

A New Deal for Globalization

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WAGES FALLING, PROTECTIONISM RISING

OVER THE last several years, a striking new feature of the U.S. economy has emerged: real income growth has been extremely skewed, with relatively few high earners doing well while incomes for most workers have stagnated or, in many cases, fallen. Just what mix of forces is behind this trend is not yet clear, but regardless, the numbers are stark. Less than four percent of workers were in educational groups that enjoyed increases in mean real money earnings from 2000 to 2005; mean real money earnings rose for workers with doctorates and professional graduate degrees and fell for all others. In contrast to in earlier decades, today it is not just those at the bottom of the skill ladder who are hurting. Even college graduates and workers with nonprofessional master's degrees saw their mean real money earnings decline. By some measures, inequality in the United States is greater today than at any time since the 1920s.

Advocates of engagement with the world economy are now warning of a protectionist drift in public policy. This drift is commonly blamed on narrow industry concerns or a failure to explain globalization's benefits or the war on terrorism. These explanations miss a more basic point: U.S. policy is becoming more protectionist because the American

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public is becoming more protectionist, and this shift in attitudes is a result of stagnant or falling incomes. Public support for engagement with the world economy is strongly linked to labor-market performance, and for most workers labor-market performance has been poor.

Given that globalization delivers tremendous benefits to the U.S. economy as a whole, the rise in protectionism brings many economic dangers. To avert them, U.S. policymakers must recognize and then address the fundamental cause of opposition to freer trade and investment. They must also recognize that the two most commonly proposed responses—more investment in education and more trade adjustment assistance for dislocated workers—are nowhere near adequate. Significant payoffs from educational investment will take decades to be realized, and trade adjustment assistance is too small and too narrowly targeted on specific industries to have much effect.

The best way to avert the rise in protectionism is by instituting a New Deal for globalization—one that links engagement with the world economy to a substantial redistribution of income. In the United States, that would mean adopting a fundamentally more progressive federal tax system. The notion of more aggressively redistributing income may sound radical, but ensuring that most American workers are benefiting is the best way of saving globalization from a protectionist backlash.

RISING PROTECTIONISM

U.S. ECONOMIC POLICY is becoming more protectionist. First, consider trade. The prospects for congressional renewal of President George W. Bush's trade promotion authority, which is set to expire this summer, are grim. The 109th Congress introduced 27 pieces of anti-China trade legislation; the 110th introduced over a dozen in just its first three months. In late March, the Bush administration levied new tariffs on Chinese exports of high-gloss paper—reversing a 20-year precedent of not accusing nonmarket economies of illegal export subsidies.

Barriers to inward foreign direct investment (FDI) are also rising. In 2005, the Chinese energy company CNOOC tried to purchase U.S.-headquartered Unocal. The subsequent political storm was so intense

that CNOOC withdrew its bid. A similar controversy erupted in 2006 over the purchase of operations at six U.S. ports by Dubai-based Dubai Ports World, eventually causing the company to sell the assets. The Committee on Foreign Investments in the United States, which is legally required to review and approve certain foreign acquisitions of U.S. businesses, has raised the duration and complexity of many reviews. Both chambers of the 109th Congress passed bills to tighten CFIUS scrutiny even further; similar legislation has already passed in the current House.

