

# EUROPEAN ECONOMIC PERSPECTIVES

## Discord over Harmony

**Recent calls for tax harmonization across the European Union make an explicit analogy between low business taxes and illegal state aids. Timothy Besley and Paul Seabright argue that there are deep flaws in this view.**

Germany has signalled that a top priority for its EU presidency will be the harmonization of business taxation. The aim is to prevent wasteful competition between member states trying to attract corporate investment and hence driving taxes below 'reasonable' levels. The Commission too, particularly internal market commissioner Mario Monti, argues that low business taxes should be treated just like illegal state aids: as 'unfair' subsidies to domestic firms at the expense of those based elsewhere in the EU.

On the surface, the analogy between tax competition and state aid seems reasonable. But it is deeply flawed for at least two reasons. First, not all state aids are illegal - only those that 'distort competition in the common market'. And while the Commission lacks clear criteria for distortions of competition, economic analysis suggests that they can only be diagnosed when state aids in one country have a clear negative impact on the economy of another. This will be true of some but not all

cases of aid; indeed, the Commission itself turns down less than 2% of all aid notifications.

State aid is most suspect when it aims to give a substantial commercial advantage to a domestic firm with significant market power - relative, that is, to other domestic taxpayers who provide the revenue to fund the aid. But here the analogy with the general level of business taxation is particularly poor. Taxes apply to all domestically established firms: they reflect the cost of operating in a particular tax jurisdiction with its public goods and services and regulatory framework. There is no more reason to expect these costs to be the same across countries than to expect that the costs of labour or traffic congestion will be the same.

The experience of the United States is instructive here: US markets for outputs and inputs are fully integrated yet considerable variations in tax policies remain. Attempts to coordinate tax policy are mostly limited to informal meetings between elected officials, such as meetings of state governors. With

*Low business taxes in one country do not necessarily harm other countries*

*Tax competition provides incentives for convergence without coordination*

*Tax harmonization is not a requirement of the single currency*

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business taxation, states have generally converged to a common base - that used by the federal government - but there is no obvious tendency for convergence in rates over time.

When US firms are asked about what influences their location decisions, taxes rarely figure among the numerous policy and non-policy factors they cite. Indeed, creating a business-friendly environment goes well beyond tax factors. For example, recent evidence suggests that union recognition laws may be particularly important. The US federal government accepts that these are policy decisions to be taken at a state level and it is hard to pinpoint deleterious consequences.

If low taxes in one country really can harm another, this has to be argued on its own merits, not by a weak analogy with state aid. Take the case of Ireland, which has enjoyed an average growth rate of around 5% a year for the last decade and a half, and has also been spectacularly successful at attracting foreign direct investment. It seems reasonable to suppose that low taxes have played a significant part in Ireland's economic success. But has this harmed other countries in the EU?

The answer is unclear. Some investment has perhaps gone to Ireland that might have gone elsewhere in the EU. But at the same time, some has come to the EU that would not otherwise have come at all. The investment in Ireland has probably been more productive than it would have been elsewhere. And Ireland's growth has probably had some modest yet positive spillover effects through trade with other EU members.

Arguably, the Irish experience has also had an important demonstration effect of the value of creating a business-friendly climate. To insist that the net effect on other countries has been negative is to go far beyond the available evidence. And a policy based on this uncertain claim risks blunting the beneficial incentives that have had such good outcomes in Ireland.

The second reason why state aid is a bad analogy for tax competition is that the latter puts downward pressure on the overall level of public expenditure while the former tends to increase it. Much of the EU effort to control state aid has been devoted to coordinating measures to reduce 'excessive' or 'wasteful' public spending. It is clear from recent decisions and policy documents that the Commission believes individual governments are subject to failures that result in excessive spending. The same belief has informed the post-Maastricht measures on debt and deficits

as well as the common concern about unfunded pension liabilities. Coordination may be a good way to reduce public expenditure or raise taxes in the long term - but it is unlikely to do both.

A more subtle view of the problems of an EU without tax harmonization is that business taxes will be too low and personal taxes too high since capital is mobile and labour is not. But while this is a coherent argument, it is far from being established empirically. It also conflicts with the widely-held belief that tax policy should favour savings.

