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WINNERS AND LOSERS

The truth about free trade.

BY JOHN CASSIDY

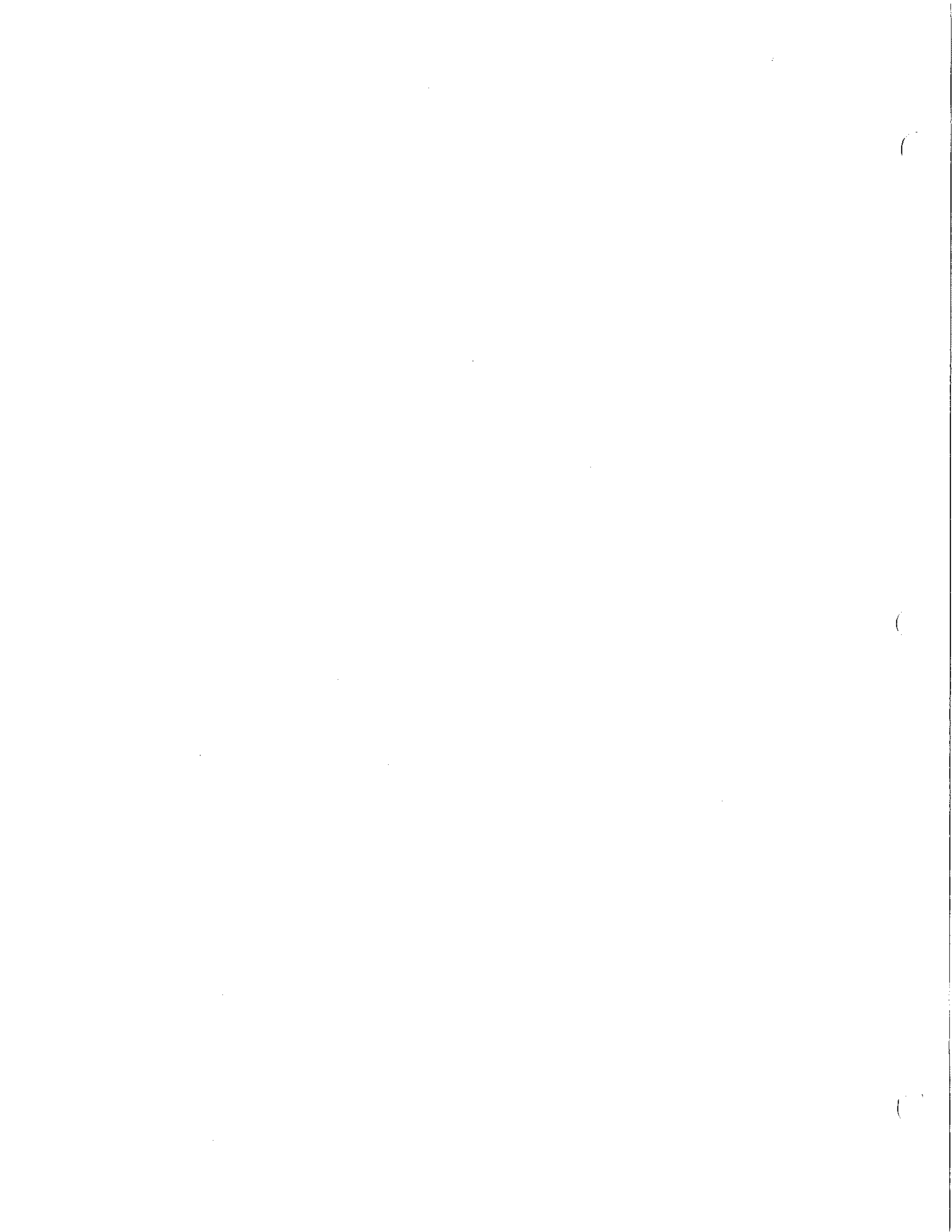
N. Gregory Mankiw, the chairman of the White House Council of Economic Advisers, is a tall, mild-mannered Harvard scholar, widely admired within his profession for his sharp mind and clear exposition. He joined the Bush Administration last year, replacing Glenn Hubbard, who returned to Columbia University, and during his first nine months in Washington he attracted little attention, which suited him fine. However, in February, Mankiw found himself in the headlines after he described outsourcing—the shifting abroad of previously secure jobs, such as accounting and computer programming—as "the latest manifestation of the gains from trade that economists have talked about at least since Adam Smith." As Mankiw put it, "Outsourcing is just a new way of doing international trade. . . . More things are tradable than were tradable in the past and that's a good thing."