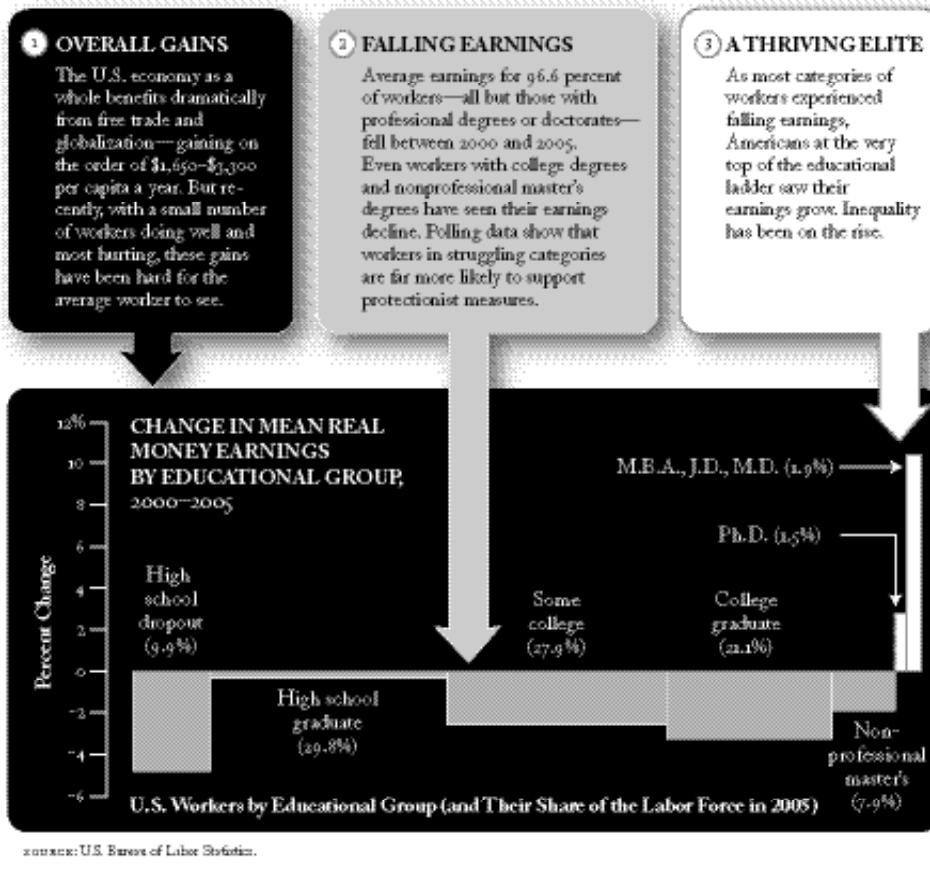
This protectionist drift extends to much of the world. The Doha Development Round of trade negotiations, the centerpiece of global trade liberalization, is years behind schedule and now on the brink of collapse. Key U.S. trading partners are becoming increasingly averse to foreign investment, as expressed both in their rhetoric (recent public pronouncements by the governments of France and Germany) and in their actions (new restrictions in China on foreign retailers).

At first glance, this rise in protectionism may seem puzzling. The economic gains from globalization are immense. In the United States, according to estimates from the Peter G. Peterson Institute for International Economics and others, trade and investment liberalization over the past decades has added between \$500 billion and \$1 trillion in annual income—between \$1,650 and \$3,300 a year for every American. A Doha agreement on global free trade in goods and services would generate, according to similar studies, \$500 billion a year in additional income in the United States.

International trade and investment have spurred productivity growth, the foundation of rising average living standards. The rate of increase in output per worker hour in the U.S. nonfarm business sector has doubled in the past decade, from an annual average of 1.35 percent between 1973 and 1995 to an annual average of 2.7 percent since 1995. Much of the initial acceleration was related to information technology (IT)—one of the United States' most globally engaged industries, at the forefront of establishing and expanding production networks linked by trade and investment around the globe.

Gains from globalization have been similarly large in the rest of the world. China and India have achieved stupendous rates of productivity growth, lifting hundreds of millions of people out of poverty. Central

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to this success has been the introduction of market forces, in particular international market forces related to trade and FDI. In Chinese manufacturing, foreign multinational companies account for over half of all exports. And in the Indian IT sector, Indian and foreign multinational firms account for two-thirds of sales.

Freer trade and investment can also enhance other foreign policy goals. The Doha Round was launched shortly after 9/11 because of the view that global poverty is intimately linked to international insecurity and instability. The Doha Round was also intended to remedy the widespread perception that previous rounds of trade negotiations had treated poor nations unfairly by failing to open the very sectors—such as agriculture—whose openness would most likely help the world's poor. Accordingly, it is believed that a successful Doha agreement would enhance the United States' image and promote its interests around the world.

There are three common explanations for why protectionism is on the rise in the United States even though globalization is good for both the U.S. economy and U.S. security interests. None, however, is convincing. The first is that a narrow set of industries, such as agriculture and apparel manufacturing, have been harmed by freer trade and, in response, have lobbied hard to turn lawmakers against liberalization. But the incentives for these industries to oppose globalization have not changed in recent years, and there are also many industries that have benefited from, and thus lobbied for, further liberalization. What is new today is that special-interest protectionists are facing a more receptive audience.

The second explanation is that policymakers and the business community have failed to adequately explain the benefits of freer trade and investment to the public. But in fact, public-opinion data show the opposite: large majorities of Americans acknowledge these broad benefits. If anything, the public seems to understand certain benefits better than ever—for example, that its enjoyment of relatively affordable toys, DVD players, and other products depends on globalization.

Finally, there is the security explanation: that the need to balance economic interests with national security concerns has resulted in a more protectionist stance. This may help explain policy debates on certain issues, such as immigration. But generally, security concerns strengthen rather than weaken the case for further trade and investment liberalization, as long as such liberalization is viewed as fair to the developing world.

