Offshoring of American Jobs

What Response from U.S. Economic Policy?

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1 Don't Cry for Free Trade

Jagdish Bhagwati

Turn to the leading American newspapers these days and you will read about the "loss of nerve," even "loss of faith," in free trade by economists. Then, you get incessant protectionist pronouncements from the New Democrats (i.e., those successful in the latest elections) in Congress, and calculated ambiguities on free trade from the Old Democrats (such as Hillary Clinton who infamously asked for a "pause" in ratifying trade deals) as they run for president. When challenged by the proponents of free trade, these politicians now typically say: "Ah, but economists no longer have a consensus on free trade," citing these very same stories they read in the newspapers.

You might think therefore that the days of free trade are behind us in the United States. Indeed, this clamor against free trade is so intense that we may soon turn to PBS and find a *Requiem for Free Trade* composed and performed from England by Sir Paul McCartney. Yet, all this hype reminds me of the cartoon where two dervishes are idly sitting on the desert sands, next to their camels, and one is reading the excitable Cairo newspaper *Al-Ahram* and telling the other: "It says that we are in ferment again."

The truth of the matter is that free trade is alive and well among economists, their analytical arguments in favor of it, developed with great sophistication in the postwar theory of commercial policy, having hardly been dented by any original arguments by the few economists, including Alan Blinder in today's debate, arrayed against it.

The Latest Celebration of the Flight from Free Trade by Economists

If one looks at the most recent flood of journalistic stories on free trade, it is astonishing (as I document in what follows) how often they have been written in funereal overtones in recent years and with disregard for the historical reality that such stories have been written recurrently in the last twenty years in major newspapers and magazines. The latest stories are by reputed journalists such as Lou Uchitelle of the *New York Times* (January 30, 2007) and the team of Bob Davis and David Wessel in the *Wall Street Journal* (March 28, 2007). They often also profile the "dissenting" economists such as William Baumol (with his coauthor, the hugely renowned mathematician Ralph Gomory) and Alan S. Blinder who is before us today.

But if their enthusiasm in imagining the failing health, even the demise, of free trade betrays ignorance of earlier such analyses that came to naught, it is equally noteworthy that these journalists are contradicted by others whose analysis of the robustness of trade among economists is more accurate. Thus, even as Davis and Wessel were writing their story of "second thoughts" on free trade (March 28, 2007) in the *Wall Street Journal*, a conservative newspaper, and proclaiming that "in many ways, the debate over free trade is moving in . . . the direction [of the skeptics and opponents]," in a telephone interview I drew the attention of Davis to the column by the brilliant and acute Eric Alterman in *The Nation* (February 12, 2007), today's most influential left-wing magazine, which correctly complained instead of the continuing approbation of free trade by economists: "This column is not going to settle the dispute over whether the United States needs a tougher trade policy. I happen to think so, but I don't expect to convince, say, Paul Krugman or Jagdish Bhagwati that I am right and they are wrong. My question is: Why does the opinion of the [political] majority of the country get nothing but contempt in public discourse?"

To gain necessary perspective on the current media stories about the economists' yet-again disappearing consensus on free trade, let me now turn to document different episodes in recent years when false notes of alarm were sounded over free trade, similar in hype to those of the motley crew that I have just cited as the latest journalists writing in a similar vein. I will assess and dismiss the "heretical" arguments that were advanced against free trade in each episode; in fact, I was cast by the media in the role of the defender of free trade in all these episodes.

Earlier Episodes of Media Frenzy

Episode 1: The Rise of Japan: Paul Krugman and Laura Tyson

By far the most striking dissent over free trade, the equivalent of a category 5 storm, came from my MIT student Paul Krugman, one of the truly profound figures today in the theory of international trade, who extended the theory of imperfect competition to trade theory and began to argue that "Free Trade Was Passé After All" in the late 1980s, about two decades ago. The effect on the media, and on the opponents of free trade, was electric, largely because the rise of Japan, and the allegations that it was protectionist while the United States was a free trader, had fed the frenzy that called for a reputable economist as an icon for protectionists.