The response to these statements was immediate and bipartisan. Senator John Kerry, the Presidential candidate-elect, accused the White House of wishing "to export more of our jobs overseas." Tom Daschle, the Senate Democratic leader, claimed that President Bush and his advisers subscribed to "Alice-in-Wonderland economics." On the Republican side, Dennis Hastert, the Speaker of the House of Representatives, said Mankiw's "theory fails a basic test of economics," and Donald Manzullo, a congressman from Illinois, called for his resignation. Even the President seemed to disown Mankiw's words. "There are people looking for work because jobs have gone overseas," he said. "We need to act to make sure there are more jobs at home."

They are different jobs

Shortly after receiving this public upbraiding, a chastened Mankiw spoke at a conference of economists, in Washington. He said that he had learned a valuable lesson: "Economists and non-economists speak very different languages. The two languages share many words in common, but they are often interpreted in different ways." Mankiw had a point. Put two economists in a room together and plain English is usually the first casualty. And yet the outcry his statements provoked cannot be dismissed as a linguistic misunderstanding. Although the number of people employed has picked up in recent months, the economy is still creating far fewer jobs than it did during previous cyclical upswings. According to the Bureau of Labor Statistics, non-farm employment peaked in March, 2001, at 132.5 million. In June, 2004, almost three years into an "economic recovery," total non-farm employment was 131.1 million. It is also an undisputed fact that many American businesses are choosing to relocate production to places like China and India, where there is ample cheap labor. I.B.M., for one, has confirmed that it is considering moving tens of thousands of jobs overseas to save money. In the past, manufacturing bore the brunt of this global labor arbitrage. Today, largely thanks to digitization and the Internet, the service sector, which employs fully four-fifths of the labor force, is increasingly affected. Many white-collar industries that once provided safe, well-paid employment, such as telecommunications, insurance, and stockbroking, are no longer immune from the temptation to outsource.

Well-educated American workers see software programmers in Bangalore earning six dollars an hour, when similarly trained domestic programmers are paid fifty or sixty dollars an hour, and, not surprisingly, they worry about their own livelihoods. Politicians are paid to reflect these concerns. As a senator, Kerry supported a host of free-trade initiatives, including the North American Free Trade Agreement and the extension of Most Favored Nation status to China. But once he embarked on a Presidential campaign he railed against "Benedict Arnold C.E.O.s" who transfer jobs overseas, and



he proposed policies designed to limit outsourcing. Senator John Edwards, Kerry's running mate, has taken an even harder line. The Bush Administration, despite its ostensible support for trade liberalization, didn't hesitate to impose tariffs on foreign steel to protect domestic producers in swing states such as Ohio and West Virginia. The steel tariffs were eventually removed, after the European Union threatened a trade war, but the United States continues to provide hefty subsidies to dairy farmers, tobacco growers, and other agricultural producers.

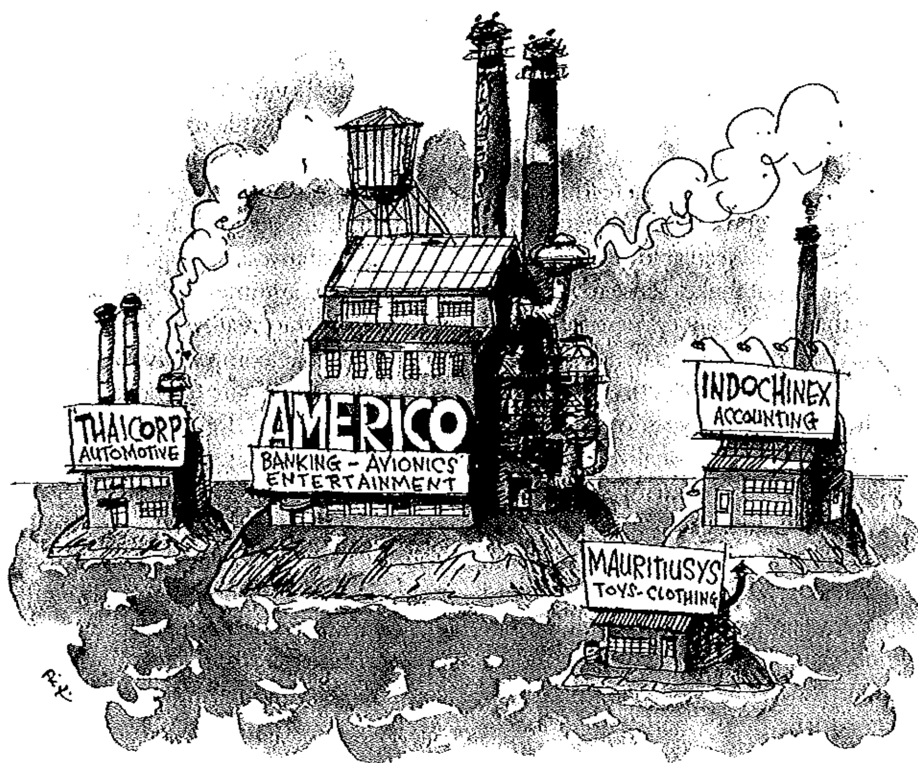
Given these political realities, it is left to economists to defend free trade, which they tend to do without reservation, regardless of political affiliation. For example, one of Mankiw's predecessors, Martin N. Baily, who served in the Clinton Administration, has just co-authored a paper entitled "Exploding the Myths of Offshoring," which echoes Mankiw's arguments almost word for word. Despite Kerry's tough public stance, many of his economic advisers endorse views similar to Mankiw's and Baily's, as do the vast majority of economic commentators. During recent months, the *Wall Street Journal*, the *Financial Times*, *Business Week*, *Fortune*, and *The Economist* have each published articles pointing out the benefits of outsourcing. Only a few journalists have dared to challenge the received wisdom, most notably CNN's Lou Dobbs, who has been conducting a virulent populist attack on businesses that shift jobs overseas. Surely Dobbs, who left CNN for a while to work at Space.com, hasn't spotted something that the luminaries of the economics profession have missed?