The general point remains: tax competition is not just like state aid - its impact is on the opposite side of the public accounts. And if you really believe that political forces result in public expenditure that is too high, then you should probably welcome tax competition if you think it will tend to cap taxes, since this adds to the pressure to cap spending.

Recent media discussion of tax harmonization has generated a number of other myths. One is that tax harmonization is intrinsically a worse infringement of national sovereignty than EU control of state aid. But if tax competition really does have bad effects on other countries, then it is reasonable to coordinate tax rates. The point is not that the argument could not possibly be true, simply that it has not been convincingly made.

A second myth, particularly prevalent among UK drinks manufacturers, is that harmonization is needed to achieve lower excise duties and hence reduce the loss of so much revenue from alcohol and tobacco to other member states. But this can be done without harmonization. The issue is not convergence: tax competition provides strong incentives for convergence anyway. It is whether to converge up or down - whether current EU tax rates are above or below their desirable long-term level. This question has not been properly asked, let alone convincingly answered.

A third myth is that tax harmonization is a requirement of the euro. But, as noted above, US states have their own tax rates within a single currency area with no apparent ill-effects. Arguments suggesting that monetary union requires curbs on deficit finance should not be confused with discussions about the appropriate structure and mix of taxation by individual members of that union.

These three myths - to take only the most striking - all have obvious flaws. The myth that tax competition is like illegal state aid is

# From Russia with Love

**Just as in the 1890s, the question of how to predict the financial collapse of nations is high on the international agenda. New CEPR research explores some lessons from a century ago.**

**T**he Asian crisis and its aftermath once again illustrate the perils of international finance. But while the policy implications of the crisis, in particular the future role of multilateral agencies like the IMF, remain far from obvious, a number of private bodies are taking action to minimize their exposure to currency risk. For example, several investment banks have developed models that seek to predict currency crashes: Credit Suisse First Boston have an 'emerging markets risk indicator'; JP Morgan have an 'event risk indicator'; and Lehman Brothers have a 'currency jump probability measure'.

From the point of view of policy, it is essential to understand the logic of this research agenda. The potential emergence of a private standard of risk perception must influence future IMF interventions since if all market participants believe that, say, a low level of reserves signals an impending crisis, they will liquidate their positions, thus provoking the crisis. The multilateral agencies are in turn bound to factor in the effects of market opinion, whatever they think of the actual severity of the situation. Alternatively, they may want to propose a different standard. At the very least, it is vital for them to understand what forces shape market sentiment.

Macroeconomists have surprisingly little to say on this issue, although a growing body of literature addresses the related question of what explains the grades given by rating

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agencies. From a theoretical perspective, there are only models of 'perfect foresight' where everything is correctly forecast, or of 'bubbles' where everything is self-fulfilling. From an empirical perspective, there is the problem of disentangling market opinion from the actions of the multilateral agencies. For example, the expectation of bailouts by public bodies may make investors complacent, reducing their awareness of risk and so distorting their incentives to acquire information and process it in original ways.

To study the market mechanism 'in the wild', it is worth examining the pre-1914 period when bailouts were not, as a rule, to be expected. In a recent CEPR Discussion Paper, Marc Flandreau focuses on the experience of Crédit Lyonnais, then a standard of prudence and planning.

Lyonnais was one of the largest international banks of the time, in a country that was second only to Britain as the largest global creditor. The bank's management was obsessive about limiting exposure to market risk while at the same time assuming a leading role in syndicated loans. So it became very concerned to provide finance only to those countries that it judged sound and, given its pre-eminence in European finance, Lyonnais opinion became extremely important in influencing the market mechanism. Each financial crisis brought a new wave of caution and analysis, to a point in the 1890s where its research department - 100 members strong at the turn of the century - produced a sovereign debt crisis indicator.

The development of the Lyonnais indicator was a direct consequence of the collapse of Barings in 1890 as a result of excessive exposure to Argentine debt. As the crisis spread through contagion reminiscent of today's turmoil, Lyonnais began to construct a precise measure of debt sustainability. Its database sought to distinguish unproductive

*Financial crises have led banks to try to minimize their exposure to currency risk*

*Banks' new risk indicators suggest that bailouts are not systematically expected*

*The emergence of a private standard of risk will influence IMF interventions*

*Crédit Lyonnais developed a sovereign risk indicator in the 1890s*

from productive borrowing, as well as measuring the efficiency of past borrowing. This led the bank to estimate the value of government assets - which could be very large since a number of governments, notably in continental Europe, were involved in infrastructure development and heavy industry such as railroads and mines - in order to discount this item from public indebtedness.

