Here's our regular listing of interesting economic policy research, gathered from hither and yon. If you reside in hither or yon and would like to send me your own interesting economic policy research, please do (ppassell@milken-inst.org).

MANAGERIAL CAPITALISM, ASIAN STYLE

The public trading of corporate stock decentralizes ownership, creating the lovely checks and balances that make greed-driven capitalism compatible with pluralist democracy. But control and ownership aren't the same thing. And Asia watchers have long understood that control of corporate wealth in industrialized East Asia remains highly concentrated, even though corporations sell stock. They hardly suspected, however, just how concentrated until the completion of a survey of the ownership of 2,980 listed corporations in Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.

The study by Stijn Claessens and Simon Djankov of the World Bank's Financial Sector Practice Department and Larry Lang of the University of Chicago, is a trove of plutocratic horrors. In Indonesia and Thailand, for example, two families (the Suhartos and Ayalas, respectively) control 17 percent of total listed corporate wealth. All told, 10 families in each country control half the corporate wealth in Indonesia, Thailand and the Philippines. In Hong Kong and Korea, 10 control one-third of the wealth. Indeed, of the nine countries studied, Japan is the only one without substantial control by a handful of families.

Such extreme insider control suggests how East Asian corporations strayed so far from the Western model of capitalism – why size became so much more important than profitability, and why the return on capital declined sharply in the years before the crisis. But it also suggests how difficult it will be to generate enduring reforms. After all, wresting power from Asia's version of the Mafia will take more than a bunch of new laws. It will, in effect, require a revolution. [*"Who Controls East Asian Corporations," World Bank Working Paper 2054; download free from www.worldbank.org.*]

YET ANOTHER USE FOR JUNK BONDS

By now, everyone – even folks who don't work for The Milken Institute – knows that the rise of the market for less-than-investment-grade debt has dramatically lowered the cost of capital for small- and medium-sized firms. You're excused, though, for not suspecting that high-yield bonds have an incidental, but potentially valuable use as a business-cycle indicator.

Mark Gertler of New York

University and Cara Lown of the Federal Reserve Bank of New York show that the spread between the yield on high-yield bonds and the riskless rate of interest has considerable predictive power. Indeed, it outperforms other leading indicators including the term spread and the Federal Funds rate. [*"The Information in the High Yield Bond Spread for the Business Cycle." Apply to authors for copies.*]

TAXING CIGARETTES

Who really pays cigarette taxes? More to the point, now that Big Tobacco is on the run, does anybody really care?

Tobacco has been Public Health Enemy Number One for a more than a decade. Yet the financial consequences of the attack on cigarette makers are still far from clear. William Evans and Diana Stech of the University of Maryland, along with Jeanne Rangel of Louisiana State, offer the most serious analysis to date – and their conclusions are disturbing.

For starters, they estimate that every dollar of excise tax increase on tobacco costs the tobacco company stockholders just eight cents. The bulk of the tax – and by implication, the cost of legal settlements in the liability cases – is passed on to smokers in the form of higher cigarette prices.

The people paying those higher taxes, moreover, are an unfortunate lot to begin with. For while just 19 percent of American adults in the top quarter of the income distribution still smoke, 32 percent of those in the bottom quartile are puffing away.

The one saving grace in taxing away the spare change of folks who make $10,000 a year is that the revenue from tobacco taxes offsets costs borne by society as a whole. Actually, earlier estimates had suggested that these "externalities" were modest – and that smokers saved the rest of us a lot of money by dying before they got their share of Social Security pension checks. But Evans and company redo the numbers to include the cost of smoking by pregnant women on their unborn children. And the figure is arguably high

Dreaming About Economic Mobility

Wage equality has risen sharply over the last quarter century, with virtually all the gains from economic growth going to those with marketable skills. Up with computer programmers; down with hamburger flippers. But to many conservatives, inequality driven by the labor market is not a significant problem as long as those hamburger flippers can spend their nights at community colleges learning UNIX.

But do they? The news on that front has been fairly grim. And the latest serious research, by Moshe Buchinsky of Brown and Jennifer Hunt of Yale, doesn't make the picture any brighter. Using 1979-91 data from the National Longitudinal Survey of Youth, they find very little mobility across quintiles of the wage distribution.

Buchinsky and Hunt do identify significant movement within income groups: inequality is cut by 12 to 26 percent when measured over a four-year horizon. But even here the glass is half full. Mobility fell through the 1980's, especially at the low end of the wage distribution. [*"Wage Mobility in the United States," Review of Economics and Statistics, August 1999.*]

enough to rationalize socking it to the poor. [*"Tobacco Taxes and Public Policy to Discourage Smoking" in Tax Policy and the Economy, edited by James Poterba, Issue 13. National Bureau of Economic Research.*]

MORE ABOUT CIGGIES

Are workplace bans on smoking a clever minimalist use of regulation to reduce smoking? Or are they just a way to make life miserable for nicotine addicts?