Surprisingly enough, he might well have. While outsourcing isn't the only reason that businesses are so reluctant to hire American workers—rising productivity and a lack of faith in the recovery are others—it is certainly playing some role, a fact that corporate executives are much more willing to admit than economists are. Moreover, economists tend to overstate the theoretical case for outsourcing, arguing that trade liberalization is always and everywhere beneficial, which simply isn't true. In today's world, where multinational corporations can produce many goods and services practically anywhere, and where investment capital can move from one continent to another at the flick of a switch, there is no economic theory which guarantees that new types of trade, such as outsourcing, automatically benefit the United States. Some Americans gain: consumers, who enjoy lower prices; stockholders, who see profits rising at companies that employ cheap foreign labor. Some Americans lose: workers whose jobs are displaced; the owners of firms whose contracts are transferred to foreign suppliers. But the economists' argument that the country as a whole inevitably benefits is questionable.

As Mankiw indicated, it was Adam Smith who developed the argument that the unfettered exchange of goods and services allows individuals to specialize in what they do best, thereby raising over-all income and prosperity. "The taylor does not attempt to make his own shoes, but buys them of the shoemaker," Smith wrote in "The Wealth of Nations," which was published in 1776. "The shoemaker does not attempt to make his own clothes but employs a taylor." It may seem remarkable that economists still refer to the work of a Scottish radical who didn't even call himself an economist—his title at Glasgow University was professor of moral philosophy—but the division of labor, which is what Smith was talking about, lies at the heart of outsourcing and offshoring. (The two phrases once had distinct meanings, but now they are used interchangeably.)

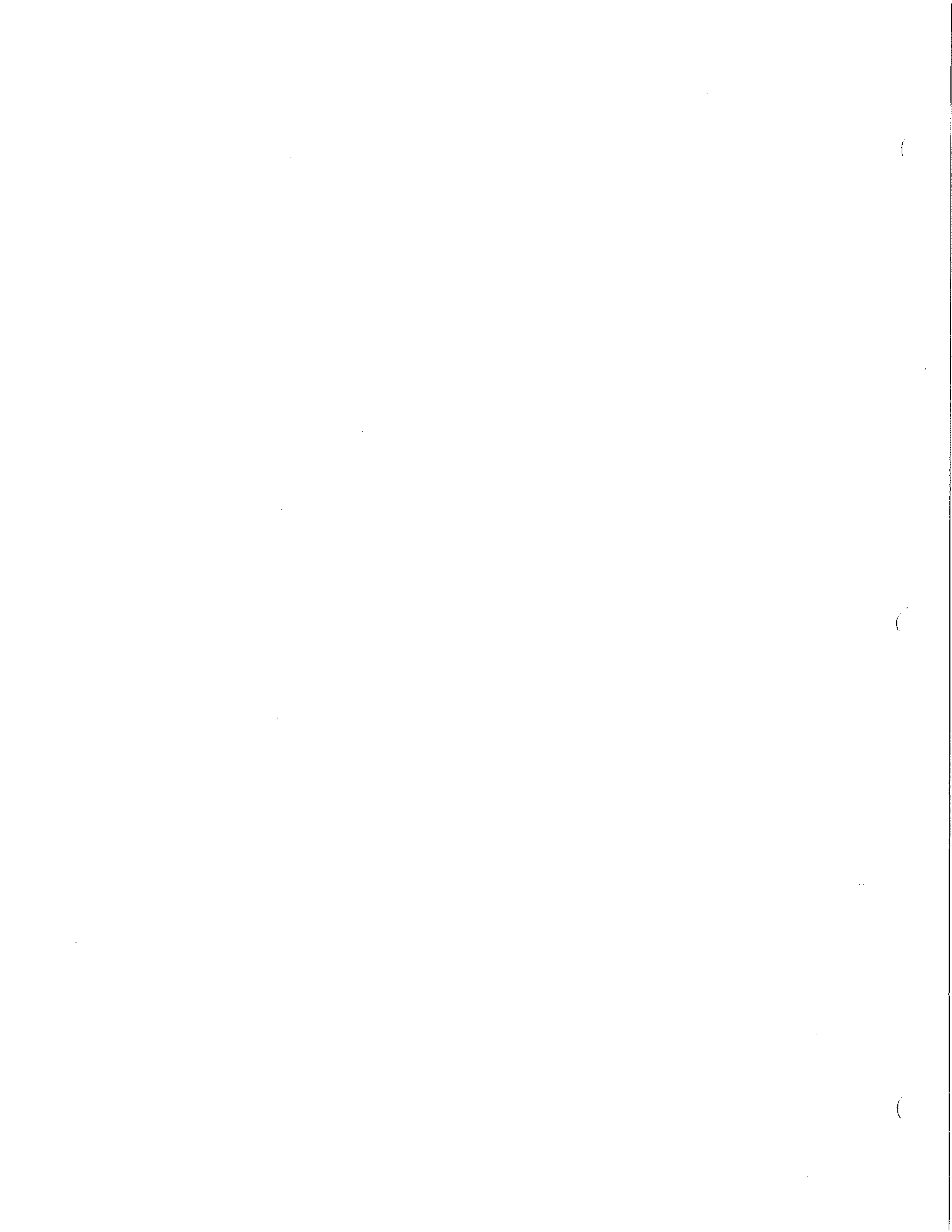
Smith took the logic of specialization and applied it to the international market, arguing that no country should produce anything it could import more cheaply from abroad. "What is prudence in the conduct of every private family can scarcely be folly in that of a great kingdom," he wrote. This analysis implied that countries should concentrate on industries in which they are the low-cost producer, or, in the language of today's economists, industries in which they have an "absolute advantage" over foreign competitors.