The estimates were then applied to past data, and the Lyonnais economists found that problems had only ever occurred in countries where the ratio of interest service (net of revenues from state-owned infrastructure) to total government revenue exceeded 40%. The ratio in Argentina, for example, had exceeded 50% when it collapsed in 1890.

This measure was then combined with other indices to serve as the basis of a formal 'rating'. There were three categories: first, 'sound countries'; second, intermediate countries; and third, bankrupt countries, such as Brazil and Argentina.

Interestingly, the measure was responsible for an 'event risk indicator' that designated Russia as 'safe'. Because most loans to the Russian government were used for industrial investments and because those investments provided a revenue, Russia's 'indebtedness' remained moderate in the eyes of the Lyonnais economists. This in turn led the French to invest massively into Russia with what, of course, turned out to be disastrous consequences.

Several lessons can be drawn. First and foremost, this episode indicates how late nineteenth century investors reacted to the absence of official data, formal ratings and international bailouts. A second lesson is the considerable importance of investors' perceptions in shaping the market mechanism itself. In particular, the markets' preference for investment finance - as opposed to consumption finance - proved decisive in comparing sovereign risks.

Third, and somewhat discouragingly, the experience underlines the problems of basing predictions on past history. Regardless of Lyonnais' caution in trying to avoid a recurrence of the Argentine problem, it entirely missed a different kind of problem. What went wrong with Russia was not the result of unproductive use of foreign resources. Instead, it came when a new regime, aiming for autarky, decided to renege on its foreign commitments, while retaining

the plants, mines and railroads for which foreign capital had paid.

The last lesson concerns the economics of financial opinion. The Lyonnais view of the world was not an individual voice in a broad market of opinions: it was the voice of an international institution. So while the bank's desire to retain credibility certainly encouraged it to do its homework, this probably led other banks to pay far less attention to risk. And the absence of other serious competing opinion - at least in France - probably induced other banks to join Lyonnais-led syndicates without due caution. But finance is a game where you make money not because you are right but because your view becomes the market view: the externalities of being a market leader cannot be ignored.

These conclusions may help to shed some light on current developments and suggest a few policy implications. First, the aggressive move that today's investment banks have taken towards research on emerging market risk seems to provide evidence that contrary to a popular view, bailouts are not systematically expected by the market - otherwise, why should they pay so much attention? In a sense, Credit Suisse First Boston, Lehman Brothers and JP Morgan are just doing what Crédit Lyonnais did one century ago - and for the same reasons.

Second, yesterday as today, there is the striking influence of past collapses on the design of current indicators. The Lyonnais method was a formidable tool to track Argentine-like crises but was totally powerless in alerting investors to the risks of Russian default. This problem is still a serious challenge for today's 'data miners', whose predictors are based on past data.

Third, the Lyonnais tale should warn multilateral agencies against the dangers of relying on market sentiment as represented by private indicators when designing their policies. Because opinion is a public good as much as anything else, private endeavours to define a standard of risk are open to manipulations and should thus be taken with a grain of salt.

This article reviews research reported in 'Caveat Emptor: Coping with Country Risk without the Multilaterals' by Marc Flandreau, CEPR Discussion Paper No. 2004 (October 1998). Flandreau is at OFCE and CNRS in Paris, and a Research Affiliate in CEPR's International Macroeconomics programme.

*But in designating Russia as 'safe', the indicator came unstuck*

*For today's 'data miners', similar indicators based on past data are flawed*

# All Change

## **Differences in housing and financial market institutions mean that interest rate moves will affect eurozone countries in different ways, according to new CEPR research. How can policy-makers ease the tensions this will generate?**

**D**espite the pressures for convergence as a result of the build-up to monetary union, the differences in housing and financial market institutions across the 15 EU members remain large. And according to new CEPR research by Duncan MacLennan, John Muellbauer and Mark Stephens, these differences will have profound effects on the relative responsiveness of output and inflation in the different countries to changes in short-term interest rates, as well as to asset market shocks of external origin.