A neat new paper by William Evans and Edward Montgomery of the University of Maryland and Matthew Farrelly of the Center for Economics Research at the Research Triangle Institute suggests the former. They used survey data to estimate the impact of workplace bans on smoking, and got surprising results. The bans apparently have reduced smoking by people with jobs by 5 percent – and cut workday smoking among those who have stuck by the habit by 10 percent. Those are huge numbers. Indeed, they would explain virtually the entire decline in smoking among the working population over the last 15 years.

One explanation, of course, is that people who find it easy to quit are more likely to take jobs in smoke-free workplaces. But the authors use solid statistical techniques to rule out that possibility.

Making smoking difficult without making it illegal seems to have had a remarkable impact. Any prospect that similar techniques could replace fines and jail-time in limiting the use of illicit drugs – namely marijuana? [*"Do Workplace Bans Reduce Smoking? American Economic Review, September 1999.*]

Democracy Pays

Wages, explain economists, are determined by labor productivity. Not quite, reminds Dani Rodrik of Harvard's Kennedy School of Government: Political and social institutions also influence rates of pay. Why else do American workers, who are six times as productive as their Mexican counterparts, earn fully 12 times as much?

In this provocative article, Rodrik tests the statistical links between democracy and manufacturing wage rates across 138 countries and finds them surprisingly strong. In the case of Mexico, for example, he estimates that wages would be 25 to 30 percent higher if Mexico were as democratic as the United States.

The big question is why. Rodrik believes (with some evidence to back him up) that democracy improves the bargaining position of labor, allowing workers to shift economic surpluses from profits to wages. It is possible, however, that bargaining power leads to economic inefficiency, reducing total output and benefiting some workers at the expense of others. If this sounds suspiciously like the chronic debate over the minimum wage, give yourself an "A" for acumen. [*"Democracies Pay Higher Wages," Quarterly Journal of Economics, August 1999.*]

THE PRICE OF FALLING PRICES

Just a few years ago the word "deflation" was not in the popular vocabulary. Today, with inflation slipping below 2 percent and Japan perhaps trapped in a downward spiral that looks eerily like the Great Depression, the idea that expectations of falling prices could disrupt the economy is no longer so easy to ignore.

But how could the opposite

of that great modern evil, inflation, be so bad? J. Bradford Delong of the University of California at Berkeley explains. Interest rates can always adjust to a world of rising prices. But it is impossible to lower the nominal rate of interest below zero. So the real interest rate can skyrocket in the face of falling prices, punishing investment and reducing aggregate demand. What's more, deflation transfers wealth from debtors to creditors, most likely increasing wealth inequality. And it can sharply reduce the value of the collateral that backs loans, undermining the stability of the banking system. Think Japan.

It is still widely assumed that deflation is a very unlikely prospect for the United States. But Delong points to vulnerabilities in our defenses: the vast amount of air in our inflated stock market; the difficulty in using monetary policy, with its long lags between cause and effect, to fight deflationary expectations. Read it and worry. [*"Should We Fear Deflation?" Brookings Papers on Economic Activity, Volume One, 1999.*]

STEADY AS SHE GOES

Everybody knows that the American economy has been growing since 1991. Almost as remarkable, the quarter-to-quarter volatility of GDP has been exceptionally low all the way back to 1984. Margaret McConnell, Patricia Mosser and Gabriel Perez Quiros, economists at the New York Fed, break down the components of output to see what has changed. And the big differences, it turns out, are in the volatility of inventory investment and consumer spending.

Is the change permanent? Certainly the unwillingness of cost-conscious businesses to invest heavily in inventory won't change anytime soon. And, most likely, increases in the efficiency of capital markets have reduced the impact of interest rate changes on residential construction are here to stay. Thus it seems possible that the Goldilocks economy is inherently less susceptible to the business cycle. [*Current Issues in*

One Big, Happy Hemisphere

The Free Trade Area of the Americas, you probably do not remember, was launched at the Miami Summit of the Americas in December 1994. Three and a half years later, in Santiago, the same group of 34 countries reaffirmed its commitment to a regional free trade area. But the hard part – negotiating the nuts and bolts of an agreement that has a prayer of being accepted back home – has hardly begun.

