

## Trade and inequality: The role of economists

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Economists have come to play an enormously important role in public policy debates. Their use of their expertise to effectively act as priests, telling the less informed public what the impact of their various policy proposals will be on the economy's future performance. Economists often tell the public that its preferred policy path will not have the intended effect, and may actually lead to outcomes that are the opposite of what is intended.

Since economists, or at least the mainstream of the economics profession, are accorded enormous respect by the major media outlets, any politician who challenges the prognostications from this group is likely to be ridiculed in the media. This ridicule is generally sufficient to derail the career of any politician who does not already possess an independent and determined base of support and/or a vast amount of wealth that she can use to sustain her political career.

As a result of their ability to influence the media, economists can be incredibly important in steering public policy, often in directions that may not be supported by most of the country. Trade policy provides an excellent example of a case in which the mainstream of economics profession has been adamant in pushing economic policies that clearly do not have the support of the bulk of the public.

The role of economists in trade debates is especially pernicious because there is no area of economics in which economists have been less honest about what their models show. They have consistently exaggerated the benefits that are predicted by standard trade models. At the same time they have ignored or downplayed the distributional consequences. In doing so, they consistently deride those who raise questions about the path of recent trade policy for failing to accept fundamental realities of the modern world.

Before laying out this case more fully, it is important to note that I am not raising any questions about the trade models themselves. There are important assumptions of these models that may be viewed as unrealistic. Most importantly, trade models generally assume full employment. If this assumption is relaxed, then it is far less clear that the elimination of trade barriers will necessarily lead to gains for the country as a whole.

The standard story of gains from trade is that fully utilized resources will be used more efficiently in the absence of barriers to trade. However, if one of the main outcomes is that a substantial number of workers end up unemployed as result of the being exposed to international competition, then the lost output due to higher unemployment can swamp any efficiency gains from reducing trade barriers.

While it is standard for economists to assume that periods of unemployment due inadequate demand are rare occurrences that can be safely assumed away for purposes of analyses, it is certainly hard to accept that this has been the case in the recent past. Alan Greenspan, along with many other economists, viewed the economy as suffering from a world-wide glut of savings in the years following the collapse of the stock bubble. Insofar as

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this description of the economy was accurate (and arguably still is), the economy's main problem is a failure to fully utilize its resources, not a failure to direct them to their most efficient uses. In this context, the removal of trade barriers may quite plausibly have led to less employment and less output, even if the employed workers were more efficiently distributed.

However, for purposes of this discussion, I will ignore the possibility that unemployment may in fact often be a problem and that trade may be a factor contributing to higher unemployment. Instead, I want to focus on three issues that follow directly from the standard trade models in which all the assumptions are chosen to support the gains from trade conclusion:

- 1) Trade does create winners and losers, and given current patterns of trade, the winners are likely to be owners of capital and highly educated workers, with the rest of the population ending up as losers.
- 2) It is possible to redistribute from the winners to the losers. However, the taxes necessarily to pay for any redistributions are themselves distortionary. It is not possible to determine a priori whether the distortions created by taxes to finance redistribution are more or less distortionary than the trade barriers that were eliminated.
- 3) There are trade barriers that have the effect of protecting workers in the most highly paid professions, such as doctors, lawyers, and accountants. There are large potential economic gains from eliminating these barriers. Removing these barriers would both increase economic efficiency and reduce inequality.

I will discuss each of these items in turn.

### **The winners and losers from trade: does the redistribution ever take place?**

The basic story of the gains from trade story is that removing trade barriers leads to a change in the relative prices of traded goods. This leads to a change in the price of factor inputs. The price of the relatively scarce factor in each country is supposed to fall, while the price of the relatively plentiful factor rises.<sup>2</sup> In the context of the United States removing barriers to trade with developing countries, the expected outcome would be a decline in the relative price of less-educated labor (the relatively scarce factor in the United States), and an increase in the relative price of more educated labor. In other words, we should expect to see an increase in wage inequality as the direct result of the trade agreements that have been pursued over the last two decades, not an accidental outcome. The gains from trade and the increase in inequality are part of the same process of a change in relative prices.