Though the pressures for institutions to converge will intensify as the euro becomes established - and there will be important changes, for example, in corporate bond markets - the barriers to convergence are often deeply rooted, not least in different national housing systems. The persistence of these differences is likely to cause instability in those economies at the extremes of the spectrum of relevant dimensions, not only eurozone members such as Finland, Ireland, but also non-members such as Sweden and the UK.

Such instability may lead to potentially serious tensions between eurozone members, these researchers contend. Moreover, unless the issues are recognised by policy-makers and concerted action is taken, the barriers to convergence in housing and credit markets and associated legal, regulatory and fiscal structures will cause the tensions to persist. These barriers matter for whether the UK and other 'outs' join the euro as much or more than whether business cycles are roughly synchronized at the moment of entry. Indeed, they matter for the success of the whole monetary union project.

Previous attempts to examine differences in the monetary policy transmission mechanisms between European countries have tended to focus on the macroeconomic level. A 1995 study by the Bank for International Settlements, for example, suggests that of the

countries studied - Austria, Belgium, France, Germany, Italy, the Netherlands, Spain and the UK - the UK had by far the greatest sensitivity of output to interest rate rises. Moreover, since variable rate mortgage costs have a large weight in household budgets, as well as in the retail prices index, the UK is unique in having a positive inflation response to a rise in interest rates both in the year of the rise and the following year before turning negative in the third year.

MacLennan and his colleagues explore the different mechanisms by which a rise in short-term interest rates affects the major components of expenditure, such as consumption and investment. They argue that economists typically place undue emphasis on minor direct effects, such as 'intertemporal substitution' - the lowering of current consumption in favour of more future consumption as the interest rate rises. The indirect effects, which operate through asset prices and expectations of income growth, are of far more importance in practice but receive less attention.

For example, institutional differences between countries in pension and corporate finance systems and differences in the scale of government debt, reflected in national differences in equity and bond market capitalization, generate differences in financial asset to income ratios and in the 'spendability' of those assets. A rise in real house prices not only leads to a positive wealth effect on non-housing consumption, in the same way as a rise in real share prices, but also a negative income and substitution effect. This implies a positive effect on the consumption of owner-occupiers and a negative effect on the consumption of market renters.

If rental housing is owned by pension funds, whose assets are regarded as relatively illiquid by consumers, a rise in house prices has bigger consumption effects in countries

*Barriers to convergence of national market institutions are often deeply rooted*

*The persistence of differences will cause instability in economies at the extremes*

*Instability may lead to potentially serious tensions between eurozone members*

*House price rises increase consumption more when owner occupation is high*

with a small market rental sector and a high rate of owner occupation. Moreover, countries can vary in the effective spendability of owner-occupied housing wealth. Spendability is high where transactions costs are low and where housing is effective collateral. Together, these differences can imply a tiny impact on consumption from a rise in real house prices in some countries and a substantial positive impact in others.

Further differences can arise in the transmission mechanism between interest rates and asset prices. Maclennan and his colleagues identify as many as five distinct elements, for example, in the effect of interest rates on house prices. Not only are there important non-linear elements in these effects, but differences in history as well as in the proportions of fixed and floating rate mortgage debt, can generate big differences between countries.

Indeed, there are big differences across Europe in housing tenure, in loan-to-value ratios and mortgage debt to income ratios as measures of credit availability, and in taxes and other aspects of transactions costs that affect the size of housing wealth effects on consumption. The responsiveness of mortgage and other borrowing rates to short-term interest rates varies greatly across Europe. Financial market capitalization relative to GDP and, underlying these, banking and corporate finance systems and especially pension systems differ substantially.

Available evidence on the effects of financial and housing assets on consumption is broadly in accord with the differences between countries predicted by this analysis. The UK, for example, which tends to be at one extreme in most relevant dimensions, has a more speculative housing market and larger housing wealth effects than core eurozone countries like Germany.

Maclennan and his colleagues argue that there are strong barriers to convergence between the different national housing and financial systems. They all have their roots in different banking histories, state ownership and intervention, and legal and regulatory structures. For example, Italy's legal process governing the use of housing as collateral is effectively non-functioning. And the mortgage markets in other countries, such as Germany and France, are notoriously closed to outside entrants.