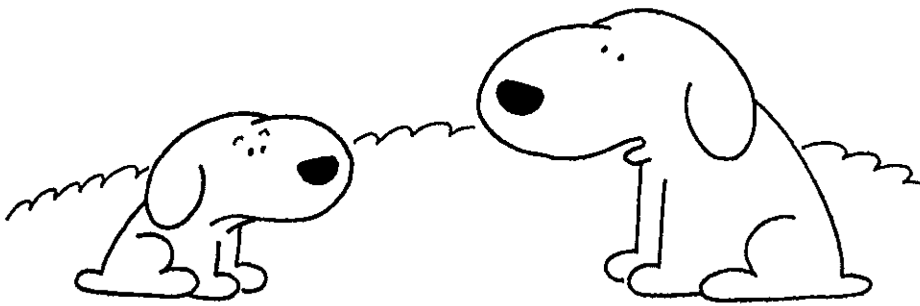
A classic example involved Lancashire textile mills, which exploited the damp climate of northern England, and Portuguese vineyards, which prospered in the southern sun. In the presence of prohibitive tariffs on imports and exports, which were widespread at the time Smith was writing, England would have been forced to make its own wine (or go without), and Portugal would have had to manufacture cloth, which would have wasted valuable resources. But if free trade was introduced each country could concentrate on its strength, with England exchanging its surplus cloth for Portugal's surplus wine,



Outsourcing isn't the only reason that Americans are losing jobs, but it's playing a role.

RICHARD THOMPSON





"All true, but their kind did invent the can opener."

to the benefit of consumers in both places.

The principle of absolute advantage is relatively easy to understand, and economists cite it all the time in an attempt to alleviate concerns about outsourcing. "The benefits from new forms of trade, such as in services, are no different from the benefits from traditional trade in goods," the Council of Economic Advisers said in its testimony to Congress earlier this year. "When a good or service is produced at lower cost in another country, it makes sense to import it rather than produce it domestically. This allows the United States to devote its resources to more productive purposes."

