## THE FINANCIAL PAGE
## EXPORTING I.P.

Free trade is supposed to be a win-win situation. You sell me your televisions, I sell you my software, and we both prosper. In practice, free-trade agreements are messier than that. Since all industries crave foreign markets to expand into but fear foreign competitors encroaching on their home turf, they lobby their governments to tilt the rules in their favor. Usually, this involves manipulating tariffs and quotas. But, of late, a troubling twist in the game has become more common, as countries use free-trade agreements to rewrite the laws of their trading partners. And the country that is doing this most aggressively is the United States.

Our recent free-trade agreement with South Korea is a good example. Most of the deal is concerned with lowering tariffs, opening markets to competition, and the like, but an important chunk has nothing to do with free trade at all. Instead, it requires South Korea to rewrite its rules on intellectual property, or I.P.—the rules that deal with patents, copyright, and so on. South Korea will now have to adopt the U.S. and E.U. definition of copyright—extending it to seventy years after the death of the author. South Korea will also have to change its rules on patents, and may have to change its national-health-care policy of reimbursing patients only for certain drugs. All these changes will give current patent and copyright holders stronger protection for longer. Recent free-trade agreements with Peru and Colombia insisted on much the same terms. And CAFTA—a free-trade agreement with countries in Central America and the Caribbean—included not just longer copyright and trademark protection but also a dramatic revision in those countries' patent policies.

Why does the U.S. insist on these rules? Quite simply, American drug, software, and media companies are furious about the pirating of their products, and are eager to extend the monopolies that their patents and copyrights confer. These companies are the main advocates for such rules, and the big winners. The losers are often the citizens in developing countries, who find themselves subject to a Draconian I.P. regime that reduces access to new technologies.

Intellectual-property rules are clearly necessary to spur innovation: if every invention could be stolen, or every new drug immediately copied, few people would invest in innovation. But too much protection can strangle competition and can limit what economists call "incremental innovation"— innovations that build, in some way, on others. It also encourages companies to use patents as tools to keep competitors from entering new markets. Finally, it limits consumers' access to valuable new products: without patents, we wouldn't have many

new drugs, but patents also drive prices of new drugs too high for many people in developing countries. The trick is to find the right balance, insuring that entrepreneurs and inventors get sufficient rewards while also maximizing the well-being of consumers.

History suggests that after a certain point tougher I.P. rules yield diminishing returns. Josh Lerner, a professor at Harvard Business School, looked at a hundred and fifty years of patenting, and found that strengthening patent laws had little effect on the number of innovations within a country. And, in the U.S., stronger patent protections for things like software have had little or no effect on the amount of innovation in the field. The benefits of stronger I.P. protection are even less convincing when it comes to copyright: there's little evidence that writers and artists are made more productive or creative by the prospect of earning profits for seventy years after they die, and the historical record suggests only a tenuous connection between stronger I.P. laws and creative output.

The U.S., in its negotiations, insists on a one-size-fits-all approach: stronger rules are better. But accepting a diverse range of I.P. rules makes more sense, especially in light of the different economic challenges that developing and developed countries face. Lerner's study found that the benefits of stronger patent laws were reduced in less developed countries. And developing countries, being poorer, obviously have more to gain from shorter patent terms for foreign innovations, since that facilitates the spread of new technology and the diffusion of ideas. Tellingly, this is the approach the U.S. takes when it comes to labor standards, arguing that we shouldn't impose developed-country standards on developing countries. But in the case of intellectual property the government's position is exactly the opposite. The only difference, it seems, is whose interests are at stake.

The great irony is that the U.S. economy in its early years was built in large part on a lax attitude toward intellectual-property rights and enforcement. As the historian Doron Ben-Atar shows in his book "Trade Secrets," the Founders believed that a strict attitude toward patents and copyright would limit domestic innovation and make it harder for the U.S. to expand its industrial base. American law did not protect the rights of foreign inventors or writers, and Secretary of the Treasury Alexander Hamilton, in his famous "Report on Manufactures," of 1791, actively advocated the theft of technology and the luring of skilled workers from foreign countries. Among the beneficiaries of this was the American textile industry, which flourished thanks to pirated technology. Free-trade agreements that export our own restrictive I.P. laws may make the world safe for Pfizer, Microsoft, and Disney, but they don't deserve the name free trade.

