

Globalisation's threat to the welfare state

There is rising public concern in many advanced economies that whatever its benefits, globalisation exposes households to formidable new threats. Firms under pressure from fierce foreign competition may be quicker to lay off staff when they become too expensive, while free movement of capital across the world means that industries may expand and contract more quickly than in the past.

One response to these risks is for governments to redistribute more effectively from the lucky to the unlucky; and to shore up the welfare state to ensure that it insulates citizens from the vicissitudes of globalisation.

Using data from more than 100 countries, CEPR Research Fellow **Giuseppe Bertola** argues in a new paper that there is also an alternative solution: fostering free financial markets, so that individuals are able to protect themselves from unexpected shocks.

The make-up of welfare states varies throughout the world, but they have traditionally supported citizens by providing education to children and young people; pensions for the elderly; and perhaps some collective insurance against periods of joblessness. However, if global market integration brings more rapid industrial change, it may render this model increasingly costly and out-of-date, as re-training throughout working life becomes more important, and labour markets potentially become more volatile.

Not surprisingly, workers in many post-industrial countries have tended to view globalisation with suspicion and even fear; and politicians have responded either by trying to hold back the tide through protectionism, or promising more financial help to those who lose out through globalisation. US economists Joseph Stiglitz and Paul Krugman, for example, have both called for more progressive taxation to offset the harsh impact of global integration on America's poor.

Bertola argues, however, that globalisation unfortunately not only increases public demands for social protection from citizens who find themselves

exposed to a fast-changing international economy - it also makes it harder for governments to provide it.

Raising taxation to pay for enhanced redistribution is more difficult when footloose firms can shift their investment overseas when their costs rise, he argues.

Meanwhile, the option of hiring workers from overseas undermines the strength of labour market institutions such as collective bargaining, which have long been crucial elements of social protection in some economies. In Germany, for example, even traditionally powerful unions have been forced to swallow painfully tight wage deals in recent years, in the face of the threat that firms will simply shift production to Poland or the Czech Republic.

At the same time, increased cross-border migration also erodes governments' ability to construct a coherent social safety-net around their citizens.

Generally, greater global financial integration means that any attempt by national governments to protect workers through higher taxes or subsidies, or to regulate the labour market more closely, can potentially trigger a greater market response.

Paradoxically, then, globalisation makes social protection at the same time more painfully needed, but more difficult to provide. Given this challenge, Bertola argues that financial markets have an important part to play. They can never successfully insure citizens against all the risks they may face, but they can help individuals to smooth consumption throughout their lifetime and to build up some protection against rainy days.

Bertola tests these intuitions about the complex connections between globalisation and the welfare state by examining data from more than a hundred countries, spanning the period 1990-2003. He uses imports and exports as a proportion of GDP to indicate the openness of an economy to international trade. He then analyses the relationship between the openness of an economy, and the size of the government spending as a proportion of GDP. He also measures how developed the financial markets are, using the

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availability of consumer credit as a proxy.

As he predicts, the data show that it is not simply the case that more open economies naturally develop a more full-blooded welfare state to protect citizens against the chill winds of globalisation.

In fact, he says, where credit markets are more developed, governments are less likely to have responded to globalisation by increasing public spending. Bertola suggests this implies that social spending and capital markets can act as partial substitutes for each other.

Higher public spending becomes less necessary where citizens are better able to protect themselves, by taking out insurance or by borrowing money to tide themselves over when times are hard. And at the same time, globalisation makes market solutions all the more

important, because governments' ability to use traditional welfare state approaches is reduced.

It is difficult to disentangle cause and effect, but Bertola's analysis suggests that in times of rapid market integration, it will be especially crucial for governments to oversee the development of open, efficient financial markets, instead of stepping up redistribution.

Without this focus on free market solutions, Bertola argues, globalisation itself could in the end be vulnerable to an explosive political tension between the growing risks to which workers are exposed and the diminishing power of governments to protect their own citizens.

DP 6480 Finance and Welfare States in Globalising Markets by Giuseppe Bertola

Making a hash of their education?

Pot-smoking teenage dropouts are a familiar social stereotype, but academic research confirms that cannabis use has a direct impact on the levels of education young people achieve. A new paper, by CEPR Fellow **Jan C van Ours** and co-author **Jenny Williams**, takes a more detailed look at this problem, and reveals that the younger a cannabis-user takes up the habit, the more seriously it will go on to damage their education.

A number of researchers have analysed the connection between cannabis use and educational outcomes, and found that children who smoke the drug during high school end up cutting short their education, by on average between 0.2 years and one year.