THE ROOTS OF PROTECTIONISM

THE FUNDAMENTAL explanation is much simpler: policy is becoming more protectionist because the public is becoming more protectionist, and the public is becoming more protectionist because incomes are stagnating or falling. The integration of the world economy has boosted productivity and wealth creation in the United States and much of the rest of the world. But within many countries, and certainly within the United States, the benefits of this integration have been unevenly distributed—and this fact is increasingly being recognized. Individuals are asking themselves, “Is globalization good for me?” and, in a growing number of cases, arriving at the conclusion that it is not.

This account of rising protectionism depends on two key facts. First, there is a strong link between individuals' labor-market interests and their policy opinions about globalization. Second, in the past several years labor-market outcomes have become worse for many more Americans—and globalization is plausibly part of the reason for this poor performance.

Research on polling data shows that opinions about trade, FDI, and immigration are closely correlated to skill and educational levels. Less skilled Americans—who make up the majority of the U.S. labor force—have long led opposition to open borders. Workers with only high school educations are almost twice as likely to support protectionist policies as workers with college educations are.

This divide in opinion according to skill level reflects the impact that less skilled Americans expect market liberalization to have on their earnings. It also reflects their actual poor real and relative earnings performance in recent decades. It is now well established that income inequality across skill levels has been rising since (depending on the measure) the mid- to late 1970s and that the benefits of productivity gains over this time accrued mainly to higher-skilled workers. For example, from 1966 to 2001, the median pretax inflation-adjusted wage and salary income grew just 11 percent—versus 58 percent for incomes in the 90th percentile and 121 percent for those in the 99th percentile. Forces including skill-biased technological change played a major role in these income trends; the related forces of globalization seem to have played a smaller role—but a role nonetheless.

There are two important points about this link between policy opinions and labor-market skills and performance. One is that it does not simply reflect different understandings of the benefits of globalization. Polling data are very clear here: large majorities of Americans acknowledge the many benefits of open borders—lower prices, greater product diversity, a competitive spur to firms—which are also highlighted by academics, policymakers, and the business community. At the same time, they perceive that along with these benefits, open borders have put pressures on worker earnings.

Given a lack of income growth for most Americans, skepticism about globalization is not without cause.

Second, a worker's specific industry does not appear to drive his view of globalization. This is because competition in the domestic labor market extends the pressures of globalization beyond trade- and foreign-investment-exposed industries to the entire economy. If workers in a sector such as automobile manufacturing lose their jobs, they compete for new positions across sectors—and thereby put pressure on pay in the entire economy. What seems to matter most is what kind of worker you are in terms of skill level, rather than what industry you work in.



The protectionist drift also depends on worsening labor-market outcomes over the past several years. By traditional measures, such as employment growth and unemployment rates, the U.S. labor market has been strong of late. Today, with unemployment at 4.5 percent, the United States is at or near full employment. But looking at the number of jobs misses the key change: for several years running, wage and salary growth for all but the very highest earners has been poor, such that U.S. income gains have become extremely skewed.

Of workers in seven educational categories—high school dropout, high school graduate, some college, college graduate, nonprofessional master's, Ph.D., and M.B.A./J.D./M.D.—only those in the last two categories, with doctorates or professional graduate degrees, experienced any growth in mean real money earnings between 2000 and 2005. Workers in these two categories comprised only 3.4 percent of the labor force in 2005, meaning that more than 96 percent of U.S. workers are in educational groups for which average money earnings have fallen. In contrast to in earlier decades, since 2000 even college



graduates and those with nonprofessional master's degrees—29 percent of workers in 2005—suffered declines in mean real money earnings.

The astonishing skewness of U.S. income growth is evident in the analysis of other measures as well. The growth in total income reported on tax returns has been extremely concentrated in recent years: the share of national income accounted for by the top one percent of earners reached 21.8 percent in 2005—a level not seen since 1928. In addition to high labor earnings, income growth at the top is being driven by corporate profits, which are at nearly 50-year highs as a share of national income and which accrue mainly to those with high labor earnings. The basic fact is clear: the benefits of strong productivity growth in the past several years have gone largely to a small set of highly skilled, highly compensated workers.

Economists do not yet understand exactly what has caused this skewed pattern of income growth and to what extent globalization itself is implicated, nor do they know how long it will persist. Still, it is plausible that there is a connection. Poor income growth has coincided with the integration into the world economy of China, India, and central and eastern Europe. The IT revolution has meant that

certain workers are now facing competition from the overseas outsourcing of jobs in areas such as business services and computer programming. Even if production does not move abroad, increased trade and multinational production can put pressure on incomes by making it easier for firms to substitute foreign workers for domestic ones.