—*James Surowiecki*

CHRISTOPH NIEMANN

## THE FINANCIAL PAGE
## IT'S THE WORKFORCE, STUPID!

In the nineteen-nineties, with U.S. corporations in the midst of what the *Times* called "the downsizing of America," a new term appeared: the "seven-per-cent rule." It was a simple formula: when a company announces major layoffs, its stock price jumps seven per cent. No one worried too much about whether the rule was accurate—it was a catchy way of expressing a basic assumption about corporate layoffs: downsizing is an easy way to make Wall Street happy. So when, recently, two companies with lagging stock prices—Circuit City and Citigroup—announced major job cuts, one might have expected their stock to soar. Instead, Circuit City saw its stock price tumble four per cent the day after it announced it was getting rid of thirty-four hundred of its most experienced sales associates, and Citigroup's stock barely budged when it said it would be cutting seventeen thousand jobs.

This may have surprised the executives who had planned the cutbacks, but it shouldn't have. Over the past decade, many academics have looked at how layoffs affect stock prices, and they've found that the seven-per-cent rule is bunk. Instead of rising sharply, the stock of companies that trim their workforces is likely to fall. A recent meta-study that surveyed research from several countries, covering thousands of layoff announcements, concluded that, on average, markets had "a significantly negative" reaction to job cuts. Individual companies, of course, sometimes see stock prices jump after layoff news, but there's no evidence that downsizing is a guaranteed hit with investors.

This isn't to say that Wall Street has gone soft—it still cares about profits, not people. But investors seem to understand that fewer people doesn't always mean more profits. Downsizing may make companies temporarily more productive, but the gains quickly erode, in part because of the predictably negative effect on morale. And numerous studies suggest that, despite the lower payroll costs, layoffs do not make firms more profitable; Wayne Cascio, a management professor at the University of Colorado at Denver, looked at more than three hundred firms that downsized in the nineteen-eighties and found that three years after the layoffs the companies' returns on assets, costs, and profit margins had not improved. It's possible that these companies would have done even worse had they not downsized, but for the average company the effect of layoffs on the bottom line appears to be negligible.

If the track record of layoffs in improving corporate performance and shareholder returns is so mediocre, why do executives still find them tempting? One reason is that executives' view of downsizing is shaped by what's sometimes called the vividness heuristic: the tendency to

give undue weight to particularly vivid or newsworthy examples. In discussions of downsizing, you don't often hear about all the companies that cut payrolls and then continued to struggle. Instead, it's the stories of companies that have reaped dramatic benefits from downsizing—like G.E. and Procter & Gamble—that become templates for how the process works. Executive overconfidence exacerbates this problem: a C.E.O. is far more likely to see himself as capable of pulling off what Jack Welch did at G.E. than to recognize the probability that layoffs will make only a trivial difference.

The increasingly short-term nature of C.E.O.s' jobs, along with the pressure on them to deliver results quickly, doesn't help matters. The average C.E.O.'s tenure today is just six years, long enough to see the benefits of downsizing (like a lower payroll) but not long enough to suffer costs that may appear in the long term. And the lack of job security means executives have to worry more about what shareholders and analysts are saying. While the market as a whole may be skeptical about downsizing, many powerful people on the Street aren't. Before Citigroup announced its layoffs, for instance, it had to contend with a chorus of critics—including its biggest shareholder—insisting that the company was a bloated giant that needed to get its costs under control. Even if the job cuts didn't move the stock price, they were at least a sign to those critics that the company was listening.

On top of all this, a C.E.O. is likely to look to layoffs as a solution because that's what almost everyone else does, too. The word "downsizing" wasn't even invented until the mid-seventies. The waves of layoffs that began at the end of that decade and peaked after the recession of 1990-91 were largely a response to crisis on the part of manufacturing companies swamped by foreign competitors and stuck with excess capacity. More recently, however, downsizing has become less a response to disaster than a default business strategy, part of an inexorable drive to cut costs. That's why Circuit City can proclaim, "Our associates are our greatest assets," and then lay off veteran salespeople because they earn fifty-one cents an hour too much.

There's nothing wrong with cost-cutting, and in any dynamic economy layoffs will be necessary. The problem is that too many companies today define workers solely in terms of how much they cost, rather than how much value they create. This is understandable: after downsizing, it's easier to measure a lower wage bill than it is to see the business the company isn't getting because it has too few salesmen, or the new products it isn't inventing because its R. & D. staff is too small. These lost opportunities may be hard to measure, but over time they can have a huge impact on corporate performance. Judging from its reaction to layoff announcements, the stock market understands this. It's time executives did, too.

—*James Surowiecki*

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