Whether or not less-educated workers end up as absolute losers in this story depends on the relative size of the two predicted effects from removing trade barriers. If the efficiency gains from removing barriers are large enough, then it is possible that less-educated workers end up as absolute gainers, even if inequality increases. The actual history of the last quarter century suggests that this is not the case. The growth of wage inequality since 1979 has meant that most workers have seen almost no real wage growth over this period. In the years from 1979 to 2005, the median hourly wage has risen by just 9 percent.

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<sup>2</sup> This is main implication of the Stolper-Samuelson theorem.

The wages of workers at the 30th have risen by just 3.5 percent and they have fallen by 2.3 percent for worker sat the 10th percentile. Even workers at the 70th percentile have seen real growth of just 10.4 percent over this period. In other words, the vast majority of the workforce have seen only minimal gains in real wages over a period in which net productivity has risen by more than 40 percent.<sup>3</sup>

The rise in wage inequality over the last quarter century is not really in dispute, nor is the stagnation of wages for most of the workforce. The only real question is the extent to which the growth in inequality can be attributed to increased trade. There has been extensive research on this topic, which has produced a wide range of estimates. At the high-end, Cline (1997) estimated that trade and immigration together explained 40 percent of the growth in wage inequality over the last quarter century.<sup>4</sup> Krugman (1995) used a simple computable general equilibrium model to conclude that trade accounted for 10 percent of the increase in inequality over this period, coming in near the lower end of the range of estimates. Based on the increase in trade with developing countries in the last decade, Bivens (2006) uses the same methodology to conclude that trade would explain 14 percent of the change in relative wages over the period since 1980.

Such changes in relative wages imply substantial reductions in incomes for most workers. For example, if trade and immigration can explain 40 percent of the 20 percentage point gap between the growth in usable productivity and the growth in wages for the typical worker, then it implies a reduction in compensation of \$2,900 a year for a full-time worker earning the median wage.<sup>5</sup> Even the 14 percent figure implied by Bivens update of Krugman's calculation, implies a loss of more than \$1000 per year for a typical worker. While the additional growth attributable to trade may partially offset these losses, most of the workforce is likely to end up as serious losers from trade.

This point is important because most discussion of trade policy only treats the workers who directly lose jobs because of trade as the losers from increased trade. The policies proposed to redistribute to the losers from trade involve retraining or in some other way compensating the workers who can directly trace their job loss to trade. This group typically numbers in the low hundreds of thousands, as opposed to the tens of millions of workers who can realistically claim to have suffered wage declines due to trade. For the most part, the trade adjustment assistance received by these workers has not made them whole in the sense of leaving them as well off as they were before they lost their jobs. However, even

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<sup>3</sup> The wage data are taken from Mishel, Bernstein, and Allegretto, 2007, Table 3.4). The net productivity figure is a "usable productivity" measure that is based on a net output measure and a CPI deflator for output. This measure allows for real wage growth to be directly compared to productivity growth. This measure is explained in Baker (2007). It is worth noting that then on-wage share of compensation increased by 8 percentage points from 1980 to 2006. This rise in non-wage compensation (mostly due to employer paid health care benefits) explains part of the gap between productivity growth and real wage growth.

<sup>4</sup> This was the finding in Cline (1997) in an analysis that only covered the years through from 1973 to 1993 found that 39percent of the rise in inequality over this period could be explained by trade and immigration flows. Since the trade share of GDP has increased by more than one-fourth since the end point of this study and immigration flows have increased by at least 20 percent, the impact of trade on inequality predicted by this methodology would be considerably larger today.

<sup>5</sup> This calculation assumes a wage of \$15.00 an hour (Mishel, Bernstein, and Allegretto, 2007, Table 3.4), non-wage compensation that is equal to 20 percent of wage compensation and a 2000 hour work-year.

the most generous trade adjustment assistance to displaced workers does nothing for the tens of millions of workers who suffer wage reductions as a result of trade.

It is certainly possible to imagine political scenarios in which various forms of trade adjustment assistance will be substantially expanded so that those who lose their jobs as a result of trade are not as negatively affected as is the case presently. It is not possible to imagine any measures that will offset the losses to the larger group of workers who suffer wage reductions. They are expected to simply endure this reduction in living standards as a necessary sacrifice for a larger economic agenda.

Economists have been especially notably for their silence on this issue. With very few exceptions they have eagerly embraced the trade agenda of recent administrations. They have been quick to denounce opponents of this agenda as “protectionists” who should not be allowed in polite circles. Yet, they rarely acknowledge the unavoidable implication of trade theory – that a large segment of the U.S. workforce will have to endure lower living standards as a result of the current course of trade liberalization. Apparently, economists believe that these people have an obligation to sacrifice in the interests of economic efficiency.

