CEPR Bulletin
JULY 2007

Reality check

In St Petersburg, in July 2006, amid the mutual back-slapping of the annual G8 summit, the leaders of the world's leading economies agreed to make whatever concessions were needed to achieve a successful conclusion to the Doha Round of global trade negotiations, which had already dragged on for five years. Just a week later, a despairing Pascal Lamy, director-general of the World Trade Organisation, officially suspended the talks, amid furious finger-pointing and name-calling by those very same countries.

Talks have since resumed, but the gap between the bonhomie of world statesmen and the bitter recriminations at the WTO's headquarters in Geneva underlined the enormity of the task of finding common ground among 150 fractious member states, each with its own commercial interests to defend. In a series of three CEPR Discussion Papers, **Simon Evenett** argues that the EU should seize on the faltering of the Doha Round as an ideal opportunity to re-think its trade policy.

For about 40 years, from the signing of the Treaty of Rome until the mid-1990s, Europe and the United States were the undisputed giants of the global market, and the give-and-take between them shaped world trade flows and dominated debate in GATT, the forerunner of the WTO.

Since the mid-1990s, however, the EU and US have had to adapt to a much more confusing economic landscape, with new powerful trading countries - in particular, China, Brazil and India - seeking to flex their political and commercial muscles.

Evenett uses a close examination of the halting, acrimonious progress of the Doha Round, launched in 2001 and still not completed, to uncover some of the political and economic interests that govern this 'multipolar' trading system. He argues that EU policy will have to be reformed fundamentally to adjust to this new world.

Europe is still the world's largest exporter, and second-largest importer - $3.6trn of goods and services crossed its borders in 2005 - yet Evenett argues that the trading bloc has had little success in pursuing its interests - and winning arguments - at the WTO.

Most spectacularly, the 2003 Ministerial meeting in Cancun collapsed in acrimony after EU Trade Commissioner Pascal Lamy (now the WTO's director-general) tried to insist that negotiations include the so-called 'Singapore Issues,' stretching far beyond the WTO's traditional remit of tariffs and quotas, to cover domestic rules on intellectual property, investment, trade facilitation, competition and the environment.

Developing countries vehemently disagreed with this widening of the WTO's remit, and - in a 150-member organisation in which every country has a veto - they showed their new-found power by walking out. More than three years later, the Doha Round has still not been completed.

As the talks have foundered, Peter Mandelson, EU Trade Commissioner, has already signalled a shift in policy. Last autumn, he published a document outlining the EU's future trade priorities. These included a new dash to secure bilateral deals with fast-growing Asian economies, including India; and a return to the pro-business, commercial focus that pre-dated Lamy's push for the WTO to take on environmental and other standards.

Evenett argues strongly that the emphasis on bilateral trade deals is a mistake. He believes the rewards to be won in these one-to-one negotiations will be paltry. China and Japan, Asia's two largest trading powers, are not on Europe's shopping list. The countries that are in Mandelson's sights, including India, have little history of undertaking radical trade liberalisation as a result of bilateral deals: they have always done so unilaterally. Where other countries have sought bilateral agreements with India, it has been essentially defensive, arguing for hundreds of exceptions to tariff reductions.

Over time, then, Europe may have to accept that the prospects for further liberalisation lie in multilateral, not bilateral, talks. Making these succeed will require a better understanding of where the interests of China, India and Brazil lie, including how political pressures at home affect their trade policies.

Examining the troubled evolution of the Doha Round helps Evenett to probe these issues. For example, Mandelson - whose mandate is set by Europe's Council of Ministers - has been tightly constrained by a

IN THIS ISSUE

Reality check •
For a few dollars more •
Don't blame it all on globalisation •
Regression to the mean •

protectionist bloc of countries, led by France, as to how much more he can give away in reforms to the Common Agricultural Policy. Yet Evenett argues that it took some years for other powers, such as Brazil, to understand and accept Mandelson's tricky position and calibrate what they were willing to give in return.