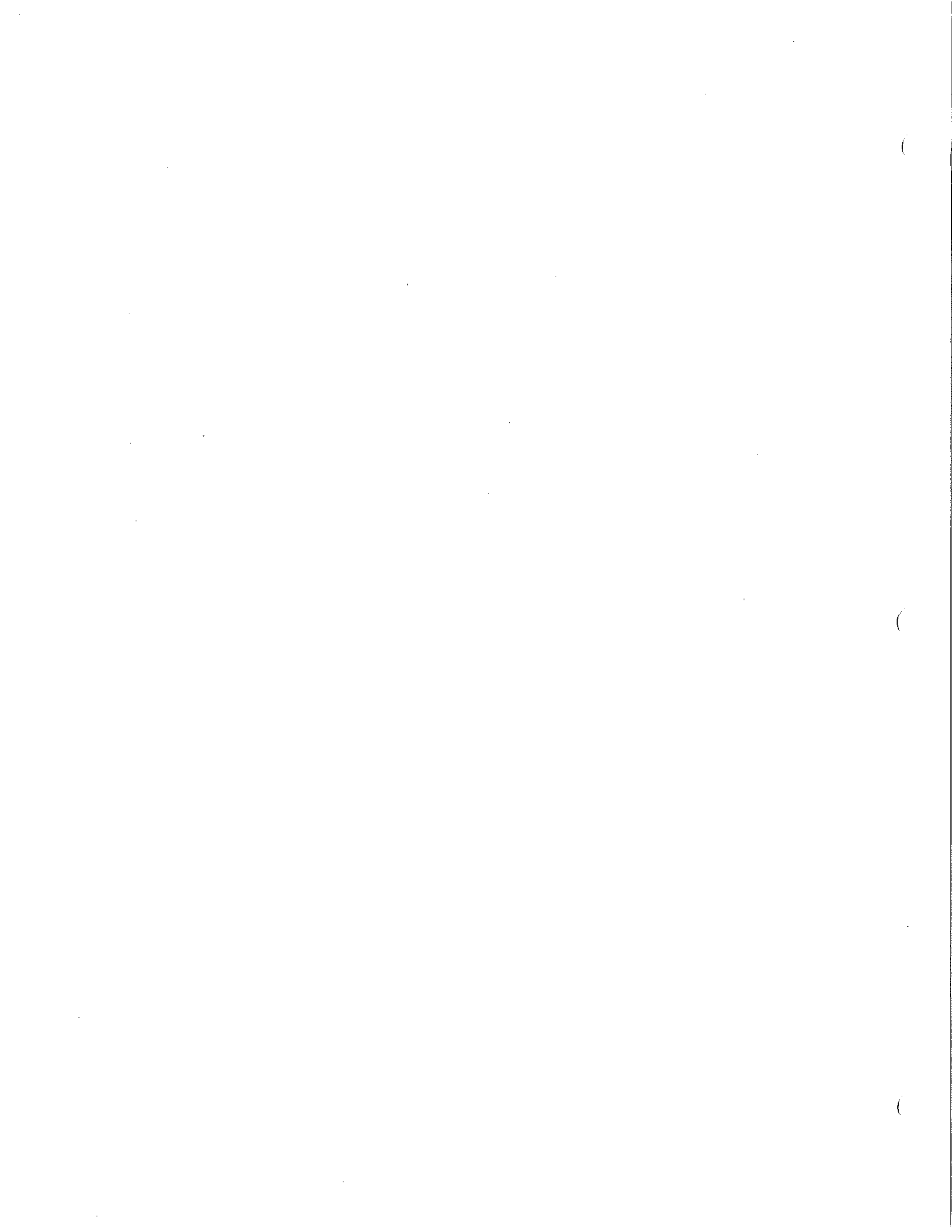
However, some types of offshoring are not so easy to rationalize. American insurance firms are hiring workers in countries like India to process customer claims. Yet many of the Americans who are being displaced are well-educated and productive employees who could probably do the job better than their Indian counterparts. Why, then, does this sort of trade benefit the United States? David Ricardo, another ancient British economist, answered this question in "Principles of Political Economy and Taxation," which was published in 1817, and it is his defense of free trade that Mankiw and his colleagues rely on to this day. Where Smith argued that nations gain by exporting goods which they can make more cheaply than other countries, Ricardo said that trade between countries makes sense even if one of the countries is the low-cost producer in every industry.

Suppose, he said, that in Portugal it takes ninety workers to make cloth and eighty workers to make wine, whereas in England cloth production requires a hundred workers and wine production requires a hundred and twenty. Then, assuming wages are the same in both countries, Portugal has an "absolute advantage" in wine *and* cloth. Should it still trade with England? Yes, said Ricardo. Compared with each other, he pointed out, Portugal's vineyards are still more efficient than its textile mills. Therefore, it makes sense for the country to specialize in wine production, export what it doesn't need, and import British cloth. Portugal's "comparative advantage" lies in wine.

Ricardo's argument is subtle—Paul Samuelson, the great M.I.T. economist, once said that comparative advantage is the most difficult economic theory to grasp—but it is also extremely powerful. It implies that the United States shouldn't try to keep hold of low-value businesses, such as insurance processing and telephone-call centers, even if its workers could operate them more efficiently than their counterparts in developing countries. Instead, it should concentrate on building up businesses like publishing and entertainment, where the displaced workers can be employed more productively. According to some estimates, the copyright business, which includes film, music, books, and software, accounts for about five per cent of the Gross Domestic Product, which means it is the biggest sector in the economy, bigger even than the auto industry. If the economists are to be believed, this is just as things should be: one industry that the United States used to dominate declines; another rises to take its place.