### **Economic efficiency and redistribution**

Most of the supporters of the current trade agenda, and especially the more liberal supporters of this agenda, do make a point of advocating redistribution from winners to losers, so that in principle at least everyone can gain from trade. As noted, this redistribution usually takes the form of retraining or readjustment assistance for workers who can demonstrate that they directly lost their jobs due to trade. Although, it has never really appeared as a serious proposition in political debate, in principle it would be possible to tax away enough of the gains from the winners to compensate all the people who lose from trade.

Before addressing efficiency questions at stake in this proposition, it is worth pointing out the different order of magnitude of the necessary transfers compared to those being discussed in national political debates presently. Most forms of trade readjustment assistance are relatively small items in the federal budget. For example, the 2008 appropriation for trade adjustment assistance is less than \$200 million, approximately 0.006 percent of the federal budget.<sup>6</sup>

By contrast, suppose that trade had the effect of lowering the wages of the bottom 70 percent of the wage distribution by an average of 2.0 percent, a relatively conservative estimate of the impact of trade on inequality. In this case, the amount of money that would have to be redistributed from higher income people to low wage workers would be close to \$50 billion annually, or 1.6 percent of the federal budget. This would be a qualitatively larger sum to raise in taxes, which perhaps explains the reason that no politician has championed this effort to date.

There is a second more fundamental point that needs to be addressed in assessing such large redistributions from the standpoint of trade policy. The argument for trade liberalization depends primarily on the claim that it increases economic efficiency. However, any revenue that is raised to pay for compensation from winners to losers will require taxes.

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<sup>6</sup> The cost of the training component of trade adjustment assistance can be found at the Department of Labor's website <http://www.doleta.gov/tradeact/docs/2008AllocationTable.pdf>.

These taxes will themselves be distortionary. While it is easy to say that the distortions that result from the taxes necessary to fund a \$200 million job retraining program will not create enough distortions to offset the gains from trade liberalization, it is far from obvious that this is true if it's necessary to raise \$50 billion to redistribute to the losers from trade.

Trade modelers often evade this issue of distortionary domestic taxes by assuming that the tax revenue lost from trade liberalization will be made up by a lump sum tax. A lump sum tax has two interesting properties. First, it does not create any economic distortions. A lump sum tax effectively just sucks up money from the economy without affecting anyone's behavior, therefore it does not create distortions. The other interesting feature of lump sum taxes is that they do not actually exist in the world. In the real world we have to raise revenue by doing things like taxing income, sales, or property. These taxes all do lead to economic distortions, unlike lump sum taxes.

As a practical matter then, an efficiency minded economist would want to compare the efficiency gains from reducing tariffs, or other obstructions to trade, with the efficiency losses associated with whatever taxes might be raised, both to offset lost tariff revenue and also to compensate the losers from trade. To do this sort of analysis you have assume that real world taxes will be used to raise the necessary revenue.

Of course once this step is made, it is far from obvious that reducing trade barriers will always increase efficiency. In some cases, import tariffs can be a relatively efficient form of taxation. This is especially likely to be the case in developing countries without well developed tax administrations. Taxing goods when they enter through ports or main border crossing is likely to be far easier than imposing income taxes or even sales taxes.

In the case of a wealthy country like the United States, income taxes or sales taxes are likely to be less distortionary than tariffs as a source of revenue, however if there is going to be compensation paid to the losers from trade, then it is necessary to raise such taxes by considerably more than is necessary to just replace lost tariff revenue.<sup>7</sup> In this case, it is far from obvious, and certainly not obvious *a priori* that trade liberalization coupled with an effective program for compensating losers is a net efficiency gain. In this scenario, one source of inefficiency is eliminated – the barrier(s) to trade—but another source of inefficiency had been added, the tax needed to compensate losers and possibly also to replace lost tariff revenues.

The story looks even worse from the standpoint of trade liberalization when we consider the fact that any redistribution program will incur administrative costs, which could be substantial, and that no adjustment program will be ever be perfectly targeted. To cover these additional costs, it will be necessary to raise more than one dollar in tax revenue for each dollar paid in compensation to the losers from trade. The question that economists, who are committed to compensating losers, must then ask is whether the efficiency gains from eliminating a set of trade barriers are greater than the efficiency costs associated with a tax increase that is large enough to both compensate losers, and cover the costs associated with a program directed to these losers.