Since the number of years of education someone receives is a key determinant of how well they are likely to fare in the job-market, understanding how drug use affects schooling is important in showing how cannabis can change someone's life-chances. It is also helpful in determining how governments should best design their anti-drug policies.

Van Ours and Williams carry out two analyses: first a standard instrumental variables estimation, which helps to separate out cannabis smoking from other causes of education being cut short; and second a new approach of constructing an econometric 'bivariate duration' model, which allows them to analyse the impact of different causal factors, over time.

The authors use the results of a large 2001 study carried out in Australia – the Australian National Drug Strategy Household Survey – to carry out their two analyses. The survey asked more than 26,000 people

about whether they had ever used cannabis; when they first used it; and their educational achievements.

The authors narrow down the sample to those people who can reasonably be expected to have completed their education already – those between the age of 25 and 50, who are no longer currently studying. This group includes 4,912 men and 6,881 women.

Simply by looking at the bald results of the survey, without analysing them, cannabis appears to have some impact: for men, 43% of non-users of cannabis had not completed high school; while for users, the figure was 47%. Among men who began smoking cannabis before the age of 15, the effect was even more pronounced: 57% had not gone on to complete a high school education.

However, carrying out an economic analysis helps to exclude the risk that what the survey results are picking up is simply correlation, not causation: because the kind of young person who takes up cannabis may also be likely to drop out of school at a earlier age, for example.

The analytical approach also helps to exclude the risk of reverse causation: perhaps a young person drops out of school because they are not very bright, for example, and then takes up cannabis smoking because they have plenty of free time, unsupervised by adults.

In their instrumental variables approach, the authors use a range of variables, including whether the respondents are Australian born; whether they live in an urban or rural area; whether they are cigarette smokers; and which Australian state they live in.

Their findings support the outcomes of other studies,

suggesting that early use of cannabis – by the age of 15 – cuts short education by an average of 1.2 years. Intriguingly, the analysis suggests that for girls, there is a risk of underestimating the impact of cannabis, because the factors that make early take-up of the drug more likely are also those that make girls more likely to complete their education.

In their second analysis, using the bivariate duration model, van Ours and Williams' findings confirm that the earlier a young person takes up smoking cannabis, the worse the subsequent impact on their education is likely to be; and the results are worse for girls.

For men, starting to smoke the drug at age 15 reduces the likely number of years they will spend in education by 0.8 years. Taking it up after 17, on the other hand, has no harmful impact on education at all.

For girls, taking up the drug at 15 shaves an average 1.2 years off the duration of their schooling; and taking it up at 13 cuts their education by 1.7 years. For girls, the age at which they can safely take up cannabis without it having any ill effects on their education is later, at 19 years.

Previous studies have shown that cannabis smokers who take up the drug at a younger age are likely to use the drug more heavily, and to smoke it for longer – and the authors suggest this may help to explain the more damaging effect of earlier take-up on educational outcomes.

Given the prevalence of cannabis-use among young people as revealed by surveys around the world, the authors point out that in many countries, up to half of young people may be having their education cut prematurely short as a result of taking the drug. That suggests a renewed government onslaught on the problem could be worthwhile; and in particular that attention should be focused on preventing younger children from taking up the drug: because – as parents probably instinctively suspect – the younger they start, the worse the impact will be in the future.

DP 6449 Why Parents Worry: Initiation into Cannabis Use by Youth and their Educational Attainment by Jan C van Ours and Jenny Williams

Doha – getting to yes

Just weeks after the suicide attacks on New York in September 2001, trade negotiators from all over the world gathered in the Qatari capital, Doha, to kick-start an ambitious and optimistic round of negotiations, with the promise of helping to deliver prosperity to developing countries – and cut terrorism off at its source.

Six years on, after a series of dramatic bust-ups and many months of confrontational to-ing and fro-ing, the Doha Development Agenda still looks a long way from what the authors of a new CEPR Discussion Paper call, 'getting to yes'. CEPR Fellows **Bernard Hoekman** and **David Vines** use bargaining theory to show just what a difficult task the WTO's 151 member-countries have set themselves, and explore some potential ways out of the current impasse.

Bargaining theory, as developed by John Nash, helps the authors to identify the hurdles that will have to be overcome in 'getting to yes'. Instead of a zero-sum game, trade negotiations like the Doha talks involve 'positive sum bargaining': it should be possible to come up with an agreement that generates net gains for all the participants.

The theory suggests the outcome will depend on three factors: the 'threat point' of each member-country – their best alternative outcome if no agreement is made; the 'negotiating set' – the list of issues under discussion;

and thirdly, of course, the respective bargaining power of each of the players.

As well as bargaining with their counterparts from other countries, trade representatives also have to negotiate with different interests back at home to ensure that any deal can secure domestic political support – another constraint on the shape of a feasible settlement.