Robert Kuttner, now the editor of *The American Prospect* and long a skeptic on free trade, celebrated Krugman's apparent heresy. Karen Pennar wrote in *Businessweek* (February 27, 1989), under the heading "The Gospel of Free Trade is Losing Its Apostles," that "Free Trade is good for you . . . Now more and more economists aren't so sure." Aside from Krugman, Laura Tyson (also one of my most distinguished MIT students) was quoted in support of "using trade policies to promote and protect industries and technologies that we believe to be important to our well-being," a position that was rejected by the Stanford economist Michael Boskin in these famous and politically costly words: there is no difference between potato chips and semiconductor chips.

Take just two of the main arguments, starting with Tyson's advocacy of trade policy as an instrument of industrial policy. Tyson claimed that industries with externalities ought to be protected. But the problem with this is that it is very hard for policymakers, and very easy for lobbyists, to decide which industries have the externalities. As the Nobel Laureate Robert Solow, as good a Democrat as you can find, once remarked, I know there are lots of industries where there are four dollars' worth of social output to one dollar's worth of private output; my problem is that I do not know which ones they are. Besides, Michael Schrage of the *Los Angeles Times* decided to actually look at how potato and semiconductor chips were made and, while the proponents of industrial policy obviously thought that semiconductor chips were made with sophisticated technology but potato chips were not, the reality turned out to be very different. Pringle chips, available in mini-bars in fancy hotels, are made by PepsiCo’s Frito-Lay subsidiary in virtually automated factories, whereas semiconductors involve mindless fitting of boards by workers with little advanced skills but much patience and ability to survive boredom. Moreover, I noted at the time in a review in the *New Republic* (May 31, 1993) of Laura Tyson’s influential book *Who’s Bashing Whom?* the exaggerated concern with what you produce as defining your economic destiny is a quasi-Marxist obsession bordering on folly. You can produce potato chips, export them, and import computers that you may use to do creative things. Equally, you could produce semiconductors, export them, and import potato chips that you could munch as a couch potato, mindlessly watching television and turning into a moron. What you “consume,” in a broad sense, is likely to be far more important to you and to your society’s well-being than what you produce.

However, Krugman’s theoretical modeling of imperfect competition among firms producing differentiated products, and the modeling of oligopolistic industries (by Krugman’s contemporaries such as Gene Grossman of Princeton University, my equally remarkable MIT student just after Krugman), did raise problems for free trade at a deeper level.[1] To understand this, consider that the last two centuries since Adam Smith wrote about the virtues of free trade had in fact witnessed repeated dissent from front-rank economists such as John Maynard Keynes at the time of the Great Depression. In essence, the argument for free trade is an extension of the argument for the Invisible Hand: if market prices do not reflect social costs, then the Invisible Hand, which uses market prices to guide allocation, will point in the wrong direction. During the Depression, evidently the market wages (which were positive) exceeded the social cost (which was zero because of widespread unemployment). So Keynes became a protectionist. Similarly, if polluters are able to pollute without having to pay for it, we would be over-producing in the polluting industry because its private cost would be below the social cost (which should include the cost being imposed through pollution). Again, the case for free trade would be compromised. Each generation seems to have discovered some market failure, appropriate to its time, which would then undermine the case for free trade.

But, writing in 1963 in the *Journal of Political Economy*, I made a simple point that turned out to be revolutionary for the case for free trade: I argued that if the specific market failure was eliminated by a suitable policy, then the case for free trade would be restored. So, if we were to introduce a "polluter pay" principle (or, tradable permits that would equally charge those who wanted to pollute), we would then be able to fully exploit the gains from trade by adopting free trade. The case for free trade had been restored after two centuries of recurrent doubts.

But there was just one important catch. If the market failure was in domestic "markets" such as labor markets where there may be imperfections such as rural-urban wage differentials or sticky wages that led to wages that exceeded "true" labor cost, then my argument was correct: the vast majority of such imperfections were indeed in domestic markets. But if these imperfections arose in international trade, then fixing these failures would involve using tariffs and so free trade could not be restored as the appropriate policy. So, if a country or its producers had some power in international markets to raise the prices at which they could sell by offering lower quantities for sale, they would do better with what economists call "an optimal tariff," an argument going back to the time of Adam Smith. Krugman was dealing with precisely such imperfections.