In future, trade negotiators will need to learn the lesson that unless they understand the domestic political pressures tying the hands of their interlocutors, they will never find a mutually acceptable agreement. Evenett suggests that trade ministers may put too much emphasis on the warm words of their counterparts from other countries at face-to-face meetings, and not enough on diplomatic intelligence about opinion back home.

Another lesson that could be learned from the suspension of the Doha Round is how little many countries seemed to believe they had to gain. Evenett argues this may be partly because of the gap between the 'bound' tariffs set in stone by the WTO during the last trade round, and the actual barriers applied by countries today. Since many have unilaterally lowered tariffs much farther than the WTO obliges them to, signing up to an agreement to make a certain percentage cut in the 'bound' tariffs will have a far smaller impact in practice.

This process of country-by-country liberalisation may also have lulled many WTO members into believing they will continue to win from global trade, without the need for another multilateral deal. Evenett points out that major nations or trading blocs have seen their exports expand by an average of 10% a year since 2000 - hardly a predicament which would compel politicians to make new sacrifices.

Despite these hard lessons, which raise questions about the prospects for renewed multilateral trade liberalisation, there may be areas where Europe can make common cause with the new trading powers in the years ahead. Evenett points out, for example, that China and India set great store by the fortunes of their multinational companies, promoting them as national champions and identifying closely with their successes.

Securing fair access to overseas markets for these firms - including the right to buy up companies anywhere in the world - is likely to be high on China and India's agenda, as exemplified by the fact that when India's Mittal Steel was seeking to take over its European counterpart Arcelor, the prime minister reportedly raised the issue with French President Jacques Chirac.

This is exactly the kind of issue Europe has sought to tackle, with its focus on drawing up new global rules and dismantling the so-called 'non-tariff barriers' which can make international trade tough, even where tariffs are already low.

Expanding this rules-based approach will not work where it is not in the commercial interests of China, India and Brazil, however. On tightening labour standards, for example, the developing countries have little to gain and much to lose. Evenett says Europe may simply be forced to accept that other levers - such as pressure through the International Labour Organisation, or through conditions on overseas aid - may be a better way of tackling these issues than through tit-for-tat trade negotiations.

The world's great trading powers blundered into the Doha negotiations, in the wake of the September 11 attacks on America, with little idea of what they meant by a 'development round', little sensitivity to each others' interests or the political mood back home, and wildly differing ideas of where they might end up. Europe - still the world's biggest exporting bloc - will have a place at the WTO's top table for many years to come, but if it is to exploit that influence to the benefit of European businesses and consumers, it will have to develop a much better understanding of where the commercial and political interests of China, India and Brazil really lie, and shape its own ambitions and strategies accordingly.

CEPR DP6282 What Can Researchers Learn from the Suspension of the Doha Round Negotiations in 2006? by Simon Evenett

CEPR 6283 The Trade Strategy of the European Union: Time for a Rethink? by Simon Evenett

CEPR DP6284 EU Commercial Policy in a Multipolar Trading System by Simon Evenett

For a few dollars more

While go-getting Americans slave away for faceless corporations sixty hours a week before slumping exhausted into bed, their European cousins manage to fit their careers around civilised lunches, siestas and long vacations. It's a cliché, but like many caricatures it has some basis in fact. The number of hours worked per employee has fallen substantially in Germany, France, Italy and Spain since the 1970s, while in the US it has remained roughly the same.

Social scientists have come up with many explanations for the differences in working practices on either side of the Atlantic, but many of them come down to culture: Europeans, the argument goes, simply value their leisure-time more highly.

A new CEPR Discussion Paper challenges that received wisdom. CEPR Research Affiliates **Claudio Michelacci** and **Josep Pijoan-Mas** show that, given the diverging developments in the US and EU labour markets over the past 30 years, European workers do not need to have a special attachment to their summer holidays to justify opting for a shorter working week than Americans, and US employees have equally valid reasons for staying late in the office.