Nevertheless, there are institutional reforms and compensating policy shifts that may ease the tensions generated by national differences

and reduce the risks of membership of the monetary union. The researchers conclude by suggesting six areas where Finland, Ireland, the UK and, to some degree, Sweden, whose characteristics tend to cluster at one end of the institutional spectrum, could take action to reduce the risks of eurozone membership.

- Encourage the use of fixed-rate mortgages and loans more generally.
- Place somewhat tougher prudential upper limits on loan-to-value ratios.
- Particularly in the UK, retain a more significant 'pay-as-you-go' element in the public pension system.
- Encourage the development of the private rented sector and encourage the move towards market rents in as much of the social housing sector as possible.
- Reduce house price volatility not by increasing frictions in the housing market – for example, by raising UK stamp duty to the higher levels seen elsewhere in Europe – since such measures reduce labour mobility, but instead by using property taxes more flexibly.
- Encourage policy-makers in the core eurozone countries to open credit markets, the legal profession and estate agents to competition, reduce legal barriers to the use of housing collateral and cut transactions costs.

The last three of these reforms would benefit Europe as a whole by encouraging labour mobility and bringing other efficiency and welfare gains. This type of harmonization is likely to be more beneficial than the harmonization of income and corporation taxes that has been so widely discussed in recent months.

This article reviews research reported in 'Asymmetries in Housing and Financial Market Institutions and EMU' by Duncan Maclennan, John Muellbauer and Mark Stephens, CEPR Discussion Paper No. 2062 (January 1999). Muellbauer is at Nuffield College, Oxford and a CEPR Research Fellow; Maclennan and Stephens are both at Glasgow University.

*'Spendability' of housing wealth is high when housing is effective collateral*

*The UK has a more speculative housing market and larger wealth effects than the current eurozone*

# Eat the Riches

## **Many developing and transition countries have appalling growth records despite wonderful economic endowments. New CEPR research blames the ‘voracity effect’.**

*Natural resource windfalls can be a curse for developing countries*

A curious and depressing phenomenon is that many developing countries that are rich in natural resources or enjoy high export prices have failed to exploit their good fortune. Oil-rich countries like Nigeria and Venezuela have actually become poorer during the past 25 years, and others, such as Mexico, have dissipated much of the potential gain. Russia today is another graphic illustration of a resource-rich economy performing far below its potential. It seems that windfalls are often a curse.

A recent CEPR Discussion Paper by Aaron Tornell and Philip Lane tries to explain this phenomenon. These researchers note that common features of these societies are multiple power blocs alongside weak countervailing legal-political institutions. The power blocs may include regional or provincial governments within a federal system; tribal or ethnic leaders; labour unions or industrial conglomerates (private or public); parties within a coalition; or individual ministers within a cabinet. An inadequate legal-political infrastructure means that private property rights are insecure and income streams are vulnerable to appropriation.

In well-ordered economies, there are a variety of controls that prevent interest groups from arbitrarily obtaining resource transfers from the rest of society. But in fragmented societies, where legal or political restrictions are absent, powerful groups may appropriate resources through their control of the fiscal process - receiving transfers financed by taxation - or by lobbying for government interventions that redistribute rents within the economy.

Tornell and Lane argue that the policy environment of a fragmented society generates not only a subpar rate of economic growth but also perverse responses to positive macroeconomic shocks, such as resource discoveries or terms of trade improvements. Consider the appropriation decision made by

each powerful group with effective access to the fiscal process. Each group wants to appropriate resources for its own private gain. Yet each group also realises that excessive taxation is a self-defeating policy, deterring investment and shrinking the size of the economic pie available for appropriation in the future. In other words, the productive economy is the ‘golden goose’ that feeds all of the groups and hence deserves protection.

But since the overall tax rate is determined by the sum of the appropriations sought by all of the fiscal groups, there is a classic ‘collective action’ problem. Each group prefers to maintain a high rate of appropriation and see taxes reduced by greater self-discipline on the part of other participants in the fiscal process. Since no group has the incentive to take the lead in achieving fiscal prudence, the outcome is an excessive rate of appropriation and taxation - and consequently, a slow rate of output growth.