But eventually Krugman and other trade economists came back to free trade in several writings, abandoning Kuttner and others to twist in the wind. Essentially, this was done through less watertight, but nonetheless compelling, "political-economy" arguments. One set of economists, among them Avinash Dixit of Princeton University, returned to the fold by saying that "there was no beef": namely, that the product market imperfections were, on empirical investigation, not substantial enough to warrant departing from free trade. Another set of economists, Krugman among them, bought into the argument that protection would make matters worse, not better. My radical Cambridge University teacher Joan Robinson used to say that the Invisible Hand worked by strangulation; the less drastic Krugmanesque demonstration that it was feeble when there were product market imperfections was now combined with the view that the Visible Hand would be crippled instead. Yet others thought that, once we allowed for tariff retaliation, it was unlikely that those who initiated protectionism would survive such retaliation to break open a bottle of champagne.

The protectionists who had celebrated Krugman as their icon were disappointed, even furious: for instance, Kuttner would write fierce critiques of Krugman for years. But the truth of the matter is that, even as these economists came back to the fold on free trade, Japan ceased to be a threat and the hysteria over Japan, thick as a dense fog, subsided. Free trade as our choice policy option was back in business.

Episode 2: The Rise of India and China: Paul Samuelson
But then the rise of India and China would lead to another category 5 storm. This time, it came from the Nobel Laureate Paul Samuelson, my teacher at MIT. Writing in the *Journal of Economic Perspectives* (Summer 2004), he argued, combining mathematics not accessible to journalists with colorful language that was, that the advocates of globalization were ignoring the reality that the rise of India and China would mean that the welfare of the United States could take a hit.[2]

Although Samuelson had been careful to stress that this did not mean that United States should respond with protection, the protectionists thought they had another icon—this time along with Keynes arguably the greatest economist of the twentieth century and a longtime proponent of free trade—in their camp! Kuttner was back in business; soon there were numerous stories in magazines and newspapers, similar to those when Krugman had arrived on the scene almost twenty years earlier: for example, Aaron Bernstein, "Shaking Up Trade Theory" in *Businessweek* (December 6, 2004), and Steve Lohr, "An Elder Challenges Outsourcing's Orthodoxy" in the *New York Times* (September 9, 2004), among many others. Samuelson was careful, as reported by Steve Lohr in his interview for the *Times* story, to emphasize that his analysis "was not meant as a justification for protectionist measures." But that was lost in the unwarranted inferences against free trade by the protectionists.

Now, economists have long appreciated that external ("exogenous") developments could hurt an economy. In fact, my Cambridge University teacher, Harry Johnson, wrote exactly on this issue in the 1950s, when the dollar was scarce and Europeans opted for the pessimistic view that U.S. growth would harm them (much as many believe to be the case for the United States as India and China are growing), and he argued that Europe could benefit instead. To see this by analogy, imagine what weather does to your welfare. If a hurricane hits Florida, that hurts. But if a good monsoon arrives in India, that helps.

So, only an unsophisticated economist (and Samuelson is right that there are some, though not necessarily the ones he cited) would rule out the logical possibility that the rise of China and India could harm the United States. That part is not news. But what became news in the popular imagination, fed by much of the media and by protectionists, was that if such a pessimistic possibility actually transpired, the appropriate response was protectionism. To see this again very simply, suppose that a hurricane does damage Florida. If Governor Jeb Bush were to respond to this by shutting off trade with the rest of the United States, if not the world, he would only be increasing Florida’s anguish. And Samuelson, whose scholarship is unimpeachable and who is no creature of passions or politics, evidently did not make this elementary error.

As this truth filtered through, as many economists noted this and Samuelson himself emphasized from time to time, the protectionists lost their new icon. Besides, increasingly economists exploring the subject showed that the pessimistic possibility that the rise of India and China to become “more like us” could reduce the U.S. gains from trade by depressing the prices of U.S. exports was not a likely outcome. As countries got similar in endowments, they could profit hugely from trade in similar products (or variety), as another student of mine, Robert Feenstra (who is today the leading applied economist on trade and heads the NBER Program on trade policy) in his Bernhard Harms Prize acceptance speech, and my brilliant Columbia University colleague David Weinstein, demonstrated empirically for the postwar period when Europe and Japan rose again from the ashes. Besides, the immediate political source of worry, the scare created by the outsourcing of a few call-answer and back-office jobs to India (which Alan S. Blinder has bought into, I am afraid), also subsided as it became evident that the notion that all online trade was one-way was at variance with the facts.

