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**Succeeding** in the Global Economy  
A New Policy Agenda for the  
American Worker

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[www.financialservicesforum.org](http://www.financialservicesforum.org)

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The Forum's three primary missions are to:

- Educate the public about the importance of robust capital markets;
- Encourage a competitive global marketplace; and
- Shape the national and international regulatory dialogue.

As a group, the Forum's member institutions employ more than 2 million people in 175 countries and hold combined assets of more than \$16 trillion -- an amount greater than the annual economic output of the United States, United Kingdom, and France combined.

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*The views, opinions, and recommendations expressed in this report are those of its authors and do not necessarily represent the views of all Financial Services Forum members.*

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# Executive Summary



**P**OLITICAL PRESSURE for a more protectionist tilt to U.S. economic policy has risen significantly in the past year. This policy drift reflects a drop in support for more open borders. Critics of U.S. trade policy (and globalization generally) argue that neither government nor private firms fully comprehend the forces at work in the global economy or appreciate the impact of these forces on individual workers and their communities. Public support for engagement in the global economy has been eroding rapidly in recent years. Left unaddressed, this erosion will gather momentum and will shape the economic-policy debate into the 2008 presidential elections and beyond.

This protectionist drift reflects a public increasingly skeptical about whether globalization benefits them. Today many American workers feel anxious—about change, and about weak or nonexistent income growth. These concerns are real, widespread, and legitimate. What role the forces of global engagement have played in this recent poor labor-market performance of most Americans remains an open question. But whatever the answer, in the current political discourse on this question globalization is front and center. There is a substantial risk that, absent an effort to clarify and address the real economic challenges at hand, policies will be implemented that isolate the United States from world markets and thereby undermine the ability of U.S. firms and workers to remain competitive in the global economy.

The goal of this report is to discuss the economic forces driving this policy drift away from global engagement, and then to offer a set of innovative policies for both the government and private sector aimed at arresting this drift. Our report explicates three key messages.

## 1. The Aggregate Benefits of Global Engagement

GLOBAL ENGAGEMENT has generated, and has the potential to continue generating, large gains for the United States overall and for the rest of the world as well. Living standards in the United States today are upwards of \$1 trillion higher per year in total than they would have been absent decades of trade, investment, and immigration liberalization.

The average U.S. household could gain as much as **\$15,000** per year as a result of continued global engagement.

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Looking ahead, annual U.S. income could be upwards of \$500 billion higher with a move to global free trade and investment in both merchandise and services. This translates into average gain of at least \$10,000 per U.S. household per year thanks to past liberalizations, \$5,000 per household per year still to be realized.

These gains arise through many important channels. Globalization matches savings pools and investment opportunities around the world; it transfers ideas and technology to firms and people everywhere; and it frees countries from needing to produce what they consume. A number of forces—technological change, policy liberalization at home, and policy liberalization abroad—have fostered ever-greater flows across borders of goods and services, capital, ideas, and people. The net result has been higher aggregate productivity and living standards for the United States.

## **2. The Distributional Challenges of Global Engagement**

THE AGGREGATE GAINS from global engagement, large though they are, are not evenly shared and do not directly benefit every worker, firm, and community. The many constituent forces of global engagement have also fostered economic changes that have pressured the well-being of many workers. These pressures are both short-term and long-term, and they often are concentrated in particular groups of workers, firms, and communities.

One very prominent cost is worker dislocation from increased product-market competition. International trade and investment are continually forcing U.S. firms to seek new ways of making profits; absent such innovations, these firms tend to scale down or even go out of business altogether. Global engagement is by no means the only source of job destruction in the American economy, but like dislocations from all sources, it often does create real costs in terms of unemployment spells and lower re-employment earnings.

Labor-market pressures are not limited to those directly dislocated and forced to move. Thanks to domestic competition among workers in the very dynamic U.S. labor market, over time the pressures of global engagement spread economy-wide to alter the earnings of even those not directly exposed to international competition.

From the mid-to-late 1970s to the mid-to-late 1990s, the real and relative earnings of less-skilled Americans was poor relative to both economy-wide average productivity gains and also the earnings of their more-skilled counterparts. And since around 2000, the large majority of American workers has seen poor income growth. Only a small share of workers at the very high end has enjoyed strong growth in incomes. The strong U.S. productivity growth of the past several years has not been reflected in broad growth in wage and salary earnings.

Economic openness has also pressured particular companies and communities. Global engagement fosters high productivity in American industries, but typically with substantial churn at the level of individual firms, with pervasive shut-down of inefficient plants and even entire companies. And because economic activity tends to be concentrated across American communities, this uneven distribution of globalization's pressures across workers and firms also means uneven pressures across communities as well. Hardship has befallen towns whose employment—and often tax revenues—are predominantly in firms and/or industries struggling against international competition.

The bottom line is that today, many American workers feel anxious—about change and about their paychecks. Their concerns are real, widespread, and legitimate. What role the forces of global engagement have played in this recent poor labor-market performance of most Americans remains an open question. But whatever the answer, in the current political discourse on this question globalization is often front and center.

### 3. A New Policy Agenda

ECONOMIC POLICY should aim to produce a growing American economy in which every American can find opportunity to use their skills to craft their own economic future. That is the only way to meet the current challenge of guaranteeing that America overall continues to benefit from global engagement while also delivering on the idea of an equal-opportunity society and thereby addressing the legitimate distributional concerns about the pressures of economic openness. Our policy proposals draw on what are commonly considered domestic economic policy tools, rather than the tools of trade policy that are the focus of much of the current political debate. Globalization has largely erased distinction between domestic and international economic policy.

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**“Economic policy should aim to produce a growing American economy in which every American can find opportunity to use their skills to craft their own economic future.”**

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First, we explain how to address the current skewness in U.S. income growth. We start here because the protectionist drift reflects a public increasingly skeptical about whether globalization benefits them in the face of weak or nonexistent income growth. As such, we consider this poor earnings performance to be the most pressing policy issue to address. Our main proposal here is to reform the Federal Insurance Contributions Act tax to make it more progressive, either by fully integrating FICA into the income tax or by adding greater progressivity into FICA itself.

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Second, we propose a menu of policy innovations designed to better facilitate adjustment by workers, communities, and firms. More can be done to smooth adjustment to the continual change in the dynamic U.S. economy in terms of hirings, firings, start-ups, and shut-downs.

One important proposal here is to combine Unemployment Insurance and the current Trade Adjustment Assistance program into a single integrated Adjustment Assistance program that offers a menu of features to all displaced workers. A second is to create a federal insurance facility that permits communities to insure their tax base against sudden economic dislocation. And a third is to identify certain communities facing significant pressures from international competition as Global Economic Development Platforms eligible for various supports aimed at attracting new investment to build new linkages to the global economy.

Third, we discuss why turning away from open borders—either a pause from liberalization or an actual move towards protectionism—is neither a viable nor desirable option.

Fourth, we propose a menu of recommendations to ensure that the United States remains fully engaged in the global economy. These proposals aim to move the discussion beyond the platitude “remain open” to a set of concrete ways to maximize America’s gains from global engagement.

One important proposal here is for Congress to renew Trade Promotion Authority on a permanent basis. U.S. policymakers should aim to achieve meaningful liberalization in the Doha Development Round not just in agriculture, but more importantly in manufacturing and services. If Doha fails, the United States should call for the negotiation of a free-trade agreement covering both goods and services that would be open to all WTO members that choose to participate. Protection of inward foreign direct investment (FDI) needs to be strengthened, and the United States should remove outdated restrictions on inward foreign investment in areas including airlines, shipping, and telecommunications. And sensible immigration reform is needed, in particular to expand the supply of visas essential to attract top talent prospects by eliminating the cap on H1-B visas.

“One important proposal here is for Congress to **renew Trade Promotion Authority** on a permanent basis.”

# Introduction: The Problem of Protectionist Drift

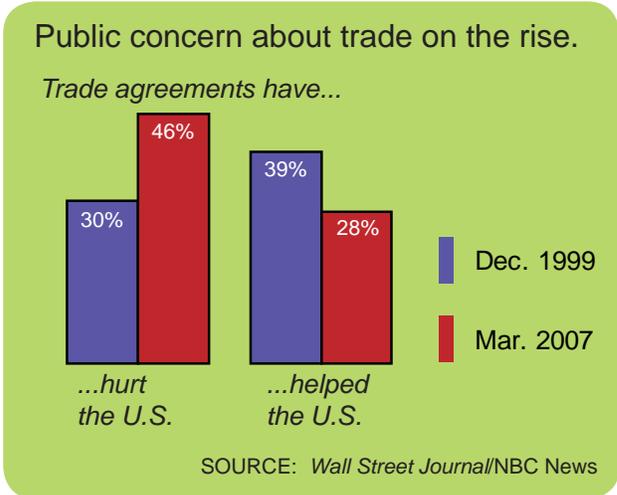
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Political pressure for a more protectionist tilt to U.S. trade policy has risen significantly in the past year. Prospects are grim for Congressional renewal of President Bush's Trade Promotion Authority. The 109<sup>th</sup> Congress introduced 27 pieces of anti-China trade legislation. In just its first three months, the 110<sup>th</sup> Congress introduced over a dozen such bills.

Congress has also seen proposals to erect higher barriers to inward foreign direct investment (FDI). The Committee on Foreign Investment in the United States (CFIUS), which is legally required to review certain foreign acquisitions of U.S. businesses to determine whether they raise national security concerns, has lengthened the duration and raised complexity of many reviews. Both chambers of the 109<sup>th</sup> Congress passed bills to tighten CFIUS scrutiny even further, and similar legislation has already passed in the current House.

Trade negotiations have generated little forward movement that might forestall the protectionist drift. The Doha Development Round, the centerpiece of global trade liberalization, is years behind schedule and in real danger of collapse. Free-trade agreements with Panama, Peru, Colombia, and South Korea have run into stiff Congressional opposition. Little progress has been made in bilateral negotiations with Thailand or Malaysia.

This policy drift reflects a drop in support for more open borders. Critics of U.S. trade policy (and globalization generally) argue that neither government nor private firms fully comprehend the forces at work in the global economy or appreciate the impact of these forces on individual workers and their communities. Public support for engagement in the global economy has been eroding rapidly in recent years.



For example, An NBC/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%) while the "helped" share

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fell by 11 percentage points (to just 28%). A 2000 Gallup poll found that 56% of respondents saw trade as an opportunity and 36% saw it as a threat—but by 2005, the respective percentages shifted to 44% and 49%.

The March 2007 *NBC/Wall Street Journal* poll also found negative assessments even among highly skilled citizens: only 35% of respondents with at least a college degree said they directly benefit from globalization (versus just 20% for those at or below a high-school degree).

Left unaddressed, the trends in public opinion will gather momentum and will shape the economic-policy debate into the 2008 presidential elections and beyond. There is a substantial risk that, absent an effort to clarify and address the real economic challenges at hand, policies will be implemented that isolate the United States from world markets and thereby undermine the ability of U.S. firms and workers to remain competitive in the global economy.

The goal of this report is to discuss the economic forces driving this policy drift away from global engagement, and then to offer a set of innovative policies for both the government and private sector aimed at arresting this drift. Our report explicates three key messages.

**1** Global engagement has generated, and has the potential to continue generating, large gains for the United States overall and for the rest of the world as well. A number of forces—technological change, policy liberalization at home, and policy liberalization abroad—have fostered ever-greater flows across borders of goods and services, capital, ideas, and people. The net result has been higher aggregate productivity and living standards for the United States.

**2** These aggregate gains, however, are not evenly shared and do not directly benefit every worker, firm, and community. Even as global engagement has generated large gains for the United States, its many constituent forces have also fostered economic changes that have pressured the well-being of many workers. These pressures are both short-term and long-term, and they often are concentrated in particular groups of workers, firms, and communities.

**3** Efforts to address these legitimate and large pressures on American workers by closing American borders is likely to be both infeasible and ineffective. Instead, both the public and private sectors must develop and implement more-creative policies both to broaden the set of stakeholders that directly benefit from international trade and investment and to assist those affected by economic change in general. We chart out a set of policy changes that aim to achieve this goal, with a focus on workers, firms, and communities.

The challenge posed by the drift toward protectionism is not just a question of perception. Real and relative income performance of many Americans—and in recent years, a widening group of Americans—has been poor. Job insecurity is high and rising for many. These concerns of American workers are the primary focus of our report. Workers are the key stakeholder on which we focus, with an ultimate goal of the mix of business and government policies that can maximize their ability to gain directly from the forces of global engagement.

Many point the finger for these labor-market pressures at international trade, and advocate policies to limit trade. We will argue that while global forces have played some role, the full set of forces at play are much broader, in ways still not fully understood. We will argue that regardless of the relative role of these different forces, the set of policies to address the legitimate concerns of American workers are not policies of isolationism. Instead, businesses and government need to consider a much broader range of policy options.

This need for fresh thinking is driven by the those broader forces of globalization which have accelerated the pace of economic change Americans have experienced in recent years relative to earlier decades. One especially notable innovation is the spread of globalization to activities in previously non-traded service sectors (such as finance, medical care, and a variety of business processes), a development that seems to be expanding yet the ultimate breadth and impact of which remain open to lively debate.<sup>1</sup>

The essence of the challenge we face is how best to reap the benefits of participating in the global economy and succeed in maintaining America’s competitiveness while reducing the human cost of adapting to the economic changes that globalization fosters. In our view, one of the key elements missing from the policy discussions is a “competitiveness agenda” for the American worker – one that ensures every American has the tools to participate productively in the global economy and benefit from the opportunities it creates.

We will set out a broad set of ideas that need to be considered by all stakeholders: workers, the business community, and elected officials. We offer a pragmatic approach of trying to ask the right questions about the challenges we face to propose policy responses that do, in fact, address those challenges. We aim to reframe the issues, to accurately identify the challenges globalization poses, and to offer business leadership in addressing them.

Our policy proposals to help ensure that American workers benefit more broadly from our participation in a global economy will largely draw on what are commonly considered domestic economic policy tools, rather than the tools of trade policy that

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1 An important early work here is: Blinder, Alan S. 2006. “Offshoring: The Next Industrial Revolution?” *Foreign Affairs* 85, March/April, pp. 113-128.