A good analogy is the fishing industry: the oceans are ‘common property’ but individual fishermen do not consider resource renewal their responsibility. As a result, in the absence of regulation, there is overfishing. Similarly, allocation decisions in a fragmented society without institutions to protect the common good can lead to inefficient outcomes.

The same mechanism leads to a perverse response to macroeconomic shocks. For example, an increase in fiscal revenues arising from higher export prices means that each group feels able to increase its appropriation rate. But since their common interest is not taken into account, the aggregate level of appropriation increases more than proportionally relative to the increased revenues, requiring an actual increase in the tax burden. Tornell and Lane label this overspending phenomenon the ‘voracity effect’.

There are many cases of resource booms being dissipated through intensified

*A fragmented society often leads to excessive appropriation and taxation*

*Resource booms can be dissipated through intensified appropriation*

*Commodity price booms and foreign aid have both unleashed the 'voracity effect'*

appropriation. During the commodity price booms of the 1970s, for example, several oil-producing countries went on spending binges, with those favoured groups with access to fiscal revenues borrowing to finance conspicuous consumption and wasteful prestige investment projects or to accumulate safe overseas assets immune from domestic taxation. Similarly, although the 1975-8 coffee boom was clearly temporary - the result of a frost in Brazil - a number of coffee producers not only failed to save the windfall but actually ran current account deficits during the high-revenue period.

Foreign aid is another powerful example of a windfall gain that can unleash the voracity effect. It is well-known that aid has often been wasted by recipient countries, either diverted by corruption or wasted on 'white elephant' projects, as various domestic interest groups seek to obtain their share of the foreign transfer via 'rent-seeking' activities.

The research suggests that the scale of the voracity problem depends on the extent to which control of the fiscal process is fragmented. The ideal situation is one in which the fiscal process is controlled in the common interest or by one powerful group: in either case, the policy-maker has an incentive to ensure that fiscal discipline is achieved and that the country responds efficiently to macroeconomic shocks. A highly polarized society in which fiscal control is split between two opposing groups is the worst of all possible worlds: each group is powerful enough to extract large transfers but wants to pass the adjustment burden to the other group.

Surprisingly, a more fractionalized fiscal process, in which many groups engage in rent-seeking, is preferable to the two-group case. This is because each group realises that the overall economic pie must be split among many, leading to moderation in the transfer requests of any individual group. Not only is growth performance better than in the two-group case, but the voracity effect in response to revenue shocks is muted.

Tornell and Lane's findings are important for evaluating the growth prospects of developing and transition countries undergoing economic and political reform. According to their analysis, the impact on growth of a switch from autocracy to a more decentralized system will depend on the effect the shift has on the ability of powerful groups to extract transfers.

If the collapse of an autocracy relaxes restrictions on the behaviour of powerful groups within a society, decentralization may actually intensify the rent-distribution struggle in these countries. This will lead to slower growth and poorer adjustment to shocks. In contrast, if the shift to decentralization brings with it the destruction of entrenched interest groups, and power becomes more diffused, then growth performance and adjustment to shocks will improve.

The implication is that for sustainable development, legal-political institutions that protect the common interest must be built in tandem with liberalization. Furthermore, pro-competition policies - making market entry easier or exposing domestic behemoths to foreign rivals - may be as important in terms of altering a country's propensity to engage in rent-seeking as in their direct impact on economic efficiency.

This highlights the importance of avoiding the creation of very big conglomerates as has happened in Russia. Since a small number of individuals wield immense economic power, they can influence the political process and, as a result, acquire effective access to fiscal revenues. This implies that it is undesirable to implement a privatization process that simply allows the creation of behemoths which pursue fiscal rents rather than efficiency.

This article reviews research reported in 'Voracity and Growth' by Aaron Tornell and Philip Lane, CEPR Discussion Paper No. 2001 (October 1998). Tornell is at Harvard University; Lane is at Trinity College, Dublin, and a Research Affiliate in CEPR's International Macroeconomics and International Trade programmes.

*The impact of political reform on growth depends on how many power blocs emerge*

*The key is to prevent a small number of blocs wielding immense economic power*

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