers for the clones. This implies that in the short run, cloning reduces inequality.

What about the long-run consequences? These depend on both fertility and how children's abilities are related to their parents' abilities. If fertility is uncorrelated with ability and if the ability distribution among natural children is the same as among their parents, cloning leads to a situation where everyone is top ability and cloning eventually disappears. If the distribution of genes, rather than abilities, is preserved by sexual reproduction, then cloning eliminates ability-reducing genes but does not necessarily eliminate inequality. But if fertility is negatively correlated with ability, cloning eventually produces a two-class society, with top ability people who are typically cloned and bottom ability people who form a reproductive caste.

This final scenario is the opposite of that described in Aldous Huxley's *Brave New World*, where clones are at the bottom of society. Rather, clones are made from an elite, who sell their precious genes to the market. The explanation is simple: the value of cloning is highest for top ability people, and this maximum value determines the market price for clones. More fundamentally, there is no economic value in producing low ability people via cloning rather than by standard means.

Protection Rackets

Why does the degree of legal protection enjoyed by shareholders vary so much across countries? New CEPR research suggests that the explanation lies in the differences between national political systems.

An alliance of entrepreneurs and workers leads to high employee and low investor protection

There are considerable cross-national differences in the degree to which shareholders are protected against the opportunistic behaviour of managers. But there is also growing evidence that better protection encourages more abundant external equity for companies, which translates into broader stock markets and more dispersed share ownership.

So why don't all countries design their legal systems to maximize shareholder protection and financial market development? That is the question addressed by Marco Pagano and Paolo Volpin in a recent CEPR *Discussion Paper*. 'Politics' is the obvious answer: legal rules are established via the political process. But how exactly do politics affect the design of legal systems?

Pagano and Volpin take the view that political decisions about legal rules are based on economic interests. Can this view offer a theoretical explanation for the observed international differences in investor protection, as well as their persistence? The issue of legal reform cannot be faced without such a theory. To know if and how investor protection can be improved in a given country, it is first important to understand how it arrived at its current degree of protection.

The researchers develop a stylized model of a country with three classes or social groups: entrepreneurs, rentiers and workers. Entrepreneurs hold a controlling stake in their companies, while rentiers – and possibly workers – are minority shareholders. Once entrepreneurs have set up their firms, a political decision can change the regime of investor and employee protection. So when signing financial and labour contracts, people must take account of the expected outcome of such a decision. In particular, the amount of external equity finance and its price are affected by the legal regime expected to prevail.

In the model, the political preferences of each group are shaped by economic motives. Rentiers – and workers insofar as they hold shares – want high investor protection so as to reduce the private benefits extracted by managers. Entrepreneurs, in contrast, prefer low investor protection. As initial owners of their companies, they ultimately bear the cost of low protection, namely reduced availability of equity capital. But this is a sunk cost at the time of the political decision: once the company has raised external equity, entrepreneurs want to lower protection to increase their private benefits.

If the political debate is only about investor protection, the outcome will be high investor protection since entrepreneurs are a political minority. But the debate may involve other issues such as employment protection, notably employers' freedom to fire workers. And only one group – employed workers – wants high employment protection.

This 'corporatist' outcome arises in systems where coalition governments are prevalent

With two issues on the political agenda, political alliances are possible. In particular, entrepreneurs may strike a deal with workers in which high employment protection is exchanged for low investor protection. Such a 'corporatist' arrangement would be mainly at the expense of rentiers, who would prefer low employment protection and high shareholder protection.

According to the model, the structure of the political system determines whether there is a corporatist outcome. If each social group is represented by a political party (none of which holds the majority of votes), this outcome will emerge if parties can vote jointly on the issues of shareholder and employee protection. Such a joint vote requires a coalition submitting a multidimensional political platform to a vote.

Anglo-Saxon countries, where coalitions are rare, have high investor and low employee protection

This implies that a combination of low investor protection and high employment protection will be associated with institutional settings where coalition governments are prevalent and the government is subject to a confidence vote. If instead parties vote on the two issues separately, high shareholder protection will get the votes of rentiers and workers, and low employee protection those of rentiers and entrepreneurs. In this case, there is a 'non-corporatist' outcome of high investor protection and low employee protection – the rentiers' favourite regime.

These predictions from the model are

consistent with the empirical evidence for OECD countries. Continental European countries and Japan, whose governments are generally formed by coalitions and subject to a vote of confidence, have low investor protection and high employment protection. In contrast, Anglo-Saxon countries, whose political systems have the opposite features, have high investor protection and low employee protection.

Widespread share ownership favours investors' rights and low employment security

The researchers also analyse a model of political competition where parties do not coincide with specific social groups. Instead, two 'non-ideological' parties design their platforms to compete for the support of all voters. In this model, the diffusion of equity ownership among voters is the key influence on the political outcome. If equity ownership is widely dispersed, parties will converge on a platform that favours shareholder rights and low employment security. But if equity ownership is concentrated, parties converge on the same regime as in the corporatist outcome. Although internationally comparable data about the diffusion of equity ownership are sparse, the existing evidence is broadly consistent with this prediction.

This article discusses research reported in 'The Political Economy of Corporate Governance', CEPR *Discussion Paper* No. 2682 (January 2001) by Marco Pagano and Paolo Volpin. Pagano is at the Università di Salerno and Co-Director of CEPR's Financial Economics programme; Volpin is at the London Business School.

The Democratic Advantage

Participatory political regimes deliver higher quality growth, according to Dani Rodrik's CEPR *Discussion Paper*, 'Institutions for High-Quality Growth' – No. 2370 (February 2000). They do so because they produce superior institutions better suited to local conditions.

Rodrik notes that the encounter between neo-classical economics and developing societies has revealed the institutional underpinnings of market economies: a clearly delineated system of property rights; a regulatory apparatus that curbs the worst forms of fraud and anti-competitive behaviour; a moderately cohesive society that exhibits trust and social cooperation; social and political institutions that mitigate risk and manage conflicts; and the rule of law and clean government. These are arrangements that economists usually take for granted, but which are typically absent in poor countries.

So the question for policy-makers is no longer 'do institutions matter?' but 'which institutions matter and how can they be acquired?' Rodrik examines the types of institutions that allow markets to perform adequately, focusing on five in particular: property rights; regulatory institutions; institutions for macroeconomic stabilization; institutions for social insurance; and institutions that manage conflict.

How does a developing society acquire institutions that support a healthy, sustainable market-based system? Rodrik emphasizes the importance of 'local knowledge', arguing that a strategy of institution-building must not over-emphasize best practice 'blueprints' at the expense of local experimentation. The blueprint approach is largely top-down, relying on the expertise of technocrats and foreign advisers. The local knowledge approach, in contrast, is bottom-up and relies on mechanisms for aggregating local information.

In principle, these mechanisms can be as diverse as the institutions that they help create. But Rodrik contends that the most reliable forms of such mechanisms are participatory and decentralized political institutions. While non-democratic forms of government have often succeeded admirably in the task of institution-building by using alternative devices, the broad, cross-national evidence indicates that they are exceptions rather than the rule. Nothing prevents authoritarian regimes from using local knowledge; the trouble is that nothing compels them to do so either.

In fact, the record is even more favourable to participatory regimes than is usually acknowledged. Rodrik's research provides evidence for four conclusions. First, democracies yield long-run growth rates that are more predictable than those generated by autocracies. Second, democracies produce greater short-term stability whatever the long-run growth rate. Third, democracies handle adverse shocks much better. And fourth, democracies deliver better distributional outcomes.

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