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are the focus of much of the current political debate. The reality is that globalization has largely erased distinction between domestic and international economic policy, and that traditional trade tools are inappropriate and/or ineffective for the challenges facing many American workers, firms, and communities.

Instead, we focus our proposals on fostering for the United States an open economy that attracts globally engaged companies whose nexus of productivity-enhancing activities yield high-quality, good-paying jobs. A critical part of this environment will be expanding the ways in which the public and private sectors equip American workers with the tools to compete for those jobs in a global market. What that means in very real terms is that America cannot afford to leave individuals on the margin. Wholly apart from the moral arguments in favor of raising living standards for all, we must recognize that there can be a significant economic cost from failing to address legitimate distributional concerns in terms of lower living standards for all.

Our proposals aim to strike a balance between the need to ensure that American firms (and the American-based operations of foreign investors) can continue to generate large gains from global engagement for America overall—fostered by further trade and investment liberalization—and the need for well-constructed, well-targeted policies to spread these gains more widely across American workers, firms, and communities.

But, where appropriate, we will also try to identify policies that firms can pursue as well. If government's role is to ensure an economic environment that is conducive to new investment in productive activities that generate high-quality employment opportunities and to maximize the ability of every American citizen to participate in those opportunities, business' role is to respond to those incentives by making the investments and generating the jobs, and contributing to the process of developing a talented workforce.

# Section 1:

## The Aggregate Benefits of Global Engagement

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Economists disagree on a lot. What is the proper way for central banks to conduct monetary policy? What is the best design of a fiscal system in terms of activities to tax and at what rates? How large a share of economic activity should be accounted for by government spending?

But there are two important economic-policy issues on which economists are nearly unanimous. One is that *productivity* is the single best indicator of the average standard of living of a country. The other is that *economic openness*—to cross-border flows of goods and services, of capital, and of people and ideas—raises the productivity and thus average living standards of a country. In this opening Section 1 of this report, we discuss and document the large gains that the United States has enjoyed in the past—and could enjoy in the future—from the forces of globalization.

### I. Why Productivity Matters

To gauge the average standard of living of a country's citizens, the single most important indicator of well-being is *productivity*: the average value of output of goods and services a country produces per worker.<sup>1</sup> The following quotation from noted economist and *New York Times* columnist Paul Krugman makes this point concisely.<sup>2</sup>

*Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker ... the essential arithmetic says that long-term growth in living standards ... depends almost entirely on productivity growth ... Compared with the problem of slow productivity growth, all our other long-term economic concerns—foreign competition, the industrial base, lagging technology, deteriorating infrastructure, and so on—are minor issues. Or more accurately, they matter only to the extent that they have an impact on our productivity growth.*

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1 It is important to stress that this report defines productivity as the productivity of labor. Economists use other productivity measures as well. For example, capital productivity is a measure of the average value of output produced per unit of capital. "Total factor" productivity is a measure of the average value of output produced per bundle of inputs such as labor and capital.

2 Krugman, 1990, pp. 9-13.

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The economics of this “essential arithmetic” for why productivity matters is very simple. Broadly defined, a country’s standard of living rises with the quantity and quality of goods and services its citizens can consume. People achieve economic well-being by consuming goods and services such as food, clothing, and medical care. Consuming these items requires some means to pay for them. For almost all people, their income is the primary — if not the only — means they have to pay for consumption.<sup>3</sup> In turn, people’s income comes from producing goods and services, usually by working with others in firms.

Thus, the more people produce —that is, the more productive they are— the more income they receive and the more they can consume. Higher productivity means a higher standard of living.

So how can a country raise its productivity? There are only three basic ways to raise a country’s overall labor productivity: (1) save and invest in other inputs like physical capital; (2) improve the technological know-how and techniques for transforming inputs into outputs; and (3) improve its allocation of workers and inputs across different industries to high-productivity uses.

One way to boost productivity is to accumulate the other inputs people work with to produce things. The most important other input people need is capital, broadly defined as goods and services that help people make other goods and services— e.g., buildings, machinery, software. All standard theories of economic growth agree on this point. The more capital workers have at their disposal, the more output each worker can produce with these tools. One of the earliest formulations of how capital accumulation raises output per worker was by Nobel Laureate Robert Solow.<sup>4</sup> More recently, Paul Krugman summarizes the theory this way.

*What can we do to speed [productivity growth] up? There is a standard economic answer ... If you want more output, say the economists, provide more inputs. Give your workers more capital to work with, and better education, and they will be more productive.*

A second way to raise productivity is to improve the technological know-how for transforming inputs into outputs. Economists generally conceive of production technology as the methods by which inputs are combined to produce output. Numerous empirical studies have documented that technology advances were an important force behind overall U.S. output growth in the 20<sup>th</sup> century. For example,

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3 Other options include selling assets or borrowing, but these are not sustainable indefinitely.

4 The link from higher investment to higher productivity assumes that an economy has not reached its “steady state” at which capital investment just offsets capital depreciation (i.e., the inevitable wear and tear on capital goods from their use). In the steady state (with constant technology and no population growth), output per worker is constant. Most economists think, however, that countries in the real world tend not to be in steady states.

Robert Solow calculated that about 75 percent of U.S. growth during the first half of the 20<sup>th</sup> century was driven by technological gains.

The third way to raise productivity is to improve the allocation of a country's workers (and other inputs) across different industries to high-productivity uses. Different industries can require different combinations of workers, capital, and ideas—for example, financial services require lots of highly educated talent and information technology equipment. A country can raise its productivity by being able to focus on those activities.

## **II. The Theory of How Economic Openness Can Raise Productivity and Living Standards**

How can economic openness contribute to higher average productivity and thus higher average living standards? Perhaps the most vivid way to demonstrate this is to see how a country that is closed off from the rest of the world raises its living standards.

A closed economy must provide its own savings for investment in building its capital stock. It cannot finance investment in tomorrow's productive capacity by tapping into savings abroad. A closed economy must generate its own ideas, technologies, and techniques for product and process innovations. It cannot rely on the people and ideas of the rest of the world, either directly or indirectly as an innovative spur. And a closed economy must produce its own goods and services to consume today. It cannot reallocate resources to specialize in its particular strengths, because doing so might mean not making enough of everything to satisfy families' demands today.

*Globalization and economic openness support productivity and living standards by relaxing all three of these constraints.*

With globalization, savings by the world's households, firms, and governments can be deployed to productive investment opportunities literally around the globe, not just at home. Some private cross-border flows of capital that support investment and ultimately worker productivity happen inside multinational corporations through their FDI abroad. Other private cross-border flows of capital take the form of portfolio investment—in equities, bonds, and other assets—all mediated by commercial and investment banks. The net effect has been to bring investors and investment opportunities together on a global basis.

With globalization, ideas that improve technology can move across borders through many different channels. Ideas accompany people as they move via immigration—indeed, there becomes a global market not just for ideas, but for the talent that creates them. Ideas are deployed within multinational corporations as they spread their innovations among parent and affiliate operations. And ideas flow via the

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internet and countless other channels by which information technology connects workers, firms, and communities. We emphasize that all these linkages can matter, not just directly but also indirectly as a spur to firms everywhere to innovate new products and processes themselves.

And with globalization, a country can trade so that it no longer needs to produce what it consumes. It can concentrate people and capital in certain activities to which it is well suited compared to the rest of the world—activities in which a country holds a comparative-advantage, in the lexicon of economics. It can then export some of these activities to the rest of the world in exchange for imports of different bundles of goods and services—imports that can be enjoyed both in greater variety and at lower prices than would be the case without trade.

There are many channels, then, through which economic openness supports high and rising average livings standards. We emphasize, however, that openness per se is no panacea that automatically delivers higher average productivity. Rather, globalization provides expanded opportunities to a country's workers, firms, and communities. To be realized, these opportunities need to be complemented with an appropriate set of government and business policies. This is a very important point that will inform our policy discussions in Section 3.

### **III. What Forces Have Been Driving Global Engagement And How Do We See It?**

In recent decades, two broad forces have driven the integration of world markets for goods and services, labor, capital and ideas. One is the decline of natural barriers. In the generation after World War II there were major innovations in the global movement of output and people: for example, containerized shipping, wide-body jets and commercial aviation. More recently there have been dramatic innovations in information and communication technologies—e.g., the creation of personal computers and the rise of the internet—that have supported international flows of ideas, capital, people, and output.

The other is the decline of *political* barriers. Governments in almost every country have chosen to liberalize their laws and regulations restricting cross-border flows. Political barriers have fallen in very dramatic fashion, perhaps the most vivid of which is the end of the Cold War and subsequent political revolution in the Soviet Union and most of its former communist satellites. For many decades after World War II, these countries were largely separate from the global economic system. Political barriers have also sometimes fallen unilaterally, i.e., as individual countries decide to engage with the world. Two of the most dramatic examples of this have been the ongoing acceleration of China and India's integration into the global economy. They have also fallen regionally and multilaterally, for example, with successive rounds of

trade liberalization in the General Agreement on Tariffs and Trade and its successor, the World Trade Organization.

The impact of falling natural and political barriers to integration has been a dramatic rise in cross-border flows of people, ideas, goods and services, and capital. For the United States and many other countries, in recent decades the rate of growth of these cross-border flows has been much higher than the rate of growth of overall economic activity measured as gross domestic product (GDP). The size of these flows today is striking. In 2006, the United States exported to the rest of the world \$1.47 trillion in goods and services, and imported from the rest of the world \$2.23 trillion. As large as these amounts may seem, capital flows are an order of magnitude bigger. In 2006, foreigners purchased \$21.1 trillion of U.S. long-term securities—while also selling \$20.0 trillion worth of such securities. That same year, U.S. residents purchased \$5.6 trillion in long-term securities—while also selling \$5.8 trillion of such securities.<sup>5</sup>

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“The impact of falling natural and political barriers to integration has been a dramatic rise in cross-border flows of people, ideas, goods and services, and capital.”

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## **IV. The Evidence on How Global Engagement Raises U.S. Productivity and Living Standards**

The discussion above identified many channels through which global engagement can raise the productivity and average living standards of a country. But what do the data show? Has the United States benefited from integrating with the world economy? By how much? Can future liberalization deliver additional gains?

We turn now to what research by academic, policy, and private-sector economists says about these very important questions. It is important to emphasize at the outset, however, that because global engagement involves so many dimensions, different studies that use different methods to quantify different dimensions can and do yield different answers. The right question to ask is not, “What is the single dollar amount by which the United States has benefited from integration with the world?” It is instead, “What does the preponderance of evidence indicate has been the range of benefits the United States has realized from integration with the world?”

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<sup>5</sup> Data on trade flows come from the Bureau of Economic Analysis, National Income Accounts. Data on capital flows come from the U.S. Department of Treasury, Treasury International Capital data.

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## Evidence on Gains to the Overall U.S. Economy: Past

Recall there are three broad channels by which countries can benefit from greater economic openness brought about by lower natural and/or political barriers: better resource allocation; expanded knowledge of technology and techniques; and higher capital accumulation. How big have the gains through these three channels been for the United States?

**Three** channels by which countries can benefit from greater economic openness:

1. better resource allocation
2. expanded knowledge of technology and techniques
3. higher capital accumulation

Start with resource-reallocation gains. Here it is important to realize that gains can be measured for firms, in terms of being able to sell more exports by specializing in comparative-advantage activities, and for individuals and families as consumers, in terms of enjoying a wider variety of goods and services to consume at lower prices. Combined, these gains have been estimated to

be large—especially once the value of broader variety is accounted for. For example, recent analyses suggest that reductions in U.S. tariffs since Smoot-Hawley in the U.S. and the rest of the world have increased real U.S. incomes by 4.5 percent of GDP, both by stimulating more capital formation and by improving resource allocation.<sup>6</sup> Increases in product variety in trade have added nearly three more percent of U.S. GDP.<sup>7</sup> In addition, a full accounting would yield additional gains from the impact of improved communications and transportation.

What about the gains from better technology and techniques? Many studies have tried to quantify economy-wide gains from the many linkages at play in these two channels. When considering both liberalization of trade and investment, the magnitudes here seem to be very large: something on the order of five to ten percent of U.S. GDP per year—above and beyond the 7.5 percent from the resource-reallocation gains of the previous paragraph!<sup>8</sup>

Taking all these channels together yields a striking picture: the global engagement of recent decades means that today, annual U.S. income is conservatively ten percentage points of GDP higher than it would have been absent this integration. This translates into an immense aggregate gain of at least \$1 trillion per year, or an

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6 See the analysis in: Bradford, Scott C. and Robert Z. Lawrence. 2004. “Non-MFN CGE Simulations.” Photocopy manuscript, Brigham Young University and Harvard University.

7 An excellent study on this topic is Christian Broda and David Weinstein, 2006, “Globalization and the Gains from Variety,” *Quarterly Journal of Economics*, 121 (2).

8 A careful, comprehensive study in this area is Bradford, Scott C., Paul L. E. Grieco, and Gary Clyde Hufbauer. 2005. “The Payoff to America from Global Integration.” In *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, edited by C. Fred Bergsten. Washington: Institute for International Economics.

average gain of at least \$10,000 per U.S. household per year—21.6 percent of the 2005 median U.S. household income of \$46,326.

To see all these channels at work, it can help to refine the focus from the overall U.S. economy down to particular industries, firms, and workers. To do this, let's start with the recent productivity performance of the U.S. economy.

Output per worker hour in the U.S. non-farm business sector has doubled in the past decade: from an annual average of 1.35% over 1973-1995 to an annual average of 2.70% since 1995. Thanks to the relentless math of compound interest, the importance of this productivity acceleration is difficult to overstate. At the previous generation's growth rate, average living standards required 52 years to double. At the current growth rate, average living standards need just 26 years to double. This difference of 26 years spans an entire generation, and so carries profound implications for the well-being of all Americans.