Working more hours obviously has a short-term benefit: it brings in higher wages. Traditional analyses of the decision about how many hours to work tend to focus on this short-term trade off between earning an extra few dollars (or euros) and enjoying another hour's leisure.

The insight at the heart of Michelacci and Pijoan-Mas's paper, however, is that the number of hours an employee chooses to work can also have longer-term effects. Workers who put in more hours are likely to become more productive - and to mark themselves out as ripe for advancement. Presented with a number of candidates with similar skill-sets, a manager may be more likely to promote the one who has put in the most hours.

The authors confirm this basic intuition - that working more hours tends to increase future earnings - with data from the US and Germany. They then use this insight to examine trends in labour markets on both sides of the Atlantic since the 1970s. In general, wage inequality - including between workers with similar skill-levels - has increased considerably in the US. In the EU, meanwhile, unemployment has tended to be higher.

These two differences are directly relevant to an employee's decision about how many hours to work. Where wage inequality is greater, particularly at similar skill-levels, there is more of an incentive for staff to put in extra hours: it is more worthwhile financially for them to distinguish themselves from other workers, and compete for promotion, or a better-paid job in another organisation. In other words, the returns to hard work may be higher than in an economy with a less equal wage structure.

Second, where unemployment is higher, and the duration of periods of unemployment tends to be longer, the benefit of those extra hours in the office is less likely to seem worthwhile working for. The higher the probability of a worker losing their job, the less worthwhile it will be for them to be stuck in the office for 50 or 60 hours a week: all their hard work may prove to have been for nothing, if they end up unemployed.

In the US, then, where wage inequality is greater, there are much bigger prizes at stake for the workers who are willing to distinguish themselves by working for more hours, and becoming more productive at their jobs. The authors suggest this may explain the fact that the number of Americans working very long hours - more than 50 a week - has actually increased in recent years, after declining for a long period.

More importantly, they calculate that these two factors - wage inequality, and the probability of becoming unemployed - can entirely explain the differences in the evolution of patterns of working hours in Europe and the US over the past 30 years. Europeans have been responding - entirely rationally - to the fact that extra hours may be rewarded with redundancy, rather than promotion, and even if they win a step up the hierarchy, they will not be proportionately as well-rewarded as their American cousins. In the US, meanwhile, employees have reacted - again, entirely rationally - to the fact that labour markets are tight, competition is fierce, and the gains to be won from a jump up the career-ladder can be immense.

This balancing act, between clocking up more hours in the hope of a pay rise and wasting effort by acquiring expertise which will generate few extra rewards - and may even be squandered in a period of unemployment - is common to workers on both sides of the Atlantic. The idea of continental Europeans with a special love for languid leisure-time may be a romantic one, but Michelacci and Pijoan-Mas suggest they are just as hard-headed as their American counterparts.

CEPR DP6314 The Effects of Labour Market Conditions on Working Time: the US-EU Experience by Claudio Michelacci and Josep Pijoan-Mas

Don't blame it all on globalisation

Workers in industrialised countries lose out from globalisation, as they are forced to compete with a rapidly expanding pool of low-cost labour and their once-formidable bargaining power ebbs away. This has become received wisdom in recent years, illustrated by the sharp fall in the share of GDP taken home by workers, rather than paid out to shareholders in profits.

But there may be other explanations for workers' leaner pickings over the past two decades. In CEPR Discussion Paper No. 6348, CEPR Research Fellow John Van Reenen and his co-authors Ghazala Azmat and Alan Manning have identified one of them: the privatisation of once state-owned industries.

The falling share of wages in national income is a widespread phenomenon that has been particularly

pronounced in the US, where workers' share declined by almost 9 percentage points between 1980 and 2000. In Germany, the drop was almost 2 percentage points.

Van Reenen et al. begin by building a theoretical model to show what happens to wages and employment when an industry shifts from state to private ownership - and then test the model's findings against real-world data.