These twin facts—the link between labor-market performance and opinions on globalization and the recent absence of real income growth for so many Americans—explain the recent rise in protectionism. Several polls of U.S. public opinion show an alarming rise in protectionist sentiment over the past several years. For example, an ongoing NBC News/*Wall Street Journal* poll found that from December 1999 to March 2007, the share of respondents stating that trade agreements have hurt the United States increased by 16 percentage points (to 46 percent) while the “helped” share fell by 11 points (to just 28 percent). A 2000 Gallup poll found that 56 percent of respondents saw trade as an opportunity and 36 percent saw it as a threat; by 2005, the percentages had shifted to 44 percent and 49 percent, respectively. The March 2007 NBC News/*Wall Street Journal* poll found negative assessments of open borders even among the highly skilled: only 35 percent of respondents with a college or higher degree said they directly benefited from the global economy.

Given the lack of recent real income growth for most Americans, newfound skepticism about globalization is not without cause. Nor is it without effect: the change in public opinion is the impetus for the protectionist drift in policy. Politicians have an incentive to propose and implement protectionist policies because more citizens want them, and protectionist special interests face an audience of policy-makers more receptive to their lobbying efforts than at any time in the last two decades.

INADEQUATE ADJUSTMENTS

BECAUSE THE protectionist drift reflects the legitimate concerns of a now very large majority of Americans, the policy debate needs fresh thinking. There is reason to worry even if one does not care about social equity. When most workers do not see themselves as benefiting from the related forces of globalization and technology, the resulting protectionist drift may end up eliminating the gains from globalization

for everybody. Current ignorance about the exact causes of the skewed income growth is not reason for inaction. Policymakers may not be able to attack the exact source (or sources) and likely would not want to even if they could identify them, because doing so could reduce or even eliminate the aggregate gains from globalization.

Supporters of globalization face a stark choice: shore up support for an open global system by ensuring that a majority of workers benefit from it or accept that further liberalization is no longer sustainable. Given the aggregate benefits of open borders, the preferable option is clear.

Current policy discussions addressing the distributional consequences of globalization typically focus on the main U.S. government program for addressing the labor-market pressures of globalization—Trade Adjustment Assistance (TAA)—and on investing more in education. These ideas will help but are inadequate for the problem at hand.

The problem with TAA is that it incorrectly presumes that the key issue is transitions across jobs for workers in trade-exposed industries. Established in the Trade Act of 1974 (with a related component connected to the North American Free Trade Agreement), the program aids groups of workers in certain industries who can credibly claim that increased imports have destroyed their jobs or have reduced their work hours and wages. TAA-certified workers can access supports including training, extended unemployment benefits while in full-time training, and job-search and relocation allowances.

In short, TAA is inappropriately designed to address the protectionist drift. The labor-market concern driving this drift is not confined to the problem of how to reemploy particular workers in particular sectors facing import competition. Because the pressures of globalization are spread economy-wide via domestic labor-market competition, there is concern about income and job security among workers employed in all sectors.

Today many are calling for reform and expansion of TAA. For example, President Bush has proposed streamlining the processes of eligibility determination and assistance implementation to facilitate reemployment. This year, TAA is due to be reauthorized by Congress, and many legislators have proposed broadening the number of industries that are TAA-eligible. TAA improvements like these are surely welcome. But they alone cannot arrest the protectionist drift.

The idea behind investing in education is that higher-skilled workers generally earn more and are more likely to directly benefit from economic openness. The problem with this approach, however, is that upgrading skills is a process that takes generations—its effects will come far too late to address today's opposition to globalization. It took 60 years for the United States to boost the share of college graduates in the labor force from six percent (where it was at the end of World War II) to about 33 percent (where it is today). And that required major government programs, such as the GI Bill, and profound socioeconomic changes, such as increased female labor-force participation.

If the United States today undertook the goal of boosting its college-graduate share of the work force to 50 percent, the graduation of that median American worker would, if the rate of past efforts are any indication, not come until about 2047. And even this far-off date might be too optimistic. In the past generation, the rate of increase in the educational attainment of U.S. natives has slowed from its 1960s and 1970s pace, in part because college-completion rates have stalled. Rising income inequality may itself be playing a role here. Since 1988, 74 percent of American students at the 146 top U.S. colleges have come from the highest socioeconomic quartile, compared with just 3 percent from the lowest quartile. Moreover, even college graduates and holders of nonprofessional master's degrees have experienced falling mean real money earnings since 2000. If this trend continues, even completing college will not assuage the concerns behind rising protectionism.