This productivity acceleration was not driven equally across all industries. Instead, much of the initial acceleration was related to information technology (IT)—and IT is one of America's most globally engaged industries. IT companies have been at the forefront of establishing and expanding production networks linked by trade and investment around the globe. Up until 1980, America was good relative to the rest of the world at making computers and related machinery. The earliest personal computers were produced largely in the United States in small manufacturing plants dotting Silicon Valley and elsewhere. But then IT firms, thanks to rising domestic competition and opening borders around the world, began to establish and expand global production networks.

Both falling natural and political barriers to trade and investment have driven the global engagement of the IT industry. Indeed, since the creation of the WTO the only industry to enact a free-trade agreement has been IT. Signed in 1996 by dozens of countries accounting for nearly 95 percent of world IT trade, the Information Technology Agreement eliminated over four years all world tariffs in hundreds of IT capital goods, intermediate inputs, and final products. This trade agreement facilitated the reconfiguration of global production, with U.S. IT firms moving to higher value-added activities such as core R&D, initial manufacturing, design, and marketing.<sup>9</sup>

The trade and investment data for the U.S. IT industry are striking. Imports and exports as a share of output have been high and rising in IT industries for decades. Imports and exports currently each equal over 100 percent of value-added of these products, far higher than in the broader economy. In the United States, parents of U.S.-headquartered multinationals account for about two-thirds of total U.S. sales

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9 For a detailed discussion of the support that international trade and investment gave to productivity growth in the IT industry, see: Matthew J. Slaughter. 2002. *Technology, Trade, and Investment*. Washington, D.C.: Emergency Committee for American Trade.

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in the central IT industries. Outside the United States, foreign affiliates of these U.S. companies now account for between 25 and 50 percent of worldwide firm value-added and employment, and around 15 percent of worldwide firm research and development—with nearly 60 percent of their output being exported rather than sold in host markets. These shares have been rising, and are generally higher than for other sectors.<sup>10</sup>

Integral to the productivity success of IT has also been cross-border flows of ideas and people. Research of the IT industry in Silicon Valley has documented that by 1998, 24 percent of the corporate executives in the region's technology companies were immigrants from China or India. This example of America's reliance on high-skilled immigrants for know-how is reflected in the overall economy: the share of U.S. Ph.D.s in hard sciences and engineering that were foreign born rose from 24 percent in 1990 to 38 percent in 2000.<sup>11</sup>

Information technology offers a very clear example of the dynamic benefits globalization has brought to many American producers.<sup>12</sup> But IT firms are by no means unique. International trade and investment are critical spurs to productivity growth in companies throughout the economy. There is now a large body of evidence for many countries that plants and/or firms exhibit substantial and persistent heterogeneity in total factor productivity and related performance. In recent years researchers have also documented a robust correlation between productivity and global engagement: plants and/or firms that export or, even more so, are part of a multinational enterprise tend to have higher productivity than their purely domestic counterparts.

Some of the most comprehensive research on this issue has been conducted by the McKinsey Global Institute (MGI), which has examined hundreds of firms and industries in countries ranging from the United States to India. A repeated finding is that exposure to "global best-practice firms" via trade and FDI stimulates firm productivity, and conversely that protection from global best practice retards it.

A clear statement of this globalization-to-productivity link appears in work by Nobel Laureate Robert Solow and former chairman of the Council of Economic Advisers Martin Baily:

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10 Matthew J. Slaughter. 2002. *Technology, Trade, and Investment*. Washington, D.C.: Emergency Committee for American Trade.

11 AnnaLee Saxenian. 1999. *Silicon Valley's New Immigrant Entrepreneurs*. San Francisco: Public Policy Institute of California. The economy-wide data come from the decennial population census of the U.S. Census Bureau.

12 See Catherine L. Mann and Jacob Funk Kirkegard. 2006. *Accelerating the Globalization of America: The Role for Information Technology*. Washington, D.C.: Institute for International Economics.

*A main conclusion of the studies ... has been that when an industry is exposed to the world's best practice, it is forced to increase its own productivity. This finding emerged from a study that compared nine manufacturing industries in the United States, Germany and Japan. For each industry, the country that had the highest labor productivity in that industry was designated as "best practice," leaving 18 industries-country pairs that were below best practice. For each of these "follower" industries, a "globalization index" was calculated, reflecting the exposure of this industry to the best practice industry [via trade and FDI]. The relative productivity levels of the follower industries was then correlated with the globalization index, and there was a clear positive correlation. This positive correlation is consistent with the view that the more a given industry is exposed to the world's best practice high productivity industry, the higher is its relative productivity (the closer it is to the leader). Competition with the productivity leader encourages higher productivity.<sup>13</sup>*

The many channels through which integration into the world economy fosters high productivity show up clearly in the basic performance data of globally engaged companies. Start with firms that export or import. It is well documented that these trading companies tend to be larger, more capital and knowledge intensive, and pay higher compensation to observationally equivalent workers than do purely domestic companies.<sup>14</sup>

Even stronger performance is documented in the U.S. companies that are part of a multinational firm—either the U.S. parents of U.S.-headquartered multinationals or the U.S. affiliates of foreign-headquartered multinationals. The following tables document how these two sets of globally engaged companies perform substantial shares of the exporting, importing, capital investment, and research and development that help foster higher average living standards (all data here are for 2004, the most recent year currently available, where shares are shares of private-sector activity).

Companies in the United States that are part of a multinational firm account for barely one in four private-sector jobs. But these firms account for over 30% of GDP, a third of capital investment, half of all trade in goods, and a remarkable almost 80% of R&D. The bottom line of all these productivity-enhancing activities shows up

<sup>13</sup> Baily, Martin Neil, and Robert M. Solow. 2001. "International Productivity Comparisons Built from the Firm Level." *Journal of Economic Perspectives*, Vol. 15, No. 3, Summer, pp. 151-172. For an additional comprehensive study on the links from economic openness to productivity, see: Robert Z. Lawrence. 2000. "Does a Kick in the Pants Get You Going or Does It Just Hurt? The Impact of International Competition on Technological Change in U.S. Manufacturing." In Robert C. Feenstra (ed.), *The Impact of International Trade on Wages*. Chicago: University of Chicago Press, pp. 197-224.

<sup>14</sup> For a detailed discussion of the facts and interpretation of these performance differences, see: Howard Lewis III and J. David Richardson. 2001. *Why Global Commitment Really Matters!* Washington, D.C. Institute for International Economics. Also see the *2007 Economic Report of the President*.

**Table 1: Performance of U.S. Parents of U.S. Multinational Firms**

<u>Activity</u>	<u>Parent Share</u>	<u>Parent Value</u>
Employment	19.0%	20.4 million
GDP	24.5%	\$2.2 trillion
Capital Investment	26.7%	\$308.7 billion
Imports of Goods	30.0%	\$448.5 billion
Export of Goods	48.8%	\$399.5 billion
Research and Development	66.1%	\$145.0 billion

**Table 2: Performance of U.S. Affiliates of Foreign Multinational Firms**

<u>Activity</u>	<u>Parent Share</u>	<u>Parent Value</u>
Employment	4.5%	5.1 million
GDP	5.7%	\$515.0 billion
Capital Investment	9.4%	\$108.1 billion
Imports of Goods	25.3%	\$378.1 billion
Exports of Goods	18.8%	\$153.9 billion
Research and Development	13.6%	\$29.9 billion

where one might hope: in paychecks. In recent years, workers at these firms earned an average annual compensation somewhere between a quarter to a third higher than the average annual compensation in the rest of the U.S. private sector. Much of this differential seems to stem from the nexus of productivity advantages enjoyed by these globally engaged firms.

### **Evidence on Gains to the Overall Economy: Prospective**

The above discussion makes clear that in recent decades the U.S. economy has benefited tremendously from global engagement. But what does the future hold? Would additional declines in natural and/or political barriers yield much else?

At the time of our writing this report, the current Doha Development Round of the WTO remains focused—as it largely has been since the round’s launch in late 2001—on agriculture and, to a lesser extent, manufacturing. Services, which make up the bulk of the U.S. economy have hardly figured in the talks to date. Economists have tried to gauge the basic resource-reallocation gains that a Doha merchandise liberalization could deliver to the United States. The consensus estimates here are quite small, even for global free trade in merchandise: something like \$20 billion in

additional annual U.S. income.<sup>15</sup>

Why does this number seem so small? One reason is that decades of trade and investment liberalization in merchandise have been quite successful in eliminating the majority of tariffs and non-tariff barriers in manufacturing. Another is that agriculture is such a small part of the U.S. economy today: just 0.9% of total U.S. GDP in 2005.

Studies agree that the major payoff from future liberalization is likely to come from liberalizing trade and investment in services. Through the three broad channels cited earlier—liberalization could deliver very large gains. Studies have estimated that global free trade and investment in not just merchandise but services as well could raise U.S. income by an additional \$500 billion per year—over \$5,000 for the average American family.<sup>16</sup>

The gains from services liberalization could be that large for three important reasons. One is that services account for such a large part of the U.S. economy today: 83.7 percent of payroll jobs, with more Americans working today in broad sectors such as retail trade, health care, and professional and business services than in all of manufacturing. A second is that the United States maintains a strong comparative advantage in many services activities. This is revealed in the aggregate trade statistics: the overall U.S. trade deficit of \$763.6 billion in 2006 masked a sizable services-trade *surplus* of \$72.5 billion that partly offset a goods-trade deficit of \$836.1 billion. And a third reason is that today both political and natural barriers to cross-border transactions in services remain relatively high even though recent IT advances are making more services activities tradable, as discussed in the Introduction to this report.

It is important to point out that for many services activities, the main channel through which U.S. firms serve foreign markets—and thus the predominant political barriers to consider—is FDI, not exporting. This fact shows up clearly in the statistics on U.S. multinational firms: in 2004, sales abroad by majority-owned foreign affiliates of U.S. multinationals were \$3.2 trillion, in contrast to just \$400 billion in goods exports by these same parent companies. For America to realize the income gains from serving

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15 See, for example: Bradford, Scott C., Paul L. E. Grieco, and Gary Clyde Hufbauer. 2005. “The Payoff to America from Global Integration.” In *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, edited by C. Fred Bergsten. Washington : Institute for International Economics. Similar results are obtained by the “Michigan Model” of University of Michigan economists Alan Deardorff and Robert Stern, as used, e.g., in: Kiyota, Kozo, and Robert M. Stern. 2007. Economic Effects of a Korea-U.S. Free Trade Agreement. Korea Economic Institute of America (KEI) Special Studies Series 4. Washington (April).

16 See note 15.

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foreign markets in services, reducing barriers abroad to FDI will be of paramount importance.

## **V. The Evidence on How Global Engagement Raises Productivity and Living Standards Abroad**

The large U.S. economic gains from globalization have been repeated around the world. In recent times India and—even more—China have achieved stupendous rates of productivity growth that have lifted out of poverty hundreds of millions of people. Output per worker in China is now growing at about 9 percent per year, an astonishing rate at which average Chinese living standards are taking just eight years to double.

Central to this success has been introducing market forces—in particular international market forces via trade and FDI. Think Chinese manufacturing, where today over half of all exports are accounted for by foreign multinational companies. Or think Indian IT software, where today two thirds of sales are accounted for by Indian or foreign multinational firms.

China and India offer important evidence against the widely articulated argument against global engagement for developing countries: that without protection, host-country firms cannot compete against their foreign counterparts. This “infant industry” logic contends that barriers to openness can insulate fledgling domestic firms from foreign competition. With this protection, firms can become more productive through channels such as learning by doing, facilitating local supplier networks, investing in physical capital, and undertaking research & development. Eventually, openness can be welcomed by a vigorous rather than vulnerable domestic industry.

Economic theory alone was never able to gauge the value of the infant-industry argument for developing countries. Instead, empirical evidence was required. The recent experiences of China and India in emphasizing export promotion, rather than import protection, are but two examples of the common outcome that infant-industry protection often fails because of at least three real-world complications.

One is that when protected, developing-country firms often do not achieve the best-practice productivity envisioned. Learning-by-doing for a largely domestic market can be insufficient; capital investments can be misdirected, and R&D can be unproductive. A second is that even if protected firms do gain efficiency, perverse political-economy incentives often arise that compel protected firms and other benefiting parties to seek more and/or longer trade protection than might be warranted. For protected firms, the highest-return activities can be political lobbying. And a third is that protection of certain industries often incurs opportunity costs of foregone comparative advantage. Even if a protected sector expands, aggregate

national welfare can still be lowered because the resources used in expansion might have been more productively hired by other firms in other sectors.

Around the world, protection against trade and FDI tends to inhibit, rather than develop, the ability of developing-country firms to compete in international markets. Exposure to global best practice induces better firm performance via access to technology, access to capital, and competitive pressures. The investments in capital and technology that are needed for firm competitiveness are more likely the more engaged firms are in global product markets—and, especially, in the global production networks of multinationals and other globally engaged firms.

Of course, the fact that developing countries can benefit from global engagement through trade and FDI does not necessarily mean that they will. Openness may be necessary for stimulating developing-country industrial development, but by no means is it likely to be sufficient. It will be important to examine what constellation of policies governments can pursue to maximize the chances of success in their efforts to develop industries through global engagement. Some of these policies can be implemented and yield results quite quickly; others are longer-term endeavors whose payoff can take many years.

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“Exposure to global best practice induces better firm performance via access to technology, access to capital, and competitive pressures.”

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## **VI. Summary: The Aggregate U.S. Gains from Global Engagement**

Global engagement has generated, and has the potential to continue generating, large gains for the United States overall and for the rest of the world as well. Through the critical channels of capital investment, technological progress, and resource reallocation, American productivity is higher because of globalization.

Living standards in the United States today are upwards of \$1 trillion higher per year in total than they would have been absent decades of trade, investment, and immigration liberalization. Looking ahead, annual U.S. income could be upwards of \$500 billion higher with a move to global free trade and investment in both merchandise and services. These very large aggregate gains appear in particular industries, firms, and workers. Information technology was one vivid example we discussed. Through many channels of cause and effect, global engagement spurs higher productivity and, ultimately, higher average earnings.