The intuition at the heart of their model is that in state-owned industries, bosses are unlikely simply to be maximising profits, as they might if they were only answerable to shareholders. There may also be some imperative to keep employment high, whether because of the desire for 'empire-building,' or pressure from political masters.

Many bosses may have an empire-building streak; but they are less likely to be able to exercise it when shareholders are keeping a close eye on them. Equally, for the boss of a state-owned industry, thousands of layoffs in an election year - for which the government is likely to get the blame - is to be avoided.

So the boss in the state-owned industry is probably interested in high employment, and not in profits alone.

Economic modelling of this idea helps to show that the boss of a nationalised industry would be more resistant to a generous wage rise for staff than his private sector counterpart. Wages are the price of labour so they affect the size of the workforce directly, determining how many staff it is profitable for a business to employ. For the boss of the privatised industry, however, wages are only one input to the profit equation.

In other words, the size of the workforce is more sensitive to wages than profits are. The boss of the state industry, hoping to avoid politically sensitive layoffs, will fight harder against a pay rise than the profit-focused leader of a privatised business, who can offset the impact on his bottom line in some other way - by squeezing his suppliers, for example, or laying off a few staff.

So the simple intuition that the bosses of state-owned industries might care about how many staff they employ, as well as their profits, leads to the conclusion that privatised industries are willing to pay their (fewer) workers more.

With many countries privatising great swathes of their industrial base over the past two decades, this insight helps to explain the falling share of labour income in GDP: it is not because workers in privatised industries are paid less, but because the size of the workforce has shrunk.

The authors test these theoretical findings against data about what actually happened during the privatisation process for several OECD countries. They select the communications industries - postal services, gas, electricity, airlines, railways, roads and telecoms - where privatisation has been widespread, but the pace and scope of it varied, so that they can isolate the impact of reform.

They find that the empirical evidence supports the central prediction of the theoretical model: that privatisation of an industry slims down the size of the workforce, but increases the average wage. In fact, the authors find that this process alone - the gradual withdrawal of the state from industry - accounts for on average one fifth of the fall in labour's share of national income since 1980. In some countries, including the UK and France, it explains more than half of the fall.

Increasing competition, as governments have deliberately made it easier for new businesses to spring up, has the opposite effect: eroding profit margins for existing players, and pushing up labour's slice of the cake. Privatisation, however, far outweighs that effect.

The authors also use the data - which includes the OECD's cross-country measures of how strongly regulated economies are - to test some of the other widespread theories about the fall in workers' share of income. They find little evidence that weaker bargaining power, through lower union membership or deregulation of the labour market, has had a systematic effect on employment and wages.

Shifts between sectors have been important, however. Manufacturing - which is generally more labour intensive, therefore giving workers a larger share of the spoils - has shrunk dramatically as a share of the economy since 1980, and that, the authors suggest, accounts for much of the fall in labour's share of income.

Privatisation may be even more to blame than the findings suggest: the authors point out that processes such as outsourcing, quasi-market reforms in health, education and so on, that fall short of a full-blown sell-off, could also have had some of the same effects on employment and wages.

Stacks of cut-price Chinese goods and an influx of keen Eastern European workers make the impact of globalisation tangible, and increase the temptation to single it out as the explanation of any unexpected economic phenomenon. But, as Van Reenen and his co-authors show, sometimes much more mundane forces are at work; and some of the most dramatic changes in our economic landscape have been made not in China or India, but here at home.

DP 6348 Privatization, Entry Regulation and the Decline of Labour's Share of GDP: a Cross-Country Analysis of the Network Industries by Ghazala Azmat, Alan Manning and John Van Reenen

Regression to the mean

Parents' power to influence their children is a fraught issue of family life and public policy. Mums and Dads fret about the company their offspring may fall into outside the bosom of the family; teachers blame parents for their unruly charges; and politicians anxious about bad behaviour often assume parenting is at fault. CEPR DP6305 suggests, however, that parents' ability to pass on cherished social values such as altruism to their children may be much weaker than is often supposed.