Episode 3: India and China and Fear of Outsourcing: Alan S. Blinder

But outsourcing happened to revive again, a couple of years ago, when the distinguished macroeconomist Alan S. Blinder, with us today, who was deeply influenced by Thomas Friedman's bestselling book on globalization—which seemed to translate the credible statement by Bangalore's remarkable IT entrepreneurs-cum-scientists such as Nandan Nilekani that they could do everything that Americans could do into the frightening non sequitur that therefore Indians would do everything that the Americans were doing—published an essay in *Foreign Affairs* (April 2006) that bought into the line that outsourcing of services on the wire would increasingly export American jobs to these countries and presumably imperil the United States and its working and middle classes. So, he was now turned into a new icon for the protectionists even though Blinder always said that he was still a free trader. In fact, Davis and Wessel (*Wall Street Journal*) built their story against free trade around him; he made it to National Public Radio and even to the iconic TV program *Charlie Rose*.

But Blinder seemed to be unaware that outsourcing on the wire (i.e., without the provider and the user having to be in physical proximity as with haircuts), which is mode 1 of supplying services in the General Agreement on Trade in Services (GATS) in the Uruguay Round agreement in 1995, was precisely the mode that the United States and other rich countries were keenest about: they saw that they would be, not losers but, the big winners, as no doubt they are. For all the call-answer services and other low-skill services now imported from countries such as India, there are many more high-skill and high-value services by rich-country professionals in architecture, law, medicine, accounting, and other professions.

But Blinder has now shifted to arguing instead that, as services became tradable online, the number of jobs that would become "vulnerable" would rise pari passu. And he lists upward of forty million jobs today that are so afflicted. He concludes that we need to augment adjustment assistance and improve education in response. There is much that may be said on this as well. For example, if you wish to talk about flux, talking only about mode 1 (online transmission of services) is incomplete. Trade economists know that this is only one of alternative modes in the supply of services: in particular, transmission of services can occur with or without the physical proximity of suppliers and users of the services. Transmitting X-rays digitally from Indiana to be read in India is one example. But then doctors can go to patients, and patients to doctors. The GATS agreement recognizes four distinct modes of service "transactions." As it happens, the different modes were distinguished in a couple of articles in *The World Economy* in the mid-1980s by me and by Gary Sampson and Richard Snape and astonishingly made their way into the GATS agreement within a decade: a remarkable triumph for us economists.[3] I described the basic distinction between service transactions that required physical proximity and those that did not, whereas

Sampson and Snape brilliantly subdivided the former into those where the provider went to the user and the other way around.

Blinder, who does not appear to have known all this when he wrote his celebrated *Foreign Affairs* article,[4] any more than I know about the relevant intricacies of macro-economics where he holds the comparative advantage instead, understates the potential for flux by thinking only of mode 1. In fact, the possible flux arises in more ways today than he talks about. That is also true because of direct foreign investment. For instance, when Senator John Kerry talked about outsourcing, he meant also, confusingly, the phenomenon where a CEO closes down a factory in Nantucket and opens it up in Nairobi, or when that same CEO simply invests in production in Nairobi instead of in Nantucket.

But the bottom line from the viewpoint of trade policy is that hardly any serious trade economist or policymaker has objected to providing adjustment assistance (or improving education) in living memory. The first Adjustment Assistance program in the United States goes back to 1962 during the Kennedy Round negotiations: Kennedy and George Meany of the AFL-CIO signed off on it. Virtually every trade legislation since has tried to improve on it. And many trade economists including myself in the 1970s—and others such as Lael Brainard, Robert Lawrence, and Robert Litan at Brookings in recent years—have written extensively and continually on the subject. Blinder, who started talking poetry ("we are in peril"), has therefore wound up talking prose ("we need adjustment assistance"). We free traders have no problem with him as he is on the same escalator even if he is behind us. If he is to remain the new icon for those who oppose free trade, they have to be pretty desperate.