All this discussion of aggregate gains is not to say that no costs are incurred in achieving them. The process of realizing these gains, through the many channels

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we discussed, is inherently dynamic. The adjustments of workers and capital being re-deployed across firms, industries, and communities may involve spells of unemployment and, over the longer run, the need to find jobs at wages lower than previously enjoyed. Indeed, as our discussion above of infant-industry protection demonstrated, for decades the economics literature has had theoretical models in which countries can, on net, suffer larger aggregate costs than gains from global engagement.

Has empirical research demonstrated that these aggregate real costs don't outweigh the aggregate real benefits? Yes. This has been a perennial question for decades, and the repeated empirical answer has been that total adjustment costs are far outweighed by total gains—sometimes by factors of 20 or even 100! Such studies can be inherently difficult, in part because of difficulty in quantifying costs such as the hardship of being forced to move geographically to regain employment. Nevertheless, there is widespread agreement that aggregate gains dominate aggregate costs.<sup>17</sup>

The evidence of this Section is, in itself, difficult to reconcile with the drift towards protectionist policies discussed in the Introduction. If globalization is so good for the U.S. economy overall, then why is protectionism on the rise? We argue that the explanation of this apparent puzzle hinges critically on distribution. Even as global engagement has generated large aggregate, on-average gains for the United States, its many constituent forces have also fostered economic changes that have pressured the well-being of many American workers, firms, and communities. Section 2 of this report examines these legitimate and widespread distributional concerns.

“Through the critical channels of capital investment, technological progress, and resource reallocation, American productivity is higher because of **globalization**.”

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17 One early study estimated that the benefits from a five-year phase-out of all U.S. trade restrictions in 1971 would be 100 times greater than the wages that would be lost during the transitional unemployment required for displaced workers to find new jobs. See Magee, Stephen P. 1972. “The Welfare Effects of Restrictions on U.S. Trade.” *Brookings Papers on Economic Activity* (3), pp. 645-701. A more-detailed follow-up study concluded that the overall gains from trade liberalization were 20 times the overall adjustment costs: see Baldwin, Robert E. John H. Mutti and J. David Richardson. 1980. “Welfare Effects on the United States of a Significant Multilateral Tariff Reduction.” *Journal of International Economics* 10(3), pp. 405-423.

## Section 2: The Distributional Challenges of Global Engagement

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In Section 1 we documented that the U.S. economy as a whole benefits greatly from global engagement. But the many forces of global engagement also impose real and often large and persistent costs on some American firms, workers, and communities.

One very prominent cost is worker dislocation from increased product-market competition. International trade and investment are continually forcing U.S. firms to seek new ways of making profits; absent such innovations, these firms tend to scale down or even go out of business altogether. And the labor-market pressures are not limited to those directly dislocated and forced to move. Thanks to domestic competition among workers in the very dynamic U.S. labor market, over time the pressures of global engagement spread economy-wide to alter the earnings of even those not directly exposed to international competition.

In this section we evaluate these distributional pressures of global engagement. We focus on three channels: worker dislocation, worker earnings, and a related angle of firms and communities. There is evidence that globalization has contributed to job loss, weak wage growth—particularly for less-skilled workers that still constitute the majority of the U.S. labor force—and increased worker anxiety.

However, a central message that emerges from our analysis is that because globalization is just one of many sources of structural change in the U.S. economy, isolating its particular contribution to these outcomes is very difficult. The U.S. economy is in a continuous state of flux, buffeted by technological and institutional innovations, demographic changes, cyclical fluctuations, government policy changes, and the many other powerful factors that shape the competitive struggles between firms. Because all these forces shape labor-market outcomes, the key policy challenge becomes not trying to isolate and limit the pressures of globalization but rather equipping American workers, firms, and communities to adapt to changes of all kinds.

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**“...the many forces of global engagement also impose real and often large and persistent costs on some American firms, workers, and communities.”**

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## I. Challenges to American Workers: Past Evidence on Employment Effects

Some people claim that trade destroys jobs. Others claim that trade creates jobs. The truth is that it does both. Trade—and the related forces of FDI, technological change, and so forth—is generally not about the numbers of jobs, but rather the kinds of jobs. Thanks to the dynamic flexibility of America’s labor market, the real issue is the reallocation of jobs across firms, occupations, and pay scales.

This flexibility is reflected in America’s generally low unemployment rate, which at the time of writing stood at 4.5 percent. But it is also reflected in the astonishing rates of churn that underlie this aggregate rate. The U.S. labor market is in a constant state of change, with a large number jobs continually being created and destroyed. In 2005, for example, the most recent full year for which data are available, private-sector employment expanded by 2.1 million.

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“Some people claim that trade destroys jobs. Others claim that trade creates jobs. The truth is that it does **both**.”

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But, this *net* increase was achieved by gross employment changes that at the establishment level were an order of magnitude bigger: 31.4 million jobs created to offset 29.3 million jobs destroyed. At the more-detailed level of worker-establishment matches, these gross flows are even larger. In recent years, each month net job creation has been attained by about 4 million worker-establishment separations being offset by slightly more than 4 million worker-establishment matches. At an average of four 40-hour work weeks a month, this means that about 25,000 jobs are destroyed every hour that America is open for business—and slightly more than that amount are created.<sup>18</sup>

What accounts for all this churn? Most of these changes took place because existing establishments expanded or contracted, but beyond this 5.8 million jobs were destroyed due to establishments closing and 6.24 million were created due to establishments opening. The worker-establishment data shows that more than half of separations are voluntary “quits” rather than involuntary layoffs and discharges, nonetheless many workers still lose their jobs for reasons beyond their direct control.

So what is the economic impact of all this job displacement? There is considerable evidence that such involuntary job loss can be costly. Research on displacement from manufacturing in general and from import-competing industries in particular

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18 The establishment-level data come from the Business Employment Dynamics database, and the worker-establishment data come from the Job Openings and Labor Turnover Survey, both of the Bureau of Labor Statistics.

has found that about two-thirds of displaced workers find new full-time jobs—but at an average wage loss of 13 percent (17 percent if one accounts for foregone wage growth during the unemployment transition). This average disguises a range of experiences: 36 percent gained re-employment at or above previous earnings, whereas 25 percent suffered earnings losses of 30 percent or more.<sup>19</sup>

What explains this range of re-employment outcomes is not the cause of dislocation. Indeed, the experiences of workers displaced from industries heavily impacted by trade are generally quite similar to those displaced from other manufacturing activities. One important influence on the costs of displacement is the business-cycle state of the overall economy. Adjustments tend to be more painful during recessions, when job losses are more common and more concentrated.

But beyond business cycles, a very important explanation of the range of re-employment outcomes is the characteristics of workers themselves. More-educated workers are less likely to lose their jobs; are more likely to change jobs with less cost; and are less likely to suffer declines in re-employment earnings. In contrast, the largest hits to re-employment earnings tend to be realized by workers who are older, less-skilled, and with established tenure. This central role for skills in understanding job transitions shows up in broader measures such as unemployment rates: at the time of writing this report, the U.S. unemployment rate for high-school dropouts was 7.2 percent—in contrast to just 1.8 percent for college graduates.

Given the magnitude of job transitions and the costs of involuntary displacement, workers are understandably concerned about employment security. Indeed, in the United States self-reports of worker insecurity have been rising: U.S. workers in the 1990s reported feeling more pessimistic about losing their jobs than in the 1980s, despite the long economic expansion of the 1990s.<sup>20</sup> And there is evidence that the expansion of international trade and investment may raise worker insecurity. Workers in the United Kingdom who work in high-FDI sectors are much more likely to report higher perceptions of economic insecurity.<sup>21</sup> And U.S. workers in service activities and occupations that are potentially tradable report both greater insecurity and a stronger desire for a strong government safety net.<sup>22</sup>

19 These data come from: Kletzer, Lori, G. 2001. *Job Loss from Imports: Measuring the Costs*. Washington D.C.: Institute for International Economics. The 17-percent figure comes from: Farber, Henry S. 2005. “What do we know about Job Loss in the United States? Evidence from the Displaced Workers Survey, 1984-2004.” Industrial Relations Section, Princeton University Working Paper Number 498.

20 Schmidt, Stefanie R. 1999. “Long-Run Trends in Workers’ Beliefs about Their Own Job Security: Evidence from the General Social Survey.” *Journal of Labor Economics* 17 (4):S127-S141.

21 Kenneth F. Scheve and Matthew J. Slaughter. 2004. “Economic Insecurity and the Globalization of Production.” *American Journal of Political Science*, 48 (4).

22 Richard G. Anderson and Charles S. Gascon. 2007. “The Perils of Globalization: Offshoring and Economic Insecurity of the American Worker,” Federal Reserve Bank of St Louis Working Paper 2007-004A.

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Are these concerns warranted? Are globally engaged firms and industries likely to be less stable than those that are not? Economic theory gives some reason to expect this. Just as globalization increases consumer choice, it also increases the options firms have in their production decisions. With the option of participating in global production networks, firms can be more responsive to costs of all kinds—wage costs included. This greater cost sensitivity can result in more-volatile employment outcomes for workers.

The empirical evidence on global engagement and employment volatility remains somewhat mixed. Early research on U.S. manufacturing plants, for example, found that most job creation and destruction was from idiosyncratic plant-specific shocks rather than broader forces such as regional or industry wages or trade flows.<sup>23</sup> Of course, the plant-specific shocks may themselves have been the result of global engagement: this speaks to an important limit of much of the data researchers use to try to disentangle the myriad influences of globalization and other forces. Recent work on services, in contrast, finds that jobs in occupations and industries in services that are potentially tradable (both domestically and internationally) have recently been less secure. For example, from 2001 to 2003 annual job-loss rates for displaced workers were 12.8 percent for those working in tradable services versus just 7.3 percent for those in non-tradable services.<sup>24</sup>

## **II. Challenges to American Workers: Recent Developments on Job Destruction and Dislocations**

Beyond the long-standing issues about job destruction and dislocations discussed in the previous sub-section, the 2001 recession and subsequent recovery have added new concerns about the costs of global engagement. We turn now to address four of these.

One new feature has been the sharp and sustained drop in U.S. manufacturing employment. Total employment in U.S. manufacturing fell sharply around the 2001 recession, from 17.3 million in mid-2000 to just 14.3 million by the end of 2003. Since then employment has drifted down even further, to just 14.1 million at the time of writing. Domestic factors, in particular the combination of slow growth in demand and rapid growth in productivity, have been the dominant source of the job loss. But U.S. trade performance—in particular, very weak export growth, appears to have played some role as well. The share of manufacturing job loss that can be attributed to trade has been estimated at somewhere between 12 and 33 percent: a minority, yes, but one that few would deny has been both significant and persistent.<sup>25</sup>

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23 Davis, Steven J., John C. Haltiwanger, and Scott Schuh. 1996. *Job Creation and Destruction*. Cambridge, MA: MIT Press.

24 J. Bradford Jensen and Lori Kletzer. 2005. “Tradable Services: Understanding the Scope and Impact of Services Outsourcing.” Institute for International Economics Working Paper 05-09.

25 See: Martin N. Baily and Robert Z. Lawrence. 2004. “What Happened to the Great U.S. Job

Second, in the 2001 recession the share of more-educated workers rendered unemployed increased. Estimates show that in 2003, 9.9 percent of all workers with a college degree or higher had been displaced during the past three years: the highest such share ever recorded. This may have reflected the secular rise in educational attainment of the overall labor force, but may also have reflected features particular to this recession (such as the concentration of employment declines in manufacturing just discussed).

Third, following the 2001 recession a sizable share of the unemployed have found it difficult to secure re-employment. Long unemployment spells can be particularly painful for many reasons: e.g., after six months when unemployment benefits typically expire. Recent unemployment rates of 4.5 to 5 percent have historically been associated with average spells of about 12 weeks and long-term unemployment shares of 11 percent. In the current recovery, however, average spells have been 18 weeks and the long-term unemployment share has averaged over 18 percent.<sup>26</sup>

The fourth and perhaps most important new concern about the job dislocations of global engagement regards the spread of offshoring to services activities. Anecdotes now abound in the business media that thanks to the IT revolution in recent years—in particular, the spread around the globe of the internet—many workers across the skills spectrum now face competition from overseas outsourcing in traditionally non-traded activities such as business services and programming. When juxtaposed with the recent facts of persistent unemployment spells and relatively high dislocations of more skilled workers, these anecdotes have contributed to a widespread perception that global engagement in services is now destroying new swatches of American jobs.

Although such services outsourcing is indeed growing rapidly, to date it remains too small a scale to account for ongoing patterns of U.S. job destruction. For example, in the years of slow U.S. employment growth 2001 through 2004, total employment in India of business-processing outsourcing services grew by about 400,000—only some of which was devoted to servicing the U.S. market.<sup>27</sup>

The bigger and still-open question is the future breadth and impact of services offshoring. Former Vice Chairman of the U.S. Federal Reserve, Alan Blinder, has argued that IT-enabled services offshoring is likely to be a major source of job disruption in the future, particularly for relatively educated U.S. workers who have generally

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Machine? The Role of Trade and Electronic Offshoring.” *Brookings Papers on Economic Activity*. Also see: L. Josh Bivens. 2004. “Shifting Blame for Manufacturing Job Loss: Effect of Rising Trade Deficit Shouldn’t Be Ignored.” Economic Policy Institute Briefing Paper # 149. And see: L. Josh Bivens. 2006. “Trade Deficits and Manufacturing Job Loss: Correlation and Causality.” Economic Policy Institute Briefing Paper # 171.

26 Lawrence Mishel, Jared Bernstein, and Sylvia Allegretto. 2007. *The State of Working America 2006/2007*. Economic Policy Institute: Cornell University Press.