Any sensible discussion of trade has to acknowledge the power of comparative advantage. Capitalism has succeeded where other systems have failed in large part because it allows countries to develop according to its dictates. Poor places, like Mauritius and Indonesia, start out by producing labor-intensive goods, such as toys and clothing. Middle-income countries, such as South Korea and Taiwan, enter more advanced businesses, such as the manufacture of automobiles and consumer electronics. And developed nations, such as Japan and the United States, operate at the frontier of technology, creating industries like wireless communications and biotechnology. This hierarchy of production helps lift poor nations out of poverty. According to the World Bank, between 1981 and 2001 in East Asia the number of people living on less than a dollar a day, which is the bank's threshold for acute poverty, fell from about eight hundred million to less than three hundred million. This dramatic reduction would not have taken place if Thailand, Malaysia, and other Asian countries had been unable to export their products to the developed world.

But how does the rise of potential economic superpowers like China and India benefit the United States? Here, Ricardo's theory needs applying carefully. In a heretical but fascinating book, "Global Trade and Conflicting National Interests," which appeared in 2000, Ralph E. Gomory, the president of the Alfred P. Sloan Foundation, and William J. Baumol, an economist at N.Y.U., examined what happens when a low-wage economy begins competing with a high-wage economy. Unlike many economists, who tend to rely on make-believe models, Gomory and Baumol tried to be realistic. They assumed that export industries operate most efficiently on a large scale, which means that they tend to be concentrated in one region, and that countries can learn things from each other, such as how to assemble televisions and write software. The results of this analysis were startling. "If the wage differential between two trading countries is sufficiently large, the loss of industries to the low-wage, underdeveloped country may well benefit both countries at the national level," Gomory testified to Congress earlier this year. "However, as the underdeveloped country develops and starts to look more like the developed one, the balance turns around and further loss of industries becomes harmful to the overall welfare of the more developed nation."



This conclusion directly challenges Mankiw's claim that free trade must, as a matter of economic logic, benefit the United States. It supports the common-sense notion that what helps one nation can hurt another, and that countries adversely affected by foreign competition can lose out permanently. Although the work of Gomory and Baumol hasn't received much attention from other economists, and it certainly isn't the final word on the subject, it implies, at the very least, that the potential gains and losses from outsourcing need to be weighed.

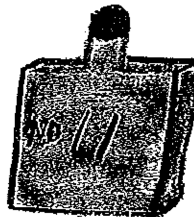
In principle, it ought to be possible for the winners from free trade—consumers and stockholders, say—to compensate the losers with monetary benefits. In practice, such transfers rarely occur. Research by the Princeton economist Henry Farber, among others, shows that workers displaced by foreign competition are usually forced to take a pay cut, that is if they are fortunate enough to find new jobs. (The average cut is thirteen per cent.) Cities hit by plant closings take years to recover, and some—such as Gary, Indiana; Flint, Michigan; and Syracuse—never do.

The nearest thing to a compensation scheme is the federal Trade Adjustment Assistance program, which has recently been expanded. In 2003, this scheme provided income support and retraining grants to more than two hundred thousand displaced workers. However, a 2001 report by the General Accounting Office has shown that it is often ineffective, especially for older, less educated workers. Other ideas have been proposed, such as "wage insurance" for workers threatened by foreign competition, and tax credits for firms that invest in worker retraining, but with the budget deficit already approaching five hundred billion dollars their cost is prohibitive.

Although the Bush Administration beefed up the Trade Adjustment Assistance program, some of its members question the very idea of compensating the losers from trade. In a capitalist system, they point out, jobs are eliminated all the time, as a result of technical progress and shifting consumer tastes. Why, they ask, should the victims of trade get a better deal than the victims of a robot? Ben S. Bernanke, a Princeton economist and a member of the Federal Reserve Board, recently estimated that the American economy eliminates roughly fifteen million jobs a year—about one in seven of the total—as it redirects workers and resources to growing industries. By comparison, Ravi Aron, an economist at the Wharton School of Business, put the number of white-collar jobs lost to outsourcing between the start of 2000 and February of 2004 at about a hundred thousand a year. Other estimates, which include manufacturing, suggest that trade will eliminate perhaps three hundred and fifty thousand jobs this year. As Bernanke points out, even if this higher figure is correct, it implies that foreign competition accounts for only about one in fifty of all job losses.

That isn't the final analysis, however. Outsourcing service-sector jobs is a relatively new phenomenon, and it is growing fast. A widely cited example features Indian radiologists who examine X-rays from places like Miami and Chicago, and transmit their diagnoses via the Internet. It isn't hard to imagine other jobs that might be affected: reservation agents, telephone solicitors, computer programmers, accountants, database managers, financial analysts, and anybody else who performs easily replicable tasks with the aid of a computer. The jobs that are likely to remain safe are those which require physical proximity and intellectual flexibility, such as nursing, plumbing, social work, and teaching.