So, these three balloons with journalists aboard, waving banners against free trade, have lost their helium. Free trade has continued to maintain its credibility among economists. Of course, there have been other, less influential assaults on free trade—among them, I must count that by Baumol and Gomory who have enjoyed nonetheless some exposure, especially from the influential left-wing columnist William Greider in *The Nation* (April 30, 2007) and ironically also from the supply-side economist Paul Craig Roberts in his assault on outsourcing in the *Wall Street Journal*.[5]

I might say simply that Baumol and Gomory make one important but familiar point, with little policy relevance as I argue now. It is the old one, which I learned as a student from R. C. O. Matthews, my Cambridge University tutor in 1954–1956, who had written a classic paper on increasing returns, and with others such as the Nobel Laureate James Meade and Harry Johnson following soon after, who showed that sufficiently increasing returns would imply multiple equilibria and that this in turn implied (among other things) that there could exist a better free-trade equilibrium than the one we may be in. Matthews and Meade, and many others such as Murray Kemp, had made this observation but by using the analytical device that the increasing returns were external to the firm but internal to the industry, a device that enabled perfect competition to be maintained. By the time Krugman was writing his dissertation in the 1970s, economists had learned how to handle imperfect competition, and so Krugman managed brilliantly to show multiple equilibria in this different, and more realistic, setting. Trade economists had known these arguments for almost half a century and taught them from standard textbooks such as mine (with Panagariya and Srinivasan). The analytical buzz therefore from Baumol and Gomory's book was muted.

But when translated into policy prescription, all it could mean was that industrial policy, buttressed Tyson-style by appropriately tailored trade policy, could nudge us toward the "better" equilibrium. But neither author managed to do this, as far as we know. So, paraphrasing Robert Solow on externalities, one might say: yes, if scale economies are important, there could be multiple equilibria and we could use trade and industrial policies to choose a "better" equilibrium; but, alas, who can plausibly compute this better equilibrium? Besides, it is hard to imagine today that, with world markets so large due to the death of distance and extensive postwar trade liberalization, there are any industries or products left where the scale economies do not pale into modest proportions. Baumol and Gomory, a brilliant pair indeed, therefore do not carry any policy salience, in my view.[6]

But one assault that is ongoing, and has had an impact on the New Democrats for sure, is that by economists associated with the AFL-CIO (such as Thea Lee), and with the labor-movement-influenced think tank Economic Policy Institute (such as Lawrence Mishel). In their view the pressure on unskilled wages, and progressively on the middle class as well, is to be traced to trade with poor countries. None of this seems to face up well to the empirical studies of the subject. In an op-ed titled "Technology, not Globalisation, Is Driving Wages Down" in the *Financial Times* (January 4, 2007), I argued that the vast numbers of empirical studies (including those by Krugman) had shown that trade with poor countries had a negligible impact on our workers' absolute real wages (as against the relative wages of the skilled and the unskilled).[7] Nor did alternative ways of tying the depressed wages to trade (and even unskilled, illegal immigration) have any empirical salience. Harvard

University Kennedy School of Government's prolific trade expert Robert Lawrence, in a splendid unpublished recent paper, concurs with this view, concluding that the impact of trade on the slow growth of wages does not "show up" in his analysis of the data.

The New Democrats who continue to believe nonetheless in this imaginary downside of free trade are not doing anyone any good. In fact, they use these erroneous beliefs to stop trade liberalization and to intimidate weak nations into accepting inappropriate labor standards in the hope of raising their cost of production to moderate the force of competition that they fear.[8]

Paul Krugman, in one of his columns in the *New York Times* (May 14, 2007) did say that his own research earlier had argued that trade did not depress wages. But then he added: "But that *may* have changed" (italics added). The suggested reason was that "we're buying a lot more from third-world countries today than we did a dozen years ago." But it is easy to show that you can multiply such imports and still not have any effect on real wages. This particular case against free trade remains unproven and will not rise above the level of innuendos until some dramatic empirical study demonstrates otherwise.[9]

Notes

September 20, 2007. An op-ed based on this article was published in *The Financial Times* on October 10, 2007. Revised slightly on August 19, 2008.