27 Nasscom Data, quoted in Baily and Lawrence (see note 24).

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believed their jobs to be insulated from international competition. Blinder has calculated a “mid-range” estimate that 26 percent of all U.S. jobs could be potentially offshored.<sup>28</sup>

How large a number is this estimate? Roughly 12 percent of Americans currently work in manufacturing, mining and agriculture, and about another three or four percent in services exports. This means that Blinder’s estimates imply that an additional ten percent of the labor force could potentially face direct competition via global engagement. This is a large increase, but it would still mean that the majority of American jobs would not face such direct competition. It should also be stressed that this figure may be an overestimate since it is based on technological possibilities that do not directly account for the many other barriers (legal, cultural, regulatory) that could inhibit such movements even when the outsourcing technology might work. And however large the spread of services offshoring turns out to be, this transition is likely to unfold over many years if not decades. Juxtaposed against the current churn of 25,000 worker-establishment matches already being destroyed every hour, this transition does not seem as dramatic.

Nonetheless, we fully agree that declining natural barriers to global engagement, thanks to IT technology, is expanding the cross-border opportunities for many previously non-tradable services activities. And it is undoubtedly true that these expanding pressures of global engagement will reach many highly skilled Americans, not just their lower-skilled counterparts.

Of course, these new concerns about services offshoring speaks to the critical point that what matters is not just the numbers of jobs but also the kinds of jobs in terms of earnings. At the outset of this Section 2, we stressed that because of domestic labor-market competition, forces such as international trade and investment spread beyond those directly impacted via job destruction to all workers via pressures on earnings. And it is important to keep in mind that global engagement can pressure incomes by making it easier for firms to substitute foreign for domestic workers even if production does not move abroad.

“It is precisely on the issue of earnings where many **American workers** have had legitimate concerns for well over a generation—concerns that seem to have widened and deepened in recent years.”

It is precisely on the issue of earnings where many American workers have had legitimate concerns for well over a generation—concerns that seem to have widened and deepened in recent years. We now turn to this issue.

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28 Alan S. Blinder, see note 1.

### III. Challenges to American Workers: Past Performance of Real and Relative Earnings

Perhaps the single most important development of the U.S. labor market in the past generation has been widening income inequality. It is now well established that income inequality across skills has been rising since (depending on the measure) the mid-to-late 1970s, and that productivity gains over this time accrued disproportionately to higher-end workers. This trend speaks to a critical message of this Section 2: the fact that the productivity gains the U.S. economy has enjoyed in recent times, which tend to lift *average* living standards as emphasized in Section 1, do not necessarily mean rising earnings and living standards for every particular American worker—and also every firm and community as well.

One can see the skewness of U.S. real-income growth in many measures. One is the overall earnings distribution itself. From 1966 to 2001, the median pre-tax inflation-adjusted wage and salary income grew just 11%—versus 58% at the 90<sup>th</sup> percentile and 121% at the 99<sup>th</sup> percentile. An alternative is earnings by educational groups. In 1975, workers with a bachelor's degree from college (but no advanced degree) earned an average of \$14,200 more than workers with just a high-school degree: an education premium of 57 percent. By the year 2000 this premium for education had grown to almost \$23,000 per year, or 93 percent.<sup>29</sup>

Different measures yield somewhat different numbers. And the trends just documented did not evolve smoothly year by year. For example, the period 1995-2000 saw strong growth in real earnings—on par or even faster than aggregate productivity growth—at all parts of the skills distribution, even for the less-skilled. This period featured ongoing economy-wide economic expansion and falling unemployment rates (down to 3.9 percent in early 2000), consistent with the state of the overall business cycle helping shape income performance.

But the overall trend has been clear: over the generation from the mid-to-late 1970s to the mid-to-late 1990s, the real and relative earnings of less-skilled Americans was poor relative to both economy-wide average productivity gains and also the earnings of their more-skilled counterparts. And this trend matters all the more because of the fact that by typical measures used by economists, the majority of American workers fall into this less-skilled category. In 2005 the median U.S. worker had a high-school diploma and about one year of post-high school education (but no associate's degree). Only about one in three workers had a college degree or higher.

What economic forces were driving this poor relative and real earnings performance for most American workers? A very large research literature by economists and other scholars has tried to answer this question. Many have looked for a possible

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29 These statistics come from the 2006 and 2007 *Economic Report of the President*.

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role of globalization through channels such as international trade, immigration and FDI. Freer trade with developing countries abundant in less-skilled labor; arriving immigrants who are predominantly less-skilled; and greater capital mobility that erodes the bargaining power of workers: global linkages like these were plausible candidates to examine. Other forces receiving much attention included “skill-biased” technological change (i.e., innovations such as the spread of IT hardware that induce firms to boost their demand for more-skilled workers) and institutional changes such as falling unionization rates, a declining real value of the minimum wage, and changing social norms.

Different studies, of course, reached different conclusions based on different data, methods, and exact questions being asked. That said, nearly all researchers agree with the consensus conclusion that the majority of earnings changes through the late 1990s were driven by skill-biased technological change, not global engagement. Trade’s role in widening inequality overall was typically ascribed at only about 10 percent; the same for immigration, although many found immigration mattered more in pressuring earnings of high-school dropouts.<sup>30</sup>

So through the late 1990s, it appeared that global engagement was playing some (albeit a minor) role in pressuring the earnings of less-skilled Americans. Since that time U.S. earnings have grown quite differently, however, a critical issue to which we next turn.

#### **IV. Challenges to American Workers: Recent Performance of Real and Relative Earnings**

How have U.S. earnings evolved in recent years? Quite differently—and in ways that, we believe, are fostering even greater disenchantment with global engagement.

One change that might seem favorable is that most of the earlier trends of rising inequality across skills have stopped. For example, the college-high school earnings premium, which as documented above rose from 57 percent in 1975 to 93 percent in 2000, fell back to just 80 percent by 2004. Similarly, the relative wages of high-school dropouts have not declined since the early 1990s, and the wages at the 10<sup>th</sup> percentile of the overall distribution have increased slightly faster than those at the median.<sup>31</sup>

Switching attention from relative to real earnings, however, reveals a dramatic

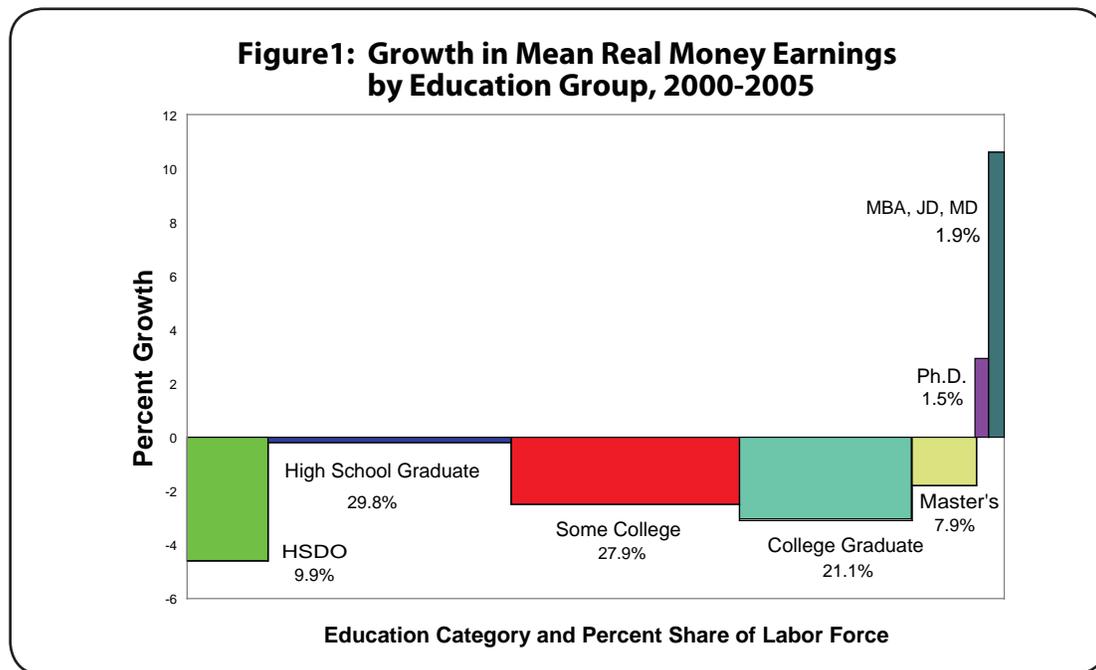
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30 This research literature is vast. A useful overview is provided by the many studies in: Robert C. Feenstra (ed.), *The Impact of International Trade on Wages*. Chicago: University of Chicago Press. Another recent overview is: Frank Levy and Peter Temin. 2007. “Inequality and Institutions in 20<sup>th</sup> Century America.” National Bureau of Economic Research Working Paper #13106.

31 The college-high school data come from the 2006 *Economic Report of the President*. The other data come from: David H. Autor, Lawrence F. Katz, and Melissa S. Kearney. 2006. “The Polarization of the U.S. Labor Market.” National Bureau of Economic Research Working Paper 11986.

change in U.S. earnings in recent years. Growth in real income has been extremely skewed to very high earners, with little or no growth for most workers.

Figure 1 documents this new pattern in real-income growth in terms of educational attainment. For each of seven educational categories, the figure reports the share of the labor force in that educational category on the horizontal axis and percent growth in mean real money earnings from 2000 to 2005 on the vertical axis.



During this period, an astonishingly small fraction of workers—just 3.4%—was in educational groups that enjoyed any increases at all in mean inflation-adjusted money earnings: those with doctorates and those with professional graduate degrees (JDs, MBAs, and MDs). In contrast to earlier decades, during this time even college graduates and those with non-professional master’s degrees—29% of workers—suffered declines in mean real earnings. And, as just noted above in terms of inequality, the real earnings of high-school graduates actually held up better than those of college graduates.

The data in Figure 1 on total money earnings, while striking, do not capture total earnings overall because they do not capture payments of benefits—a category that can include health insurance, life insurance, and equity or stock-option grants. The recent earnings picture for all Americans improves somewhat when all compensation is considered: U.S. total real employment costs rose 5.3 percent from year-end 2000 to year-end 2006. This rise was partly accounted for by ongoing sharp increases in health-care costs—increases that do not increase well-being for workers of unchanged health benefits. Moreover, this still translates into an annual average of just 0.9 percent: far less than that period’s 2.8 percent average annual

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increase in aggregate non-farm labor productivity, and far less than the rates of growth of the late 1990s. And like money earnings in Figure 1, this overall increase in total earnings was likely skewed to high earners (these total data are not available disaggregated by fine skill groups like that in Figure 1).

This astonishing skewness of U.S. income growth appears in other cuts at the data. Growth in total income reported on individual tax returns has been extremely concentrated in recent years, for example, the share of national income accounted for by the top 1 percent of earners reached 21.8 percent in 2005—a level not seen since 1928. From 2004 to 2005, the mean income change reported by the bottom 90 percent of tax filers was a decline of about 1 percent; in contrast, the mean change for the top 1 percent of filers was a rise of 14 percent.<sup>32</sup>

The second notable change in the recent pattern of U.S. income has been the sharp rise in corporate profitability. Since 2000 U.S. corporate profits have nearly doubled, from \$817.9 billion in 2000 to \$1.62 trillion in 2006. This rise has not been concentrated in one particular sector, but rather has been enjoyed quite widely across many industries. As a share of total national income, these corporate profits are today near 60-year highs at about 14 percent. The concentration of equity ownership in America means that higher corporate profitability may have contributed to the just-discussed skewness of total-income growth.<sup>33</sup>

To summarize: in recent years the large majority of American workers has seen poor income growth. Indeed, 96.6 percent of Americans are in educational groups whose mean total money earnings have been falling, not rising, since 2000. Only a small share of workers at the very high end has enjoyed strong growth in incomes. The strong U.S. productivity growth of the past several years has not been reflected in wage and salary earnings, and instead has accrued largely to the earnings of very high-end Americans and to corporate profits.

For the approximately two thirds of American workers without a college degree or higher, this poor earnings performance in recent years is largely a continuation of the long-run trend since the mid-to-late 1970s (with the exception of the late 1990s).

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32 The data in Figure 1 come from the U.S. Bureau of Labor Statistics. Total money earnings each year includes all money wages, salary, bonuses, commissions, tips, etc. for employees in companies plus net income from any farm or self-employment activity as well (all before deductions for items such as taxes and union dues). These earnings are deflated by the Consumer Price Index-Urban. Each educational group's share of the labor force on the horizontal axis is the share of 2005 payroll jobs. Data on tax filers come from Thomas Piketty and Emmanuel Saez. For additional facts on the skewness of recent income growth, see the paper by Autor, et al (note 30).

33 These are corporate profits with inventory-valuation and capital-consumption allowances, as reported by the U.S. Bureau of Economic Analysis. Also, the median American household no longer owns any stocks (directly or indirectly): the share of households with any ownership fell from 51.9 percent in 2001 to 48.6 percent in 2004, the most recent year of data available. See Table 6 in: Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore. 2006. "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances." *Federal Reserve Bulletin*, Vol. 92, February, pp. A1-A38.

But for college graduates and those with non-professional master's degrees, this poor income performance is a new and presumably unwelcome development.

So what forces explain this recent poor income performance for so many American workers? At least some of it may reflect the business cycle. It is well established, for example, that corporate profits and thus profit's share of national income are pro-cyclical. Profits tend to fall during recessions (such as in 2001) and then rise rapidly with the onset of recovery for reasons such as higher capacity utilization. We note that the share of U.S. national income accounted for by total labor compensation was about the same in 2006 as it was in 1997. If the current economic expansion persists, then like in the late 1990s the overall U.S. labor market might tighten enough to accelerate growth in earnings.

It may also be the case that recent income trends have been driven by structural forces such as global engagement, skill-biased technological change, and evolving labor-market institutions. In much of the business-policy discussions of these possibilities, globalization tends to rise to the top of the list. For example, anecdotes abound that with the IT revolution, many workers with even college or non-professional master's degrees now face competition from overseas outsourcing in activities such as business services and programming. And the ongoing integration of world markets (especially capital markets) thanks to declining natural and political barriers (e.g., China's WTO accession in 2001) may have increased the scale over which very-skilled Americans in activities such as entertainment, finance, and management can operate.

We want to stress that, unlike for the period of the 1970s through the 1990s, this recent period of new trends in the U.S. labor market has *not* been comprehensively examined by economists and other scholars. Accordingly, there is *not* yet a research consensus on what explains these income trends. In particular, consensus on globalization's role has not yet been established. Because of the new development of falling mean earnings of college graduates and master's degrees, we suspect that any role for global engagement will be more complicated than just trade with low-income countries.