In addition, many countries are members of overlapping coalitions. The G33 is a group of countries, including India, with large subsistence farming sectors, which fights to be allowed to retain some protection against a flood of agricultural imports, for example; while the G20 represents the big agricultural exporters such as Argentina. Thus many parties in the talks have to bargain over common positions within the groupings they belong to, as well as defend their individual interests in the talks.

In game-theory terms, these extra layers of complexity mean that the Doha Round is a multi-level game. This framework helps Hoekman and Vines to identify a number of problems that have dogged the talks throughout their six years.

One challenge is to assemble the constellation of domestic interests needed to support a deal. Over the years, with the WTO and its predecessor the GATT, and through unilateral action by many countries, much

liberalisation has already been achieved, especially in goods trade.

The big prize left for a Doha Round, Hoekman and Vines argue, would be a lowering of agricultural tariffs in the rich, OECD countries - many of which still give their farmers generous protection. But while the farm lobby against such concessions remains fierce, other industry groups - which might normally be expected to form a pro-free trade bloc - feel they have little more to gain from tariff reductions in developing countries.

To complicate matters further, in the years since the last round of WTO talks was completed, many countries have liberalised much more than their WTO commitments require. Actual tariffs are often much lower than the 'bound' tariffs mandated by the WTO, and that means quite large tariff-reductions could be agreed to as part of the Doha talks, without making any practical difference on the ground - or generating any benefits for exporting countries that might be expected to join the political clamour for a deal.

Hoekman and Vines point out that even 'binding' existing tariffs - making them legally enforceable by the WTO - would be an important achievement, because it prevents countries unilaterally reversing some of the liberalising moves they have made in recent years; but in a decade of rapidly-growing world trade, industry has become complacent about the likelihood of a fresh wave of protectionism.

The scope of the 'negotiation set' in the Doha round has created another problem. Some groups of countries - particularly the EU - have been determined to try to extend the WTO's mandate beyond its traditional role of tackling tariffs and other forms of discrimination at national borders, to encompass so-called 'behind-the-border' issues, such as domestic regulations governing foreign investment and competition policy.

The political contentiousness of these so-called 'Singapore issues' became painfully clear at the WTO summit in Cancun, Mexico, in 2003, when developing countries walked out rather than discuss them, and the talks collapsed.

Hoekman and Vines argue that attempts to widen the WTO's negotiation-set are also a mistake, for practical reasons. Once domestic regulations are involved, a much wider group of stakeholders - way beyond trade ministries - need to be involved in negotiations; and the trade-offs become fearsomely complicated.

Moreover, unlike the WTO's traditional competence in tariff barriers, these broader regulatory issues cannot be traded off against one another in an incremental way - 'I'll cut my agricultural tariffs by 10%, if you cut your manufacturing tariffs by 20%', and so on.

Hoekman and Vines also identify another problem with the 'negotiation-set': the talks were called a 'development round' because of the perceived importance of using trade to tackle poverty. Pascal Lamy - then EU trade negotiator, and now WTO director-general - suggested developing countries should receive a 'round for free', being excluded from making concessions on market access.

The notion of a development round has been formalised in two principles: 'special and differential treatment,' meaning developing countries will not be asked to make such deep cuts in tariffs as the WTO's richer members; and 'special products' meaning they will have to carry out only limited liberalisation for particular goods.

Hoekman and Vines argue that this approach is seriously misguided, and in reality will not help development. Allowing opt-outs to specific countries 'hollows out the principle of non-discrimination' that has been central to the WTO from the outset. It also makes it almost impossible to ascertain the outlines of a 'fair' deal: if developing countries are not being asked to give anything, how can anyone determine what it is reasonable for them to demand?

Instead, Hoekman and Vines argue that developing countries should be full negotiating partners, offering tariff reductions on a quid-pro-quo basis with developed countries; but aid-for-trade should be used, to ensure that they can take full advantage of the new markets that open up as a consequence of any deal. Importantly, they argue that WTO members have to accept that trade alone simply cannot deliver development.

Earlier this year, the chairs of the two major WTO negotiating committees in Geneva - Crawford Falconer for agriculture, and Don Stephenson for non-agricultural goods - issued discussion papers which sketched the outlines of a potential deal.

Hoekman and Vines argue that the deal as envisaged is still worth fighting for: it would reduce agricultural tariffs to around 10% in OECD countries; and cut goods tariffs to around 10% in developing countries. But if the Doha Round is to succeed, they say, the WTO must be allowed to stick to its original role of providing a forum for countries to bargain about the barriers to foreign goods and services at their borders; and ensuring that the global trading system is transparent, and fair. That is a tough enough task in itself.