Jagdish Bhagwati is University Professor, Economics and Law, Columbia University, and Senior Fellow at the Council on Foreign Relations. A new edition of his 2004 book, *In Defense of Globalization* (New York: Oxford University Press), has just been released. His latest book on trade, *Termites in the Trading System: How Preferential Trade Agreements Are Undermining Multilateral Free Trade*, was published by Oxford University Press in 2008.

Alan S. Blinder focuses on online outsourcing of services in his own writings as well as in this debate organized by Benjamin M. Friedman; but the issues raised are far more general for free trade itself, and have been advertised as such by the media. So, for both analytical and public-policy reasons, I cast my own contribution very wide, putting Blinder's arguments into necessary perspective. I must also say that I have addressed the economics of the important contributions of Paul Krugman and Paul Samuelson, whom I deal with in addition to Blinder in this essay, in several places and do not repeat them here since my writings are readily available and some are even cited here.

1. I have dealt with the analytics and also the policy implications of Paul Krugman's famous article, "Is Free Trade Passé?," *Journal of Economic Perspectives* 1, no. 2 (Fall 1987): 131–144; and my response in the Bernhard Prize Lecture, "Is Free Trade Passé After All," *Weltwirtschaftliches Archiv*, reprinted as chapter 1 in my *Political Economy and International Economics*, ed. Douglas Irwin (Cambridge, MA: MIT Press, 1991). For the latest, and most easily accessible, post-Krugman statement of the postwar theory of commercial policy, see chapter 1 of my *Free Trade Today* (Princeton, NJ: Princeton University Press, 2002).

2. Paul Samuelson, "Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization," *Journal of Economic Perspectives* 18, no. 3 (Summer 2004): 135–146.

My own article, "The Muddles over Outsourcing," written with Arvind Panagariya and T. N. Srinivasan, appeared in the same journal (*Journal of Economic Perspectives* 18, no. 4 [Fall 2004]: 93–114), right after Samuelson's, and was regarded by many in the media as a "response" to Samuelson. It was not; we were not even aware of Samuelson's article when we wrote ours. Our article was in fact the first analytical exercise, with a number of theoretical models, exploring trade in services; and it was also the first to argue that several critics and commentators, including economists, were muddling up very different notions of what "outsourcing" meant and hence muddling their arguments, in turn.

3. Jagdish Bhagwati, "Splintering and Disembodiment of Services in Developing Nations," *The World Economy* 7 (June 1984): 133–143; and Gary P. Sampson and Richard H. Snape, "Identifying the Issues in Trade in Services," *The World Economy* 8 (June 1985): 171–181.

4. A referee objected that Blinder is aware of the GATS and of the different modes of service transactions. I am sure that this is true now. However, my reseach associate has searched Blinder's *Foreign Affairs* article and found no mention of GATS or of the different modes.

5. William Baumol and Ralph Gomory, *Global Trade and Conflicting National Interests* (Cambridge, MA: MIT Press, 2000).

6. There is one other argument in Baumol and Gomory that does not rely on scale economies. It is simply that technology may diffuse abroad and that this may create difficulties for the United States. This is similar to the concerns that India and China may become more like the United States in terms of their endowments and hence the gains from trade may diminish for the United States. But I have dealt with that argument already in discussing Samuelson.

7. There has also been dispute about how stagnant real wages have been, with some economists such as Marvin Kosters and Richard Cooper arguing that, once benefits and perks outside of strict wages are allowed for, the stagnation turns into slow growth. But I avoid this debate, arguing only about the explanation of stagnation or slow growth, as the case may be.

8. I have dealt with the phenomenon of export protectionism in the form of demands for higher labor standards in the poor countries in my book, *In Defense of Globalization* (New York: Oxford University Press, 2004), and particularly in the afterword to the new edition issued in August 2007. In discussing the protectionism that now characterizes the New Democrats, I have dealt with this issue in several other places, such as the *Financial Times*, and do not enter that set of arguments here.

9. As it happens, Robert Lawrence’s recent empirical research shows that Krugman’s “may have” needs to be replaced by “has not.”