Indeed, we expect researchers will face more difficulty than in the past trying to separate different forces such as trade, FDI, and technological change. Suppose that a U.S. multinational company establishes a new affiliate in India to provide internet-enabled back office accounting support for its U.S. operations. Would this case be an example of trade, FDI, or technological change? The answer seems to us to be yes, yes, and yes.

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## V. Challenges to American Firms and Communities

Our discussion in this section has focused on the pressures that global engagement can place on American workers. We want to briefly point out that these same pressures also affect American firms and communities as well. Despite the large aggregate gains that America has realized from economic openness, these gains have not accrued directly to every single American firm and every single American community.

Start with companies. In Section 1 we emphasized that through many channels, global engagement fosters high productivity in American industries. It is important to stress that this productivity impact typically arises from substantial churn at the level of individual companies and their constituent plants and establishments. Research on many industries in the United States and abroad has documented that overall productivity gains induced by global engagement (and by other forces, too) typically entail the shutdown of inefficient plants and even entire companies. Rather than all companies and plants staying open and realizing proportionate gains, more-productive firms thrive and expand while less-productive competitors struggle.<sup>34</sup>

Because economic activity tends to be concentrated across American communities, this uneven distribution of globalization's pressures across workers and firms also means uneven pressures across communities as well. Some have thrived with the opportunities presented by global engagement, innovation, and related forces. Think of Silicon Valley, home to much of the IT revolution discussed in Section 1. At the same time, hardship has befallen other communities whose employment—and often tax revenues—are predominantly in firms and/or industries struggling against international competition. Think of many cities and towns in Georgia and South Carolina that have struggled to maintain activity in textiles and apparel after the elimination of the trade-limiting Agreement on Textiles and Clothing.

Communities like these can fall into a self-reinforcing cycle. Initial losses of jobs and taxes strain local public services like schools; struggling people and families eventually move away in the face of unemployment and stagnant property values, while struggling companies do the same or close altogether; and subsequent losses of jobs and taxes strain communities further. These downward cycles can play out over many years, if not decades.

The U.S. automobile industry offers a clear example of the challenges global engagement can present to American companies and communities. Through both international trade and investment, America's "Big Three" automobile firms have

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34 See, for example, the following survey: Bartelsman, Eric J., and Mark Doms. 2000. "Understanding Productivity: Lessons from Longitudinal Microdata." *Journal of Economic Literature*, 38, pp. 569-594. These authors report, "Of the basic findings related to productivity and productivity growth uncovered by recent research using micro data, perhaps most significant is the degree of heterogeneity across establishments and firms in productivity in nearly all industries examined."

faced decades of widening competition against the likes of Toyota and Honda. These foreign-headquartered firms have innovated relentlessly, and the intensity of this competition has forced Chrysler, Ford, and GM to continually raise productivity and product quality—e.g., to reduce assembly times and quality defects. America as a whole has benefited greatly from this international competition: consumers, in particular, have enjoyed wider variety, restrained prices, and higher quality.

But this competition has affected different companies very differently. In recent years the Big Three have collectively lost tens of billions of dollars and reduced their U.S. payrolls by nearly 100,000 workers. In the past year Ford and GM have embarked on dramatic restructurings to stave off bankruptcy, and Chrysler has just been sold by Daimler to the private-equity firm Cerberus for far less than its acquisition price. Meanwhile, many foreign firms like Toyota have thrived: their profits and stock prices have soared, and they continue to build new U.S. plants even as the Big Three continue to close theirs.

This competition has also affected different communities very differently. Many cities and towns in the traditional Big Three footprint states like Michigan, Indiana, and Ohio have suffered. Today Michigan, where motor vehicles accounted for 11.6 percent of 2004 total labor compensation, has one of the country's highest unemployment rates and is suffering falling home prices in many places. At the same time, in other states including Alabama and Mississippi, communities have thrived with the construction of new production facilities of foreign-owned automobile firms. 328,100 Americans worked at U.S. affiliates of these multinationals in 2004, each earning an average annual compensation of \$65,651.

## **VI. Summary: The Political Economy Challenge Presented By Distributional Pressures**

Despite the aggregate gains that global engagement has brought to the United States overall, its constituent forces do not directly benefit all workers, communities, and firms. Achieving these overall benefits necessarily entails immense churning and change. Many workers, firms, and communities are hurt, not helped, by these forces. This has been true in the past; it is true today; and it will be true in the future.

America's integration into the world economy in recent decades has coincided with important changes in the U.S. labor market. From the mid-to-late 1970s to the mid-to-late 1990s, the real and relative earnings of less-skilled Americans was poor relative to both economy-wide average productivity gains and also the earnings of their more-skilled counterparts. And since around 2000, the large majority of American workers has seen poor income growth. Indeed, 96.6 percent of Americans are in educational groups whose mean total money earnings have been falling, not rising, since 2000. Only a small share of workers at the very high end has enjoyed strong growth in incomes. The strong U.S. productivity growth of the past several

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years has not been reflected in wage and salary earnings, and instead has accrued largely to the earnings of very high-end Americans and to corporate profits.

The bottom line is that today, many American workers feel anxious—about change and about their paychecks. Their concerns are real, widespread, and legitimate. What role the forces of global engagement have played in this recent poor labor-market performance of most Americans remains an open question. But whatever the answer, in the current political discourse on this question, globalization is often front and center.

Recall the dramatic drop in the support of American voters described in the Introduction. The evidence here in Section 2 explains this drop. Public support for engagement with the world economy is strongly linked to personal labor-market performance, and the protectionist drift reflects a public increasingly skeptical about whether globalization benefits them in the face of weak or nonexistent income growth. In short, policymakers face an increasingly skeptical public about whether globalization benefits them—a skepticism not without cause given the lack of recent real income growth for most Americans. This change in public opinion is the foundation of the protectionist drift in policy described in the Introduction.<sup>35</sup>

What can be done to address all this? The most commonly heard reply is, “more skills through more education.” The idea behind investing in education is sound: higher-skilled workers generally earn more, experience less-costly transitions across jobs, and overall are more likely to directly benefit from economic openness as they provide a foundation for the American economy to attract and retain globally engaged companies. Upgrading the skills of American workers through education—and also striving to improve American education, from pre-school through college and beyond—we wholeheartedly support.

The limitation of this approach, however, is that upgrading skills is a process that takes *generations*. Any gains here will come far too late to address today’s opposition to economic openness. 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, then if past were prologue, graduation of that median American worker would 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.<sup>36</sup>

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35 This argument of the critical links among labor-market performance, public opinion, and the protectionist drift is taken from: Kenneth F. Scheve and Matthew J. Slaughter. 2007. “A New Deal for Globalization.” *Foreign Affairs*, July/August, pp. 34-47.

36 This argument of why education alone is not sufficient to halt the protectionist drift is taken

So the question remains. What policies can be implemented today to strike a delicate balance of allowing America to continue to realize the aggregate benefits of global engagement while also addressing the legitimate concerns across American workers, companies, and communities about the economic pressures generated amidst these aggregate gains? In Section 3, we offer our answer to this question.

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from: Kenneth F. Scheve and Matthew J. Slaughter. 2007. "A New Deal for Globalization." *Foreign Affairs*, July/August, pp. 34-47.

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## Section 3: A New Policy Agenda

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In this Section we offer a package of policy ideas designed to stimulate debate and point toward a new synthesis on the goals of economic policy in today's global age.

We start from the premise that economic policy should aim to produce a growing American economy in which every American can find opportunity to use their skills to craft their own economic future. That seems to us to be the only way to meet the current challenge of guaranteeing that America overall continues to benefit from global engagement while also delivering on the idea of an equal-opportunity society and thereby addressing the legitimate distributional concerns about the pressures of economic openness.

Our prescriptions might, in some respects, seem radical. But we do not see them as such when viewed in the context of the very real economic pressures that global engagement is imparting to American workers, firms, and communities. We have articulated them in ways designed to stimulate discussion of alternatives and ways forward. The ultimate goal is a new policy agenda that works for all Americans. Many of our ideas present new choices and trade-offs, and we maintain great faith in the deliberative democratic process to find workable solutions.

That said, we are firm in two views. One is that this process cannot work if the debate is not well-informed by the relevant facts, however uncomfortable they may be. The second is that people at all points on the political spectrum cannot simply reiterate long-held positions aimed at key constituencies rather than at true progress to address our largely unprecedented challenges.

We present our menu of policy proposals in four sections. The first two speak to the legitimate anxiety about the economic pressures of global engagement. The second two speak to expanding American's integration into the world economy.

First, we explain how to address the current skewness in U.S. income growth. We start here because the protectionist drift discussed in the Introduction reflects a public increasingly skeptical about whether globalization benefits them in the face

of weak or nonexistent income growth. As such, we consider this poor earnings performance to be the most pressing policy issue to address.

Second, we propose a menu of policy innovations designed to better facilitate adjustment by workers, communities, and firms. The dynamic forces of the U.S. economy foster widespread, continual change in terms of hirings, firings, start-ups, and shut-downs. More can be done to smooth adjustment to this churn.

Third, we discuss why turning away from open borders—either a pause from liberalization or an actual move towards protectionism—is neither viable nor desirable option. Any such turn would be a mistake on many dimensions.

Fourth, we propose a menu of proposals to ensure that the United States remains fully engaged in the global economy. These proposals aim to move the discussion beyond the platitude “remain open” to a set of concrete ways to maximize America’s gains from global engagement.

## **I. Policies to Address Poor Real-Income Growth**<sup>37</sup>

As we explained in Section 2, in recent years the large majority of American workers have seen poor income growth. The strong U.S. productivity growth of the past several years has not been reflected in wage and salary earnings, and instead has accrued largely to the earnings of very high-end Americans and to corporate profits.

There is not yet a research consensus on what explains these income trends. In particular, consensus on globalization’s role has not yet been established. But for the critical policy question of whether America continues to integrate into the global economy, this current lack of consensus is largely irrelevant. The protectionist drift now underway in America reflects a public increasingly skeptical about whether globalization benefits them in the face of weak or nonexistent income growth.

Some of the recent poor income performance for so many American workers likely reflects forces of the business cycle. This means that if the current economic expansion persists, then like in the late 1990s the overall U.S. labor market might tighten enough to accelerate growth in earnings. This implies a broad goal for macroeconomic policy—both the fiscal policy of Congress and the monetary policy of the Federal Reserve—of sustaining this expansion.

But because much of the recent poor income performance seems structural, then to prevent an acceleration of the protectionist drift there is a strong case for greater income redistribution. Both to allow global engagement to generate large

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37 The policy proposal in this section is taken from: Kenneth F. Scheve and Matthew J. Slaughter. 2007. “A New Deal for Globalization.” *Foreign Affairs*, July/August, pp. 34-47.

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overall gains for America, and to minimize the economic distortions that indirect redistribution can introduce, we favor the direct approach of using federal fiscal policy, our society's main tool for such efforts.

How do we propose to increase the progressivity of our current tax code? First, it is important to recognize that the personal income tax is already quite progressive. A sizable fraction of Americans pay no federal income tax, while those at the top of the scale pay a large share of this total tax.<sup>38</sup>

The personal income tax, however, is not the whole story. The U.S. revenue base is made up a number of different forms of taxation. One, in particular, is very large and very regressive. It is the Federal Insurance Contributions Act (FICA) tax, which is paid by every working American to support Social Security and Medicare.

FICA is large. In fiscal 2005, FICA taxes accounted for \$760 billion in revenue, over 69 percent of the government's \$1.1 trillion take from the progressive income tax. And while there are elements of progressivity in the benefits it provides, the funding of FICA is regressive, for two reasons: it is a flat rate on a (largely) capped base: 15.3 cents on every dollar a worker earns up to \$97,500.<sup>39</sup> Moreover, FICA falls only on labor earnings, not other forms of income people might realize. This means that FICA exacerbates, rather than offsets, the pre-tax earnings trends we have discussed in this report.

In fiscal 2005,  
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accounted for  
**\$760 billion**  
in revenue, over  
**69 percent**  
of the government's  
**\$1.1 trillion**  
take from the  
progressive  
income tax.

Many supporters of the FICA tax's current structure argue that the tax is akin to a contribution to a retirement plan, and that every American should be obliged to contribute to prevent erosion of political support for broad social programs like Medicare and Social Security. We do not find this argument sufficiently compelling. In practice these social programs are largely pay-as-you-go, not fully funded, which means FICA is simply another revenue source the federal government uses to make

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<sup>38</sup> Provisions like the Earned Income Tax Credit ensure that taxpayers on the low-end of the income scale pay no income tax. The burden of the income tax already falls heavily on upper-middle-income and high-income households. The Alternative Minimum Tax is presenting growing uncertainty about what effective income tax Americans face, as each year it takes a large bite out of the income of an ever-growing number of American taxpayers that typically view themselves in the middle class, broadly defined.

<sup>39</sup> There are separate portions of the FICA tax for Social Security and Medicare. FICA imposes a flat tax of 15.3 percent on the first \$97,500 of gross income for every worker (with an ongoing 2.9 percent flat tax for the Medicare portion beyond that). In statute, the worker and his/her employer each pays half of the total FICA tax. But in reality, the company's contribution ultimately comes out of it willing to pay the worker, with the net result being that FICA takes a full 15.3 percent of a worker's gross income before income taxes even come into play.

transfers and purchase goods and services. We think that the protectionist drift is a greater political danger than the intended but not practiced underpinnings of America's entitlement programs.

Without taking on the broader issue of needed reforms in Social Security and Medicare, we think there is real virtue in seeing FICA as simply a tax that is capable of being restructured to leave more of the average worker's hard-earned income in their pockets as a means directing the economy-wide benefits of globalization more to the average worker's kitchen table. In proposing FICA reform, in no way are we questioning the value of Social Security and Medicare as integral parts of America's social safety net. Indeed, our broad goal with FICA reform is to broaden this safety net to better address the pressures of global engagement.