One report, from Forrester Research, a technology consulting firm in Cambridge, Massachusetts, suggested that between now and 2015 about 3.3 million white-collar positions will shift abroad. Outsourcing of manufacturing jobs is also on the rise. According to Economy.com, a research firm based in West Chester, Pennsylvania, taking service industries and manufacturing together, the number of jobs moving overseas will reach six hundred thousand a year by 2010. Predictions of this nature should be regarded as educated guesswork, but they illustrate that concern about outsourcing isn't a passing fad—a situation that at least some mainstream economists are willing to acknowledge.

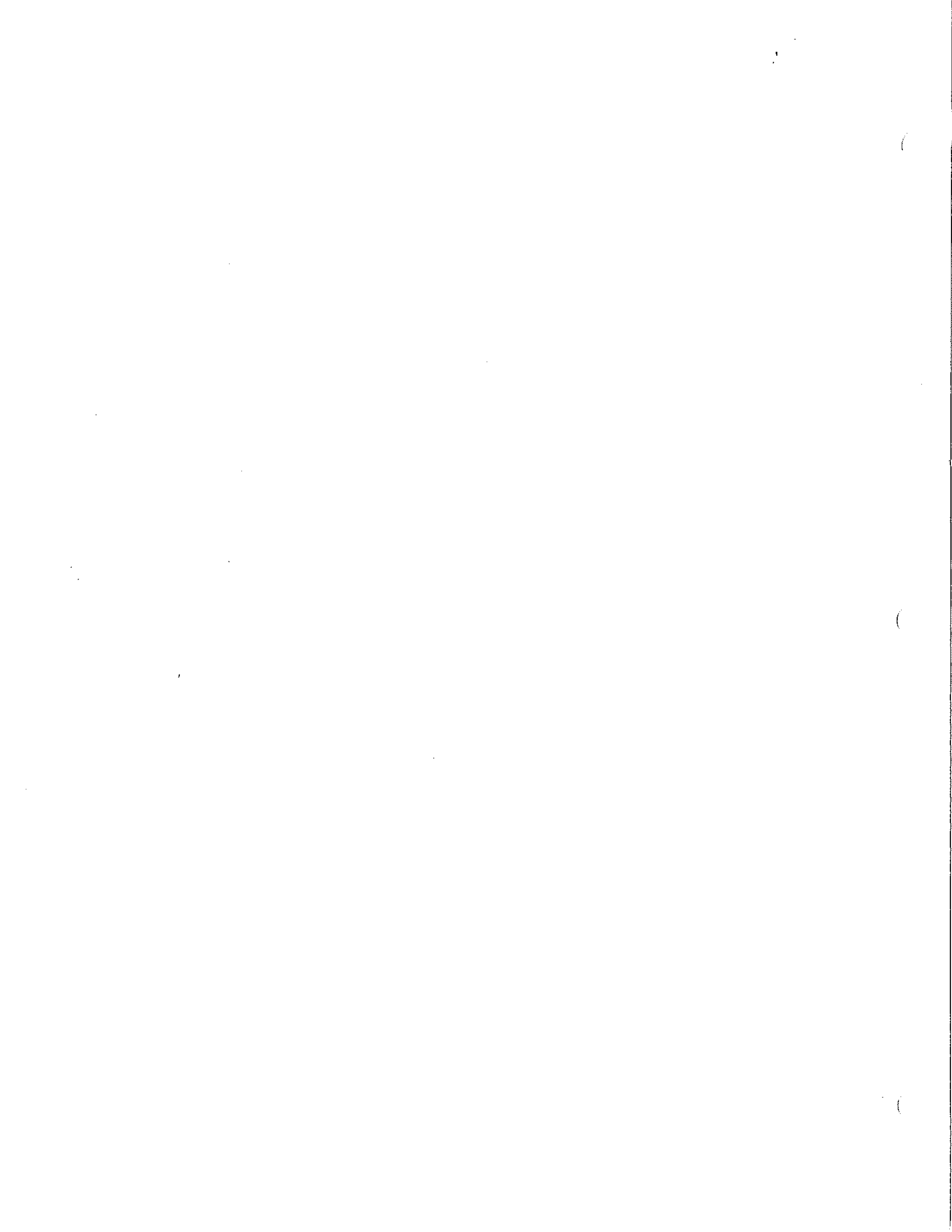


"A huge, new swatch of our jobs will become vulnerable to foreign competition over the next few years," Berkeley's J. Bradford DeLong and Stephen S. Cohen wrote in an article that DeLong recently posted on his Web site. "This new set of potentially tradeable jobs are in many cases held by people who are not accustomed to layoffs. Often, they are high-paying, clean, good jobs. Some are the best jobs. The people who hold them are quite convinced that they are on top—that they have these jobs and that these jobs are well-paying—because they are the best people who deserve to have them; they are smart and industrious."