Jeffrey Schott and Gary Hufbauer of the Institute for International Economics assess the chances of getting something done any time soon. While they make a bow to the fashionable pessimism that emphasizes the difficulties of integrating low-income countries into a regional trading system dominated by the United States, they are surprisingly upbeat. They outline a plausible path for getting from here to there. And they emphasize the importance of the process, independent of the result – for the prospect of regional integration could be a strong motivator for Latin economies transforming their state-dominated economies into free market systems. [*"Wither the Free Trade Area of the Americas?" The World Economy, August 1999.*]

Economics and Finance, Sept. 1999; download free from http://www.ny.frb.org/rmaghome/curr_iss/1999.html.]

BRING ON THE CARBON DIOXIDE

Two years ago at Kyoto, environmental lobbies won a commitment from Europe, the United States and Japan to sharply reduce emissions of greenhouse gases. Global warming, the argument ran, was a clear and present danger that required immediate remedial action.

But Robert Mendelsohn of Yale isn't so sure. Recent changes in the projected impact of warming, he reckons, "are so dramatic that it is not clear whether the net economic effects from climate change over the next century will be helpful or harmful."

So, what has happened to turn the conventional wisdom on its head? For one thing, ecological modeling is now incorporating the positive impact of carbon on agricultural productivity as well as the negative impact of heat stress and more extreme weather on farm output. For another, parallel efforts at modeling the economic effects are becoming more sophisticated, incorporating adaptive behavior that offsets some of the adverse consequences of changes in atmospheric temperature.

The bottom line, suggests Mendelsohn, is that the politics of carbon control are about to become more complicated. The near-consensus for aggressive remedial action by the rich nations is likely to fray. And some developing economies, which have generally opposed efforts to curb emissions, may find that their interests really do lie in collective action.

Of course, yet more research could turn the debate once more. And it seems clear that for at least another decade or two, policy will have to be made in the absence of certain knowledge of the consequences. Anyone for Russian roulette? [*"The Greening of Global Warming," American Enterprise Institute Press. To order, go to www.aei.org.*]

— *Peter Passell*

Defending the Evil Empire

Go ahead, confess.* If you've been following the Microsoft antitrust trial, you've been delighted to watch the software giant take its licks. Who, after all, hasn't been frustrated by the bugs in Windows? And who isn't just a teeny, weeny bit jealous of Bill Gates and his billions?

But not all is fun and games here. If Microsoft is forced to change its aggressive ways, the case could have enormous impact on the market for software. In particular, it could spell the beginning of an era of far greater Government involvement in markets for information technology products – one in which the prevalence of economies of scale and network externalities effectively leave the Government in the position of picking winners.

David Evans, a senior vice-president at NERA, the economics consulting firm working for Microsoft, lays out the argument that the Justice Department has blundered into a battle that shouldn't be taking place. And in the process, he offers a quick and easy tutorial on the economics of the software market. [*"Pick an Argument – Any Argument: The Government's New Economic and Legal Theories in U.S. v. Microsoft," in Regulation, Issue 3, 1999.*]

*While we're all confessing, I should note that I'm a consultant to Microsoft — *PP*

For most Americans social insurance brings to mind Social Security and Medicare for the elderly, and much of the recent public debate has focused on the financing problems those two programs face down the road. The scope of this book is much broader. Michael Graetz and Jerry Mashaw, both law professors at Yale, are concerned with the whole system of insuring against adverse economic outcomes from cradle to grave. Thus, under the rubric of social insurance they include programs aimed at protecting the economic position of children, insuring against unemployment and disability during the working years, providing income in retirement and insuring everyone against illness.

In the first part of the book – the part excerpted in this issue of *The Milken Institute Review* – the authors tackle the philosophical underpinnings of social insurance. They define social insurance as the moderation of the risks of income loss, and ask how we should we divide responsibility for insuring against economic risks between families and the collective. These risks are diverse, but in many respects predictable on the basis of age, social position or genes. Thus, for the more fortunate, individual savings, inheritance and private insurance will usually offer a cheaper, more attractive option.

Even if we mandate universal coverage, is it enough that individuals are allowed to arrange their own coverage – thereby excluding the disadvantaged or those with risks greater than their own? How should we chose between systems of "community rating," in which everyone is assigned the same risk and premium charge, and "experience rating," in which all the available information is used to divide individuals into risk classes?

The latter is attractive as a means of reducing the "moral-hazard" element of insurance because it encourages the efficient use of resources and because it seems only reasonable that those who use more of a service should pay more. Non-economists, however, tend to view efforts to sort out risk as unfairly penalizing individuals for personal characteristics that are often beyond their control. And they tend to be less impressed with the incentive effects created by price differences – as in, "people won't stop smoking in order to obtain cheaper health insurance."

Graetz and Mashaw raise these issues, but they don't really provide new answers. Instead, they argue for a system of universal insurance, but recognize that the risks are too diverse to be met by a single, comprehensive program.

BARRY BOSWORTH is a senior fellow at The Brookings Institution.