CEPR Research Fellow Olivier Jeanne and his co-authors, Marco Cipriani, Paula Giuliano, carried out a 'public goods experiment' with a group of 38 parents at an elementary school in Washington, DC. Each adult was given an allocation of five tokens, and asked to either keep them or put all of some of them into the group pot (without knowing who else was in their group). Those tokens given to the group would be doubled, and shared out again among its members. The game was repeated ten times. Later in the day, the economists played the same game with the children of these 38 parents, allotting them to exactly the same groups.

The optimum strategy in the game is to share, multiplying the size of the pot for the common good; but self-interested players are likely to choose to hold on to their tokens instead.

The average parent shared 2.9 of their 5 tokens, the average child shared 2.76. The ethnic origin of all of the parents and children involved was African-American or Hispanic, but these outcomes were very similar to those found in experiments conducted on white groups, questioning the findings in some values surveys which suggest minority ethnic groups hold lower levels of 'prosocial' values such as altruism than their white peers.

More importantly, however, Jeanne et al. found no significant correlation between the parents' decisions and those of their children. The offspring of parents who kindly shared their allocation of tokens with the group were no more likely to share their own tokens than their classmates.

This finding suggests that parents' efforts to instil in their children the value of the importance of sharing have less effect than they might hope, and chimes with theories in social psychology stressing the importance of children's peer groups, rather than their families, in determining their social values.

The results indicated that children are also affected by the size of their family: those with more brothers and sisters, accustomed to having to squabble for attention, tended to be less inclined to share, and keener to hoard their tokens. This finding offers more support to the idea that environmental surroundings - such as how many siblings there are at home - are likely to be as important in forming moral and social values as any number of exhortations to good behaviour by well-intentioned adults.

The relevance of these findings to parents fretting about their children's behaviour is obvious, but Jeanne et al. argue that the transmission of values is also an important component in economic theory. Values such as trust are crucial in allowing trading and exchange systems to develop, for example, so the economist needs to know how they are created and sustained. It appears that where children are concerned, charity certainly does not begin at home.

CEPR DP6305 Like Mother Like Son? Experimental Evidence on the Transmission of Values from Parents to Children by Marco Cipriani, Paula Giuliano and Olivier Jeanne

The Centre for Economic Policy Research (www.cepr.org), founded in 1983, is a network of over 700 researchers based mainly in universities throughout Europe, who collaborate through the Centre in research and its dissemination. The Centre's goal is to promote research excellence and policy relevance in European economics. CEPR Research Fellows and Affiliates are based in over 237 different institutions in 28 countries. Because it draws on such a large network of researchers, CEPR is able to produce a wide range of research which not only addresses key European policy issues, but also reflects a broad spectrum of individual viewpoints and perspectives. CEPR has made key contributions to a wide range of European and global policy issues for over two decades.

CEPR Officers:

Chair of the Board Guillermo de la Dehesa
President Richard Portes
Chief Executive Officer Stephen Yeo
Research Director Mathias Dewatripon

The **CEPR *Bulletin*** is prepared by Heather Stewart, Economics Correspondent at *The Observer*, and presents highlights of recent Reports and Discussion Papers. CEPR's **Discussion Paper** series is intended to disseminate research quickly in order to stimulate comment and discussion. Of the 600+ papers published each year, many will go on to appear in the leading academic journals. CEPR Discussion Papers are available to purchase individually through our website at **www.cepr.org/pubs/new-dps/dp_papers.htm**, and are also available through a variety of subscription options. For more details, visit ***www.cepr.org/subscribers***

53-56 Great Sutton St., London EC1V 0DG, UK
Tel: +44 (0)20 7183 8801 Fax: +44 (0)20 7183 8820 Email: cepr@cepr.org
www.cepr.org