GLOBALIZATION AND REDISTRIBUTION

GIVEN THE limitations of these two reforms and the need to provide a political foundation for engagement with the world economy, the time has come for a New Deal for globalization—one that links trade and investment liberalization to a significant income redistribution that serves to share globalization's gains more widely. Recall that \$500 billion is a common estimate of the annual income gain the United States enjoys today from earlier decades of trade and investment liberalization and also of the additional annual income it would enjoy as a result global free trade in goods and services.

These aggregate gains, past and prospective, are immense and therefore immensely important to secure. But the imbalance in recent income growth suggests that the number of Americans not directly sharing in these aggregate gains may now be very large.

Truly expanding the political support for open borders requires a radical change in fiscal policy. This does not, however, mean making the personal income tax more progressive, as is often suggested. U.S. taxation of personal income is already quite progressive. Instead, policymakers should remember that workers do not pay only income taxes; they also pay the FICA (Federal Insurance Contributions Act) payroll tax for social insurance. This tax offers the best way to redistribute income.

The payroll tax contains a Social Security portion and a Medicare portion, each of which is paid half by the worker and half by the employer. The overall payroll tax is a flat tax of 15.3 percent on the first \$94,200 of gross income for every worker, with an ongoing 2.9 percent flat tax for the Medicare portion beyond that. Because it is a flat-rate tax on a (largely) capped base, it is a regressive tax—that is, it tends to reinforce rather than offset pretax inequality. At \$760 billion in 2005, the regressive payroll tax was nearly as big as the progressive income tax (\$1.1 trillion). Because it is large and regressive, the payroll tax is an obvious candidate for meaningful income redistribution linked to globalization.

A New Deal for globalization would combine further trade and investment liberalization with eliminating the full payroll tax for all workers earning below the national median. In 2005, the median total money earnings of all workers was \$32,140, and there were about 67 million workers at or below this level. Assuming a mean labor income for this group of about \$25,000, these 67 million workers would receive a tax cut of about \$3,800 each. Because the economic burden of this tax falls largely on workers, this tax cut would be a direct gain in after-tax real income for them. With a total price tag of about \$256 billion, the proposal could be paid for by raising the cap of \$94,200, raising payroll tax rates (for progressivity, rates could escalate as they do with the income tax), or some combination of the two. This is, of course, only an outline of the needed policy reform, and there would be many implementation details to address. For example, rather than a single

on-off point for this tax cut, a phase-in of it (like with the earned-income tax credit) would avoid incentive-distorting jumps in effective tax rates.

This may sound like a radical proposal. But keep in mind the figure of \$500 billion: the annual U.S. income gain from trade and investment liberalization to date and the additional U.S. gain a successful Doha Round could deliver. Redistribution on this scale may be required to overcome the labor-market concerns driving the protectionist drift. Determining the right scale and structure of redistribution requires a thoughtful national discussion among all stakeholders. Policymakers must also consider how exactly to link such redistribution to further liberalization. But this should not obscure the essential idea: to be politically viable, efforts for further trade and investment liberalization will need to be explicitly linked to fundamental fiscal reform aimed at distributing globalization's aggregate gains more broadly.

SAVING GLOBALIZATION

AVERTING A protectionist backlash is in the economic and security interests of the United States. Globalization has generated—and can continue to generate—substantial benefits for the United States and the rest of the world. But realizing those broad benefits will require addressing the legitimate concerns of U.S. voters by instituting a New Deal for globalization.

In many ways, today's protectionist drift is similar to the challenges faced by the architect of the original New Deal. In August 1934, President Franklin Roosevelt declared:

Those who would measure confidence in this country in the future must look first to the average citizen. . . .

This Government intends no injury to honest business. The processes we follow in seeking social justice do not, in adding to general prosperity, take from one and give to another. In this modern world, the spreading out of opportunity ought not to consist of robbing Peter to pay Paul. In other words, we are concerned with more than mere subtraction and addition. We are concerned with multiplication also—multiplication of wealth through cooperative action, wealth in which all can share.

Today, such multiplication will depend on striking a delicate balance—between allowing globally engaged companies to continue to generate

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large overall gains for the United States and using well-targeted fiscal mechanisms to spread the gains more widely.

Would addressing concerns about income distribution make voters more likely to support open borders? The public-opinion data suggest that the answer is yes. Americans consistently say that they would be more inclined to back trade and investment liberalization if it were linked to more support for those hurt in the process. The policy experience of other countries confirms this point: there is greater support for engagement with the world economy in countries that spend more on programs for dislocated workers.

U.S. policymakers face a clear choice. They can lead the nation down the dangerous path of creeping protectionism. Or they can build a stable foundation for U.S. engagement with the world economy by sharing the gains widely. A New Deal for globalization can ensure that globalization survives. 🌐