

FACULTY OPINION: A NEW DEAL FOR GLOBALIZATION*

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In March, I returned to Tuck from Washington, D.C., where since the fall of 2005 I had been serving as a member on the Council of Economic Advisers (CEA) in the Executive Office of the President. In this Senate-confirmed position, I held the international portfolio, advising policy makers—the president, Treasury Secretary Henry Paulson [D’68], Federal Reserve Chairman Ben Bernanke, and others—on issues including international trade and investment, currencies, and the competitiveness of the U.S. economy.

Since my return, the most common question I have gotten is, “So, how was it?” I am of two minds about it. On the one hand, it was great. Created in 1946, CEA has a long history among academic economists as a forum for applying academic scholarship and teaching to provide nonpartisan, nonpolitical input to the important policy challenges facing the country. I deeply appreciated Tuck’s granting me the ability to take a leave of absence for this service, and I am now enjoying bringing that service back to Tuck—through enriched teaching, new research ideas, and a broadened outreach to the business-policy community. But on the other hand, measured in terms of policy outcomes, my CEA tenure was not so great. In case you haven’t noticed, U.S. economic policy is becoming more protectionist by the day.

Trade Promotion Authority for the president expired on June 30, with no prospect for renewal. The 109th Congress introduced 27 pieces of anti-China trade legislation; the 110th introduced over a dozen in just its first three months; and more than one is likely to be law by year’s end. The Doha Development Round of WTO trade negotiations—the centerpiece of global trade liberalization—is years behind schedule and now on the brink of collapse. Scrutiny of inward foreign direct investment has risen. And efforts at comprehensive immigration reform, which would have expanded inflows in many ways, collapsed in July.

At first glance, this protectionist drift is puzzling. We economists are justly chided for disagreeing on many questions, but nearly to a person, all economists agree on the merits of open borders. Global engagement has generated, and has the potential to continue generating, very large gains for the United States overall and for the rest of the world as well. Living standards in the United States today

* The title for and many ideas in this essay are borrowed from the recent *Foreign Affairs* article by Kenneth F. Scheve and me, “A New Deal for Globalization,” July/August 2007, pp. 34–47. This essay draws on two additional recent works by me as well: “Succeeding in the Global Economy: A New Policy Agenda for the American Worker,” coauthored by Grant D. Aldonas and Robert Z. Lawrence, policy research paper for the Financial Services Forum, June 26, 2007; and “Happy Birthday ITA,” *Wall Street Journal* op-ed column, July 17, 2007, p. A17. All three works can be downloaded from www.dartmouth.edu/~mjs.

are upward 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 upward of \$500 billion higher with a move to global free trade and investment in both merchandise and services.

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. The net result is higher productivity and higher average living standards. A good snapshot of this appears in the words on the back of any iPod: “Designed by Apple in California, Assembled in China.”

So what explains the protectionist drift? It is commonly blamed on narrow industry concerns, or a failure to explain globalization’s benefits, or the war on terrorism. These explanations miss a more basic point: U.S. policy is becoming more protectionist because the American public is becoming more protectionist, and this shift in attitudes is a result of stagnant or falling incomes. Public support for engagement with the world economy is strongly linked to labor-market performance, and for most workers labor-market performance has recently been poor.

The key issue here is not the number of jobs. The dynamic and flexible American economy continues to create jobs with a very low unemployment rate. Rather, it is incomes. In the last several years, a striking new feature of the U.S. economy has emerged: real (i.e., inflation-adjusted) income growth has been extremely skewed, with relatively few high earners doing well while incomes for most workers have stagnated or, in many cases, fallen. Only 3.4 percent of workers were in educational groups that enjoyed increases in mean real money earnings from 2000 to 2005 (the most recent year of data): mean real money earnings rose for workers with doctorates and for workers with professional graduate degrees (i.e., MBAs, JDs, and MDs) and fell for all others. In contrast to earlier decades, today it is not just those at the bottom of the skill ladder who are hurting; even college graduates and workers with nonprofessional master’s degrees saw their mean real

money earnings decline. By many measures, inequality in the United States is greater today than at any time since the 1920s.

The American public is 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.

So, what to do? The two most commonly proposed responses—more investment in education and more trade-adjustment assistance for dislocated workers—are very important to pursue. But given the scope of the problem at hand, they alone are nowhere near adequate. Significant payoffs from educational investment will take decades to be realized, and adjustment assistance is too small and too narrowly targeted on specific industries to have much effect.

Truly expanding the political support for open borders will require a significant increase in redistribution that guarantees that globalization’s gains are widely shared—a New Deal for globalization. The most promising first piece of this new deal would be to link trade and investment liberalization with building greater progressivity into the Federal Insurance Contributions Act (FICA) payroll tax for social insurance. By virtue of being both a flat rate on a largely capped base (in 2005, a flat 15.3 percent tax on the first \$94,200 of gross income for every worker, with then just a 2.9 percent flat tax for the Medicare portion on any gross income beyond), FICA is a regressive tax that tends to reinforce rather than offset the pretax inequality associated with globalization and other forces. And this regressive tax is nearly as big as the progressive income tax is: in fiscal 2005, \$760 billion versus \$1.1 trillion. FICA taxes should be cut for lower-earning Americans. Cuts could then be paid for by raising the FICA cap, raising FICA tax rates on higher earners, or some combination of the two.

What else might this new deal entail? Combine Unemployment Insurance and the current Trade Adjustment

Assistance program into a broadened, integrated adjustment assistance program that offers a menu of features to all displaced workers. Create a federal insurance facility that permits communities to insure their tax base against sudden economic dislocation. Allow individuals to deduct the full cost of education and training expenses from their gross income for tax purposes, even when those expenses are directed at preparation for an entirely new career.

Determining the right scale and structure of all these policies (in particular, tax reform linked to liberalization) would require a thoughtful national discussion among all stakeholders. But this should not obscure the essential idea: to be politically viable, efforts for further trade and investment liberalization will need to be explicitly linked to fundamental reforms of tax and other policies aimed at distributing globalization's aggregate gains more broadly.

I have long been the first person in the room to extol

the benefits of globalization. But there are many, many American workers, firms, and communities that are hurt, not helped, by globalization's forces. Left unchecked, today's emerging protectionist drift may end up eliminating the gains from globalization for everybody. Earlier this year, the 20 CEOs of the commercial banks, investment banks, insurers, and investment firms of the Financial Services Forum were polled about threats to global economic growth and their businesses. What threat topped the list of responses? Not Sarbanes-Oxley, or inflation, or the yen carry trade. Protectionism.

We in America face a stark choice: shore up support for an open global system by ensuring that a majority of workers benefit from it, or accept the protectionist drift wherever it may take us. Given the aggregate benefits of open borders, the preferable option is clear. Whether this option is chosen remains perilously unclear.