**DP 6458 'Multilateral Trade Cooperation: What Next?'
by Bernard Hoekman and David Vines**

One pillar or two?

In a pair of new papers, CEPR Research Fellow **Michael Woodford** attacks two widely-held tenets of current thinking about monetary policy – the idea that financial integration leaves central banks powerless in the face of global developments; and the insistence of the European Central Bank that money-growth matters in setting interest rates.

In August 2007, when it might have seemed that central banks were at the mercy of the financial turmoil sweeping through markets across the world, Mervyn King, the governor of the Bank of England, insisted he still had firm control of domestic inflation. 'Zimbabwe has demonstrated very clearly that if you want to have a high inflation rate, boy can you have one. And I could produce that here too if anybody was foolish enough to ask us to do it,' he said.

Woodford provides a firm theoretical footing for King's claim in the first of his two papers, by taking aim at the popular idea that globalisation has eroded the power of central banks; and inflation is no longer simply 'made at home'.

It has become commonplace to talk about 'global liquidity' and 'global slack,' as if central banks must now approach monetary policy-making in a completely different way. However, Woodford carries out a painstaking analysis of these concepts, using a New Keynesian model of the economy, and shows that they reflect a misunderstanding about the linkages between global developments, and domestic inflation.

He finds that globalisation does mean key relationships in the economy – between a given level of interest rates and the level of aggregate demand, for example – can be altered by outside events. That does not mean, however, that raising interest rates will suddenly make no difference, leaving central banks impotent in the face of global integration.

In the paper, Woodford models separately the effect of integrating goods markets, financial markets and labour markets on inflation, and the impact of changes in interest rates. Even when he assumes a much more radically integrated global economy than we have today, however, he finds no evidence that central bankers' powers will suddenly ebb away.

In fact, in some cases, the logic is the reverse of what the 'global liquidity' argument would suggest. For example, loose monetary policy abroad might tend to lead to a cheaper currency, cutting the costs of foreign goods, and eating into the market for domestic goods, and hence into domestic demand. So lower overseas interest rates might actually slow the domestic economy, rather than creating excess 'global liquidity'.

Woodford argues that monetary policy abroad might affect the level of demand for a given level of interest rates at home; but it doesn't mean that shifting interest

rates is suddenly a useless tool. As King put it, 'does anyone believe that if we changed interest rates to 50% per cent it would have no noticeable effect on the economy?'

Woodford rides into another, more technical dispute about the conduct of contemporary monetary policy in a second recent paper. He examines the European Central Bank's controversial 'two-pillar' system of analysing economic developments – and dismisses it as unnecessary.

The ECB's first pillar is the standard economic analysis conducted by all inflation-targeting central banks; but it supplements this with a controversial 'second pillar,' which involves monitoring movements in the money supply.

In recent years, the ECB's approach has received backing from economists, including Stefan Gerlach, who argue that while in the short run the empirical relationship between money-growth and inflation is variable, in the very long run it always holds. This leads to the argument that a single model cannot explain both the short-term fluctuations of inflation – determined by short-run factors such as changes in prices and wages – and the longer-term correlation between money-growth and inflation.

Gerlach suggests that this problem means central banks should use a 'money-augmented,' or 'two-pillar' Phillips curve to analyse inflation, instead of a single, unified approach. Estimates of the output gap are used to predict short-run inflation, while money-growth is used to forecast the long-run.

In his paper, however, Woodford attacks the empirical argument that the relationship between the money-supply and inflation is so robust over the long-term – even across centuries – that it gives central banks a strong enough reason to keep it under control, even if it has little explanatory power in the short-run.

Woodford argues that using a standard New Keynesian model of the economy, he can predict the long-run, or low-frequency relationship between money-growth and inflation – without having to assume there is any causal link involved. There is a stable relationship between money and demand in the economy, built into his model; but it is not a causal one.

This approach can explain many of the empirical findings – such as comparisons between long-run moving averages of money-growth and inflation – that have been used to support demands for a second monetary pillar. Woodford carries out a detailed series of economic simulations, based on his model, and generates long-run correlations between monetary growth similar to those found in empirical studies of the euro-area – without having to assume any causal link.

He argues that these results suggest that a single model – and one monetary pillar – is enough; and the ECB should simply abandon the second pillar, which it only adopted at the outset because monetary analysis was at the heart of the respected German Bundesbank's approach, and the fledgling bank in Frankfurt wanted to stress its hawkish credentials.

DP6447 'Does a "Two-Pillar Philips Curve" Justify a Two-Pillar Monetary Policy Strategy' by Michael Woodford

DP6448, 'Globalisation and Monetary Control' by Michael Woodford

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