Given all this, we propose the following change to the FICA tax.

**Congress should either fully integrate FICA taxes into the income tax or introduce greater progressivity into the FICA tax itself through measures including raising the cap, in order to increase the progressivity of the overall tax system and to ensure broader sharing of the benefits of American's participation in the global economy.**

Implementing this proposal would involve many important details. Determining the right scale and structure of redistribution would require thoughtful national discussion.<sup>40</sup>

## **II. Policies to Facilitate Adjustment by American Workers, Communities, and Firms**

Section 2 of this report documented the enormous churn within the American economy. Every hour that America is open for business, 25,000 worker-establishment job matches are destroyed. Jobs appear and disappear, and companies start up and shut down, at amazing rates. Globalization is one among many forces that drive this dynamic reallocation of people, capital, and ideas to emerging business opportunities.

But all this adjustment can present very real costs to American workers, communities, and firms. What is to be done? We re-emphasize that without all this dynamic reallocation, average living standards would be harmed, not helped. Trying to

<sup>40</sup> Kenneth F. Scheve and Matthew J. Slaughter (see note 38) analyze one particular option: to eliminate the full payroll tax for all workers earning below the national median. In 2005, the median total money income of all payroll workers was \$32,140, and there were about 67 million workers at or below this earnings level. Assuming that the mean labor income for this group was \$25,000, then these 67 million workers would receive a tax cut of about \$3,800 each. Because the economic incidence 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.

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shield the economy from these changes is not an option. Rather, policy must strive to reduce the costs of these changes and thereby facilitate adjustment to help as many workers, communities, and firms respond to the challenges of globalization and ultimately directly benefit from its opportunities.

Before listing our policy proposals to better facilitate adjustment, it is important to point out that they share a common theme of rethinking much of what is taken as given about our current economic life of working and saving. Today there are about 138 million payroll jobs in the U.S. economy. Many think of the eight-hour shift for the typical payroll job as what a wage-earner owes the employer to take home a pay check.

But, thought of another way, those eight hours represent a daily investment by that worker in the success of his or her company's enterprise. This enterprise may or may not be fully engaged in and succeeding in the global economy. Indeed, as Section 2 discussed, globalization accelerates the need for and the pace of economic change. This means that American workers, firms, and communities are today increasingly exposed to the risks of international competition. Given this, standard investment theory suggests an increased need for insurance mechanisms to hedge and manage this risk. These risk-management tools can be best provided not just by the government but, where possible, by the private sector as well.

### **Adjustment Policies for Workers**

For decades, high rates of job destruction and job creation have been a persistent feature of the American economy. In recent years anxiety about this churn has risen, in part because of spreading concern that declining natural barriers to global engagement thanks to IT technology is expanding the cross-border opportunities for many previously non-tradable service activities. Job turnover often imposes real costs, in terms of unemployment spells and lower re-employment earnings.

Economic openness is only one of the drivers of America's labor-market turnover, but it tends to predominate the discussions of how government policy can mitigate the costs of dislocations. The main U.S. government program here is Trade Adjustment Assistance, the program established in the Trade Act of 1974 that aids groups of workers in certain industries for whom increased imports have destroyed their jobs or have reduced their work hours and wages.

We regard TAA as well-intentioned but, because of its design, inadequate. The avenues by which globalization fosters economic change are many and, more important, both ever expanding beyond the scope of TAA and often intimately linked to other forces as well (such as technological change). We also point out that TAA's scale is insufficient relative to the size of these forces: fiscal 2005 TAA outlays by the Department of Labor were \$845 million, about 0.03% of total federal spending.

Given the breadth of these forces and the need to cushion worker adjustments of all kinds, we suggest the following two proposals.

**Congress should reform current adjustment assistance programs by combining Unemployment Insurance and the current Trade Adjustment Assistance (“TAA”) program into a single integrated Adjustment Assistance program that offers a menu of features to all displaced workers including: (1) wage insurance, (2) the portability of health insurance, (3) assistance with geographic relocation or with establishing new businesses, and (4) retraining.**

- Folding TAA into a unified program of adjustment assistance would reflect the reality of ever-changing, closely related sources of job churn.
- Appropriately designed wage insurance would cushion the cost of lower re-employment earnings. To mitigate likely moral-hazard problems here, the federal government should play a leading role here but private-sector provision of wage insurance (like auto and life protection) would be encouraged.
- Portability of health insurance would address the reality that the majority of Americans with health insurance receive it via their employer.
- Reform of existing supports such as retraining and relocation expenses would be encouraged—e.g., where feasible, to allow benefits uptake even after regaining employment rather than only when unemployed.

**Congress should allow individuals to deduct from their gross income for tax purposes the full cost of education and training expenses, even when directed at preparation for an entirely new career.**

- Rather than limit the tax deduction for training related to one’s current job, it should be broadened to encourage individual workers to continue to invest in themselves and upgrade their skills throughout their lifetimes however they best see fit.
- In a global economy, the best adjustment policy is likely to be the one that a worker undertakes well in advance of his or her actual need to adjust; expanding deductibility of educational expenses would provide incentive to do just that.

### **Adjustment Policies for Communities**

Today there already are many state and local programs designed to assist communities with economic development in the face of local shocks such as the downsizing or shutdown of a major employer. These programs speak to the critical point discussed in Section 2, that very different economics can be at work at the state and local

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level than at the national level. The churn essential to help grow our \$13.7-trillion economy is often not the perspective facing communities. Rather than seeing many firms throughout the economy capable of absorbing workers and capital released from a downsizing firm, the community's perspective can be one of catastrophic loss of jobs, income, and tax revenue that can become self-reinforcing.

To help communities better manage the risks of downsizing that can hit their local economies, we have two proposals. One is to create government-backed insurance of local tax bases, with payouts during periods of sudden economic hardship to prevent sudden drops in the provision of public services. The other is an innovation to attract new investment to struggling communities to allow them to build new links to the global economy.

**Congress should create a federal insurance facility that permits communities to insure their tax base against sudden economic dislocation.**

- This would allow communities to better manage economic risk, by allowing them to continue to provide essential public services during sudden economic hardship. The goal would not be to stop adjustment altogether, but rather to smooth its intensity over time. Towns with such insurance would become more attractive investment locations.<sup>41</sup>

**Congress should enact legislation that would identify certain communities facing significant pressures from international competition as Global Economic Development Platforms ("GEDPs") eligible for trade preferences, tax benefits, and federal financing aimed at attracting new investment to build new linkages to the global economy.**

- Trade preferences would eliminate any duty on goods produced in a GEDP when those goods finally enter the customs territory of the United States (akin to Foreign Trade Zones).
- Tax benefits currently available to Empowerment Zones and Enterprise Communities would be extended to GEDPs, with extensions such as reducing corporate tax rates applicable to income generated by operations in the GEDP.
- Investments in GEDPs would be eligible for private-sector financing that counts towards a financial institution's score under the Community Reinvestment Act, to foster the growth of ancillary businesses within GEDPs.
- GEDPs could receive additional benefits, such as access to a special GEDP visa to help staff their businesses and access to a new suite of services from the U.S. Department of Commerce to help their businesses deepen their global engagement (e.g., to identify both suppliers and export opportunities abroad).

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<sup>41</sup> This policy proposal is taken from: Robert Z. Lawrence and Robert E. Litan. 1986. *Saving Free Trade: A Pragmatic Approach*. Washington, D.C.: The Brookings Institution.

## Adjustment Policies for Firms

Firms must continually adjust to stay profitable. In that sense, the best government policy is one that keeps U.S. markets open to maximize the competitive pressure on firms to innovate to become more productive. At the same time, however, not all firms succeed in these efforts. Given this reality, we propose three new government policies to give U.S. companies even more flexibility in their efforts to succeed at innovation. Our goal is not to slow or prevent downsizing and shut-downs. As discussed in Section 2, this dynamism is essential for realizing overall productivity gains. Rather, we aim either to encourage more of activities that have broader social benefits beyond the benefits to firms (education and information flows) or to resolve current policy uncertainty (trade safeguards) that, unchecked, will inhibit innovation.

**Congress should allow firms a credit against income taxes for the marginal increase in expenses they might incur in extending their internal education and training facilities to workers outside the firm or to students in local community colleges.**

- This would encourage firms to partner with their local community in building a workforce that is better matched to meet industry's needs in a complex, competitive, and ever-changing economic environment.

**Congress should expand programs to help companies learn how to gain certification under international standards.**

- Existing National Institute of Standards and Technology efforts to assist companies with international standards, including their implementation of lean management and quality assurance techniques, could be expanded—possibly by combining the current TAA program for firms with the existing Manufacturing Extension Partnership and outreach efforts by the USFCS.

**USTR should place a high priority within the current rules negotiations under way as part of the Doha Development Agenda on reestablishing a workable safeguard mechanism within the WTO.**

- This would allow the United States greater flexibility and certainty in providing American firms with both the time and incentive to adjust to international competition.
- This mechanism should be obtained even if it requires in exchange that the United States accept additional disciplines on its use of antidumping and countervailing duty measures.

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### III. Why Trade Protection is Not the Answer

The above discussion has laid out our policy proposals for addressing legitimate concerns about the disruptions and pressures generated by America's engagement with the global economy. But some might wonder, "Where are the new trade barriers? Where are the penalties against countries that don't play by the rules—especially those that manipulate their currencies? Where are the solutions to close America's yawning trade deficit?" Many in America's current business-policy debates about globalization say that trade barriers must be part of the, if not the, solution for addressing people's concerns.

We disagree completely. For at least seven reasons, trade protection would be an extremely poor instrument for dealing with the concerns and problems we have identified. We now briefly explain each reason in turn.

First, many—if not most—of the economic pressures on American workers, firms, and communities are different from the pressures of global engagement. They stem from domestic forces such as technological and institutional innovations, demographic shifts, cyclical fluctuations, and the competitive struggles between firms within our borders. All these forces would still be present even if the United States were completely closed to the rest of the world.

Second, America's integration into the world economy has been driven not just by falling barriers due to policy but also by falling natural barriers as well. Indeed (as discussed in Section 2), in the past decade arguably the most important change in globalization has been the revolution in information technology that has widened the range of service activities tradable across borders. Government trade policies would have almost no ability to thwart the flows that have been facilitated by IT advances and other forms of falling natural trade barriers. Accordingly, many of globalization's pressures on Americans today would persist regardless of U.S. trade policy.

Third, global integration has also been driven by policy liberalizations in other countries. Tariffs and quotas on specific U.S. products or services would do little or nothing to alter this course set by other countries that are emulating the success of the U.S. economy by opening themselves to world markets. China, India, and countless other countries will continue to integrate into the world regardless of U.S. trade policy. Accordingly, many of the pressures generated by their integration will continue to be felt here as well (e.g., via changes in world prices).

Fourth, even if trade barriers could improve certain labor-market outcomes for Americans, better targeted domestic policies could achieve the same goals at lower cost. It is well analyzed and demonstrated that the cost per American job saved by trade barriers (real or hypothetical) tend to be several times the wages earned in that job. Higher tariffs on steel, for example, might increase employment of

steelworkers. But by making steel more expensive, they also reduce employment economy-wide in all the other industries—autos, machinery, etc.—that need steel as an input. Trade barriers impose large costs of resource allocation (discussed in Section 1). These costs are avoided by measures that redistribute income through transfers and taxes.

Fifth, trade barriers would incur the longer-run cost of inhibiting productivity growth. Through many channels (discussed in Section 1), economic openness fosters productivity growth and thus rising average living standards. Trade barriers would restrict these channels: e.g., by depriving U.S. firms of access to best-practice technologies and management techniques. Isolating the United States from the global economy would risk altering its culture of innovation and independent thinking that for generations has been a core source of comparative advantage—at a time when the world economy is offering greater rewards than ever to precisely that culture.

Sixth, new U.S. trade barriers could have damaging policy effects abroad. One would be reduced interest in further policy liberalization abroad. Today the biggest remaining barriers to trade and investment are abroad—especially in fast-growing low-income countries like China and India. If the United States stops liberalizing we will lose leverage in trying to negotiate market access abroad. Another would be outright retaliation. History offers clear precedents here: e.g., many countries have established expansive anti-dumping regimes by following closely U.S. practice. Either less liberalization or outright retaliation would hurt many American workers and firms trying to benefit from access to global markets.

Finally, beyond the various economic considerations just outlined, there are critical considerations of America’s strategic and national-security interests. Freer trade and investment can enhance many foreign-policy goals. Indeed, the Doha Development Round was launched shortly after 9/11 because of the widespread view that global poverty is intimately linked to international security and stability. Time and again since the end of World War II, the United States has provided leadership in the world’s shared efforts to foster peace through prosperity. With Doha on the brink of total collapse, new U.S. trade barriers could not be worse timed.

“Isolating the United States from the global economy would risk altering its culture of innovation and independent thinking that for generations has been a core source of comparative advantage—at a time when the world economy is offering greater rewards than ever to precisely that culture.”

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But what about the U.S. trade deficit? Wouldn't U.S. trade barriers level the playing field in a way that eliminates this problem? The answer is no.

The United States has been running large trade deficits because total U.S. savings by companies, the government, and households is far less than the capital investment undertaken by American companies. This gap is financed by tapping into savings abroad, an exchange which manifests in trade deficits. The U.S. trade deficit can be reduced only by raising national savings and/or lowering national investment. The most commonly heard proposals today for trade protection today are for barriers against particular countries. In today's complex global economy with many producers in many countries, such bilateral barriers would simply induce greater imports from other sources. Total U.S. spending, saving, and thus the trade deficit: all would be virtually unchanged.

In short, the trade barriers so commonly proposed as remedies to the pressures of global engagement are simply inapposite to the task. Indeed, for all the reasons just outlined they represent the single worst option policymakers could choose. We are not alone in this view. Here are the words of former Federal Reserve Chairman Alan Greenspan.<sup>42</sup>

*Protectionism in all its guises, both domestic and international, does not contribute to the welfare of American workers. At best, it is a short-term fix at a cost of lower standards of living for the nation as a whole.*

The United States must continue to engage with the global economy. Our final subsection proposes how best to do that.