Without having examined any data on this question, I would be skeptical that the answer would in general be yes. Economists usually do not think that most government

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<sup>7</sup> If the liberalization involved the elimination of non-tariff barriers such as quotas or other obstacles to imports, then the revenue needs are somewhat lower.

programs are very efficient, and they often have some cause for this view. If we envision adjustment assistance programs that are one or two orders of magnitude larger than the existing programs and the tax revenue needed to pay for such programs, it seems quite plausible that the distortions that result from the necessary tax increases are considerably larger than the gains from trade liberalization. But, this is really the topic that proponents of the current trade agenda should be investigating. There is no basis for determining the answer to this question based on existing research.

### **Professional protectionism: the barriers to trade in highly paid professional services**

While economists can be criticized for failing to be forthcoming about the fact that most of the workforce likely ends up losing from current trade policies, and that the distortions created by policies designed to compensate losers may be larger than the efficiency gains from trade liberalization, these are not the worst sins of the economics profession when it comes to trade policy. The biggest failing of the economists concerns what they have kept off the table, specifically the large array of legal and practical barriers that protect workers in highly paid professions (e.g. doctors, lawyers, economists) from competition with their counterparts in the developing world.

The standard view among economists seems to be that there is already free trade in these professions and that the people who hold these highly paid positions in the United States just happen to be the best in their specialties, true winners in global competition. It is easy to show that this view is nonsense.

There are a wide range of barriers that prevent professionals in the developing world from working in the United States. The most important of these restrictions is the rule that applies to employers seeking foreign workers, which requires that they first attempt to find a United States citizen or green cardholder, before they seek out a non-citizen for the job. They must also claim that they are offering the prevailing wage for the job in question.

While this restriction may be poorly enforced, the fact that the law exists on the books is likely to prevent the emergence of Wal-Mart hospitals, Wal-Mart law firms, or Wal-Mart universities that explicitly seek to hire professionals from the developing world, and pay them wages that are much lower than the standard in the United States. These Wal-Mart institutions could then charge much lower prices than existing hospitals, law firms, and universities and thereby gain enormous market share. Eventually, the existing institutions would also have to cut the wages they paid for professionals in order to stay in business. This would lead to lower wages in the highest paid professions, but also lower costs for medical care, legal services, and education.

In this scenario, we would see the same sorts of gains from trade that economists love to tout, except that it would lead to greater equality rather than greater inequality. (We can have retraining programs for the doctors, lawyers, and economists who lose their jobs due to trade.) Yet, virtually no economists ever discuss this sort of vision when they push an agenda for liberalized trade.

To convince themselves that they and their professional friends and relatives really are just the hardworking and/or lucky winners in global competition, economists tend to embrace the “Mexican avocado theory of international trade (MATIT).” According to the

MATIT, there are no barriers to trade in agricultural products in the United States because it is possible to buy an avocado grown in Mexico in most grocery stores. The MATIT as applied to the highly paid professions leads to the conclusion that there are no barriers to foreign professionals working in the United States because their doctor was born in India or the economist in the next office was born in China. Using the MATIT, economists have little difficulty concluding that the United States has free trade in highly paid professional services because they personally can identify one or more foreign born professionals working in the United States.

Of course this is not serious analysis. Intelligent and highly motivated professionals from the developing world can overcome the barriers that are intended to limit entry, but this fact hardly proves that such barriers do not exist. Economists would openly ridicule the application of the MATIT to any other sector of the economy, but somehow they find it compelling when discussing trade in highly paid professional services.

The ability of economists to overlook barriers to trade in highly paid professional services is truly astounding. In 1997 there was an effort by the major doctors' associations to restrict the number of foreign doctors who were entering the country. They complained that the large number of foreign doctors entering the country was depressing their wages. (Note, the doctors did not claim that the foreign doctors lacked adequate training and were threatening the public's health. The argument was about wages, not safety.) On the other side, people argued that foreign doctors were working in underserved areas in the inner cities and countryside where U.S. born doctors did not want to work.