Some economists privately acknowledge that the arguments about outsourcing are nuanced, but they fear that any weakening of support for free trade could do untold damage to the economy. During the Great Depression, Congress introduced the infamous Smoot-Hawley Tariff Act, which raised duties on a range of foreign goods. Other countries retaliated, and the subsequent downturn in international trade intensified the slump. The economists are right when they say protectionism isn't the answer to outsourcing. But they need to get beyond pat slogans about free trade.

John Kerry has at least tried to address the issue. His outsourcing plan, which was largely drawn up by Jason Furman, a young economist who was formerly one of Mankiw's students at Harvard, would revoke tax breaks for companies that shift production overseas and redistribute some of the extra revenue in the form of subsidies to firms that expand hiring in the United States. Politically, this proposal is an astute response to popular concern about outsourcing. Practically, it is unlikely to have much impact. All too often, the cost reductions that firms enjoy by moving jobs abroad are so large that hitting them with a tax increase wouldn't make much difference to their calculations. And employment subsidies often end up benefitting workers who would have been hired anyway.

There is another issue, which hasn't been addressed. At the moment, the outsourcing debate is focussed on jobs and employment security. Soon, it will revolve around wages and benefits as well. Ultimately, it is the level of demand in the economy, not trade policy, that dictates the pace of job creation. As long as the Federal Reserve and Congress utilize



monetary and fiscal policies effectively to keep up spending, the economy should eventually create enough jobs of some sort to occupy most people who want to work. But what sort of pay will they command? A long-established theorem of international economics—the "factor-price equalization theorem"—states that when two countries start out with similar technology and skills but different wage rates, trade between them will reduce wages in the high-paying country and increase wages in the low-paying country until, eventually, workers in both places end up earning the same amount.

Until now, most American workers have been able to escape this pincer movement, but as countries like China and India fulfill their potential this may change. More and more American workers will be forced to compete with poorly paid labor in the developing world, and the downward pressure on American wages could become irresistible. In the nineteen-seventies, when Asian manufacturers targeted their American rivals, Japanese wages were about half of American wages, and the resultant competition was one reason that workers' earnings stagnated for a generation. Today, workers in India earn between a fifth and a tenth as much as their American counterparts. "On the one hand, economists will say that the gains from trade will thereby be that much greater for the economy as a whole," DeLong and Cohen write. "On the other hand, the potential downward pressure on loser workers in rich countries will be that much greater as well."

Some industries that compete internationally, such as pharmaceuticals and avionics, have succeeded despite paying their workers high wages, because the United States has maintained an edge in science and technology. But the ongoing transfer of knowledge and expertise to developing countries, as well as changing attitudes toward business and entrepreneurship in those societies, means American leadership can no longer be taken for granted.

RELEVANT

The essential point is that comparative advantage is no longer endowed by nature: through hard work and enlightened administration, countries can wrest it from each other's grasp. Ricardo was writing about economies dominated by agriculture and rudimentary manufacturing, where a favorable climate and the ready availability of raw materials were vital. These days, the keys to economic success are a well-educated workforce, technical know-how, high levels of capital investment, and entrepreneurial zeal—all of which countries can acquire with the help of supportive governments, multinational firms, and international investors.

A couple of months ago, the *Times* reported that the United States is losing its dominance in basic scientific research, reflected in the fact that the proportion of American articles in a number of top physics journals fell from sixty-one per cent in 1983 to twenty-nine per cent in 2003. This decline reflects disturbing trends throughout the education system. Indian colleges, with their strong programs in science and math, are producing more than forty thousand graduates in computer science a year, with enrollment increasing all the time. In the United States, meanwhile, many colleges are struggling to fill their science programs, and high-school dropout rates are higher than they were thirty-five years ago. In 1969, 77.1 per cent of seventeen-year-olds graduated; in 2002, the most recent year for which statistics are available, the figure was 72.5 per cent. As Pedro Carneiro, a lecturer at University College, London, and James J. Heckman, a professor at the University of Chicago, pointed out in a recent paper, "By many measures, since 1980, the quality of the U.S. workforce has stagnated, or its growth has slowed down dramatically."

If the United States is to meet the challenge posed by a truly global economy, it will have to insure that its scientists are the most creative, its business leaders the most innovative, and its workers the most highly skilled—not easy when other nations are seeking the same goals. A truly enlightened trade policy would involve increasing federal support for science at all levels of the education system; creating financial incentives for firms to pursue technological innovation; building up pre-school and mentoring initiatives that reduce dropout rates; expanding scholarships and visas to attract able foreign students and entrepreneurs to these shores; and encouraging the development of the arts. In short, insuring our prosperity involves investing in our human, social, and cultural capital. But don't expect to see that slogan on a campaign bumper sticker anytime soon. ♦