## **IV. Sustaining America's Engagement with the Global Economy**

Global engagement has generated, and has the potential to continue generating, large gains for the United States overall and for the rest of the world as well. Through critical channels such as of capital investment, technological progress, and resource reallocation, American productivity is higher because of cross-border flows of goods and services, capital, people, and ideas.

Today there are many difficult policy challenges in the areas of trade, investment, and immigration. For each of these areas, we now propose concrete steps policymakers should take to help further integrate America into the world economy.

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<sup>42</sup> "Economic Flexibility" speech, to the National Association of Business Economics Annual Meeting, Chicago, IL, September 27, 2005.

## Trade Promotion Authority

Congress needs to send as clear signal as possible to U.S. trading partners that the United States will overcome the protectionist drift to remain fully engaged in the global economy. The swiftest way to communicate that message would be the prompt renewal of the President's Trade Promotion Authority. The Constitution grants Congress the power to regulate foreign commerce, but the President negotiates on the nation's behalf. To square these competing constitutional powers, Congress has for decades offered Presidents limited grants of negotiating authority—for many years known as "Fast Track" authority, now called TPA—that permits Presidents to submit trade agreements he has negotiated to Congress for an up-or-down vote without the possibility of amendment. The most recent grant of TPA will lapse at the end of June, 2007, which has led U.S. trading partners to question the United States' commitment to ongoing negotiations and to the world trading system generally.

- **Congress should renew TPA on a permanent basis**, to send the clearest possible signal that the United States does not intend to cede its leadership in shaping the global trading system.
- **This permanent TPA renewal should be conditioned on strict consultation requirements, with the opportunity to withdraw TPA if those requirements are not met**, to vindicate Congress' constitutional oversight of this critical facet of U.S. trade policy.

## Trade Negotiations

Despite recurring calls for a hiatus in trade negotiations, the only way to break down political barriers U.S. exporters face or eliminate unfair trade practices that distort competition for U.S. firms is through negotiations with our trading partners. That said, both Congress and the Executive must refocus our strategy both to maximize the economic payoff and to address the underlying concerns that have eroded public support for further liberalization.

- **U.S. policymakers should prioritize the Doha Development Agenda as expeditiously as possible**, even at the expense of further bilateral agreements in the short run.
- DDA should achieve meaningful liberalization not just in agriculture, but more importantly in manufacturing and, especially, services in large emerging economies.
- **U.S. policymakers should reform our rural economic policy by delinking program payments from production**. This opportunity is presented both by current DDA difficulties and by the 2007 Farm Bill renewal.

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- **U.S. policymakers should negotiate stronger multilateral disciplines on market-distorting practices** that injure U.S. economic interests and create the perception of unfair trade.
  - **U.S. policymakers should prioritize trade liberalization in environmental goods and services such as biofuels and products that would contribute to energy efficiency and reduced carbon emissions.**

**Whether Doha fails or succeeds, U.S. policymakers should promote within the WTO a system of “variable geometry” that addresses the diversity of its membership by allowing pluri-lateral agreements among those partners who are willing to engage in deeper economic integration in areas such as FDI and competition policy.** *(Recall (from Section 1) the very large economic gains the United States realized from the Information Technology Agreement, which was this sort of liberalization among the willing.)*

- **U.S. policymakers should begin knitting individual FTAs into the basis for a wider agreements** that eliminate conflicting rules of origin and other requirements and thereby achieve truer market integration.
- **If Doha fails, the United States should call for the negotiation of a free-trade agreement covering both merchandise and services that would be open to all WTO members that choose to participate.**

### **Trade Enforcement**

Aggressive enforcement of U.S. trade agreements is essential to ensure public support for further liberalization. The United States Trade Representative should significantly increase its enforcement efforts, both to ensure that U.S. exporters gain from negotiations to assure Congress and the American public that agreements are enforced once reached.

- **USTR should add a checklist to its annual National Trade Estimates report that clearly identifies the past year’s efforts to reduce trade barriers identified there,** whether through negotiation or litigation.
- **USTR should begin to identify what foreign trade practices most inhibit U.S. exports and then develop strategies for eliminating them,** either through negotiation (where such practices are not currently subject to disciplines) or litigation (when international rules have been broken).
- **Congress should significantly expand the resources available for enforcement of U.S. trade agreements,** both to allow the Commerce Department to serve as the primary investigator and to allow USTR to function like a U.S. attorney in determining which cases to bring.

## Addressing Labor and Environmental Issues

A consensus on how to generally approach issues such as labor and the environment in trade agreements is essential for progress. The recent agreement between the Bush Administration and Congressional leaders on the enforcement of core principles of the International Labor Organization labor standards in the free-trade agreements with Panama and Peru hopefully sets in motion a consensus on this set of issues. But simply signing trade agreements with these new provisions will not ensure that labor and environmental conditions in developing countries improve. They need to be reinforced with positive incentives and technical assistance to ensure implementation.

- **In future trade agreements, U.S. policymakers should offer additional incentives by accelerating liberalization in areas of particular interest to our trading partners conditioned explicitly on improvements in working conditions and the environment**, much as was done in the agreement with Cambodia over textiles market access in the late 1990s.
- **Congress should expand funding for, and the responsible Executive departments should increase the visibility of, efforts to implement and enforce labor and environmental agreements**, both through cooperative programs bilaterally and through existing international mechanisms (like the ILO) that already exist.

## Investment

Continued U.S. openness to inward foreign direct investment is a critical indicator of maintaining American engagement with the global economy. The same holds true for opening markets abroad to U.S. investment. In May, President Bush issued an Open Economies and Investment Statement stating that the policy of the United States is to welcome foreign investment. This statement, America's first since 1991, was very welcome, as is the balanced approach that seems to be coming out of the current legislative process. But because international capital flows are so central to global engagement, and because part of America's current protectionist drift concerns inward FDI, we think it important to reinforce those points.

**Congress should limit the scope of inward investment reviews by the Committee on Foreign Investment in the United States strictly to those national-security considerations raised by specific investments.**

- Attempts to address broad security concerns would be better addressed by more direct means.
- CFIUS is not the proper forum to address broad security problems, such as the vulnerability of our telecommunications infrastructure, through individual investment reviews.

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**Congress should remove outdated restrictions on inward foreign investment in airlines, broadcast, shipping, and other areas.**

- These restrictions were originally enacted for national-security concerns that do not exist today. These restrictions have led to substantial economic costs, and can be removed and replaced with the usual CFIUS process to address any concerns raised by specific transactions.

**Both the Treasury Department and USTR should promote a multilateral agreement inside the WTO of rules on investment for both goods and services in the post-DDA global system.**

- American multinational companies, especially those in services, serve foreign customers overwhelmingly through affiliate sales abroad rather than exports from the United States. This investment agreement would foster the global competitiveness of U.S. firms.

**Immigration**

Like the current Congressional debate on investment, the discussions on immigration will also send a powerful signal to our trading partners and foreign investors about the degree of U.S. commitment to the global economy. It is not, however, that portion of the current immigration discussion that receives the most attention—i.e., the treatment of currently undocumented workers—that will send that signal. Rather, it will be the treatment of highly skilled immigrants: both those working in America for many years if not permanently, and also those transiting in and out to support the flexibility of America’s globally engaged companies.

- **U.S. policymakers should expand the opportunity our immigration policy offers to highly-skilled potential immigrants**, which need not conflict with the current laudable emphasis on family ties.
- **U.S. policymakers should expand the supply of visas that are essential to attract top prospects from the global talent pool to the United States. In particular, start by eliminating the cap on H1-B visas.**
- **U.S. policymakers should increase the flexibility with which globally-engaged firms with U.S. operations can move personnel within their operations internationally** (e.g., use of L-1 visas) in order to ensure potential investors that if they invest in the United States, immigration laws will not hamper their ability to staff their operations optimally.

# Author Biographies

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## Grant D. Aldonas



Grant Aldonas holds the William M. Scholl Chair in International Business at the Center for Strategic and International Studies (CSIS). Previously, he had a distinguished career in law, business, and international economic policy, including service at senior levels in the U.S. government. Mr. Aldonas came to CSIS from Akin Gump Strauss Hauer & Feld, where his practice focused on international trade, investment, corporate governance, and corporate social responsibility. While at Akin Gump, he served as chairman of the U.S. arm of Transparency International. Before joining Akin Gump, he served in the Bush administration as the Commerce Department's under secretary for international trade from 2001 to 2005, where he was one of the president's principal advisers on international economic policy and managed a federal agency of 2,400 employees with offices in 80 countries and a budget of \$350 million. In his role as under secretary, he also served as a member of the board of the Overseas Private Investment Corporation and as executive director of the President's Export Council.

Prior to his service in the administration, Mr. Aldonas was chief international trade counsel to the Senate Finance Committee. During his tenure, Congress passed a number of significant trade bills, including the Trade and Development Act of 2000, Permanent Normal Trade Relations for China, legislation replacing the Foreign Sales Corporation provisions of the Internal Revenue Code, and a series of tariff bills. Before entering public service, Mr. Aldonas was a partner with the Washington, D.C., law firm of Miller & Chevalier where his practice focused on international trade, tax, government procurement, and international litigation. He also served as counsel to the Bipartisan Commission on Entitlement and Tax Reform and as an adviser to the Commission on U.S.-Pacific Trade and Investment. He was appointed chair of the American Bar Association's Task Force on Multilateral Investment Agreements and served as vice chair of the ABA Section of International Law and Practice's Committees on Trade and Foreign Investment.

Mr. Aldonas began his career as a Foreign Service officer, serving tours in Mexico, the Department of State, and the Office of the U.S. Trade Representative. He continues to serve as an adjunct professor of law and member of the board at the Georgetown University Law Center. He also continues his role as principal managing director of Split Rock International, a Washington, D.C.-based consulting and investment advisory firm, and as a member of the board of the Center for International Private Enterprise and the Global Fairness Initiative. Mr. Aldonas received his B.A. in international relations in 1975 and his J.D. in 1979 from the University of Minnesota.

## Robert Z. Lawrence



Robert Z. Lawrence is Albert L. Williams Professor of International Trade and Investment at the Kennedy School of Government, Harvard University, a Senior Fellow at the Peterson Institute for International Economics, and a Research Associate at the National Bureau of Economic Research. He served as a member of the President's Council of Economic Advisers from 1998 to 2000. Lawrence has also been a Senior Fellow at the Brookings Institution. He has taught at Yale University, where he received his PhD in economics. His research focuses on trade policy.

He is the author of *Can America Compete?; Crimes and Punishments? An Analysis of Retaliation under the WTO; Regionalism, Multilateralism and Deeper Integration; A US-Middle East Free Trade Agreement: A Circle of Opportunity?* and *Single World, Divided Nations?* He is coauthor of *Has Globalization Gone Far Enough? A Prism on Globalization; Globophobia: Confronting Fears About Open Trade; A Vision for the World Economy; Anchoring Reform with a US-Egypt Free Trade Agreement* and *Saving Free Trade: A Pragmatic Approach*.

Lawrence has served on the advisory boards of the Congressional Budget Office, the Overseas Development Council, and the Presidential Commission on United States-Pacific Trade and Investment Policy.

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# Matthew J. Slaughter



Matthew J. Slaughter is Professor of International Economics at the Tuck School of Business at Dartmouth. He is also currently a Research Associate at the National Bureau of Economic Research and a Senior Fellow at the Council on Foreign Relations, and he currently serves on the academic advisory boards of the International Tax Policy Forum and the Tuck Center for Private Equity and Entrepreneurship.

From 2005 to 2007, Professor Slaughter served as a Member on the Council of Economic Advisers in the Executive Office of the President. In this Senate-confirmed position he held the international portfolio, advising the President, the Cabinet, and others on issues including international trade and investment, energy, and the competitiveness of the U.S. economy. In recent years he has also been affiliated with the Federal Reserve Board, the International Monetary Fund, the World Bank, the National Academy of Sciences, the Institute for International Economics, and the Department of Labor.

Professor Slaughter's area of expertise is the economics and politics of globalization. Much of his recent work has focused on the global operations of multinational firms, in particular how knowledge is created and shared within these firms and how their activities are structured across borders. He has also researched the labor-market impacts of international trade, investment, and immigration, and has studied the political-economy question of individual attitudes about globalization. This research has been supported by several grants from organizations including the National Science Foundation and the Russell Sage Foundation. Over forty articles by Professor Slaughter have been published as book chapters and in peer-reviewed academic journals. He also co-authored the book *Globalization and the Perceptions of American Workers*. He currently serves in various editorial positions for several academic journals.

In addition to numerous presentations at academic conferences and seminars, Professor Slaughter has spoken to many audiences in the business and policy communities and he has testified before both chambers of the U.S. Congress. His work has been widely featured in business media such as Business Week, The Economist, Financial Times, Newsweek, Time, Wall Street Journal, and the Washington Post. He has been interviewed on many TV and radio programs such as CNN's Lou Dobbs Tonight and NPR's Marketplace. In recent years he has also served as a consultant both to individual multinational firms and also to several industry organizations that support dialogue on issues of international trade, investment, and taxation.

Professor Slaughter joined the Tuck faculty in 2002. Prior to coming to Tuck, since 1994 he had been an Assistant and Associate Professor of Economics at Dartmouth, where in 2001 he received the school-wide John M. Manley Huntington Teaching Award. Professor Slaughter received his bachelor's degree summa cum laude and Phi Beta Kappa from the University of Notre Dame in 1990, and his doctorate from the Massachusetts Institute of Technology in 1994.

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Grant D. Aldonas is the William M. Scholl Chair in International Business at the Center for Strategic and International Studies. He has been directly involved in the debate over international trade and globalization for three decades as a diplomat, trade negotiator, a leading international attorney and a policymaker with the Commerce Department and Senate Finance Committee. Prior to joining CSIS, he served as Under Secretary of Commerce for International Trade from 2001 to 2005. He is also founder of Split Rock International, which provides strategic advice to firms operating in global markets and operates a microfinance fund making investments in the developing world.

### **Robert Z. Lawrence**

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