There were no prominent economists involved in this debate making the obvious economic argument, that foreign doctors are depressing the wages of U.S. born doctors, and this is good. Lower wages for doctors, means lower health care costs, which will increase the money that consumers have available for other spending and lead to more economic growth. The model is exactly the same whether the X axis is labelled "steel" or "physicians' services."

The result of this debate was that tighter rules were imposed on foreign doctors entering the country and the number of medical residency spots available to foreign trained doctors was cut back substantially. In other words, the doctors were able to get the protection they wanted. Furthermore, they were able to get this protection without economists, or the newspaper pundits who defer to economists, calling them knuckle-scraping Neanderthals.

In fact, this episode seems to have gone virtually unnoticed by trade economists, in spite of the large sums of money at stake. The country spends around \$160 billion a year paying physician salaries. By contrast, it spends around \$70 billion a year on steel. While most trade economists probably do not even know about the restrictions imposed on the entry of foreign physicians in 1997, all of them could probably explain the basic outlines of President Bush's tariffs on imported steel from 2002. The latter were explicitly time limited and peaked at 30 percent for a small category of items. By contrast, U.S. physicians earn almost twice as much as their counterparts in other wealthy countries (net of malpractice insurance). The gap between physicians' salaries in the U.S. and their pay in the developing world is even larger. Clearly the economic costs of restrictions on foreign physicians dwarf the costs of the steel tariffs, but only the latter concerned trade economists.

The idea of free trade in professional services is remarkably foreign to free trade advocates. They have difficulty even understanding what it means. The basic point is very

simple. We carry through the exact same sort of process that we did with NAFTA. In the case of NAFTA, U.S. manufacturers were asked to identify the obstacles that prevented them from setting up manufacturing operations in Mexico. The trade agreement was then designed to remove these obstacles. This meant ensuring the security of investments in Mexico, protecting them against nationalization, excessive taxation, or restrictions on the repatriation of profits. On the U.S. side the deal was constructed to prevent the possibility of barriers to imports from Mexico, not only in the form of tariffs or quotas, but also in the form of product or safety regulations that could obstruct imports.

If we believed in free trade in professional services our trade negotiators would sit down with hospitals, law firms, universities, and other employers of highly paid professionals and determine the obstacles that prevent them from hiring large numbers of professionals from the developing world. At the top of this list would be immigration restrictions that sharply limit the quantity of highly paid professionals who can enter the country and that also require that foreign professionals be paid comparable wages to U.S. professionals. If Wal-Mart can pay less than the domestic price for Chinese made shoes and toys, thereby depressing the wages of manufacturing workers in the United States, then hospital and universities should be able to do the same in hiring physicians and professors.

It is also important that the licensing standards be made fully transparent. It would also be useful to allow for students to be tested in their home countries (by U.S. certified testers of course). This will allow smart kids in India, China, Mexico, and elsewhere to train in their home country to meet the requirements necessary to be a doctor, lawyer, architect, or some other professional in the United States. If a student in the developing world passes the appropriate test and gets licensed, then they should have the same opportunity to work in the United States as student who was educated in New York or Los Angeles. This would be free trade in professional services.<sup>8</sup> Just as it is cheaper to produce shoes and toys in the developing world than in the United States, it is also cheaper to educate doctors and lawyers in the developing world. In the absence of the obstacles to trade in highly paid professional services, most professionals in the United States would be educated in the developing world.

It is worth noting that it is possible to ensure that developing countries are not harmed by this brain drain. It would be a relatively simple matter to impose a tax associated with the issuance of a work permit that would be repatriated to the country of origin to finance the education of more professionals. Since a large percentage of the most highly paid workers are in licensed professions, there is little basis for concern that these workers will work off the books to evade taxation. By the nature of their work, they have to be openly available and visible to the public. For this reason, highly paid professionals will be far less likely to work off the books than custodians, dishwashers, or other workers in relatively low-paying jobs.

If the upward redistribution of the last quarter century is to be reversed, increased international competition for the most highly paid professionals will almost certainly have to be part of the picture. Since the upward redistribution over this period went primarily to these high-end workers, rather than corporate profits, reversing this upward shift in income will require bringing down the relative wage of these workers.

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<sup>8</sup> It is worth mentioning that the flows of professionals need not have much impact on the overall rate of immigration. They are around 4 million workers in these highly paid professions. If an increased inflow of foreign professionals increased this number by 50 percent over the next decade, this would imply an inflow of 200,000 professionals annually. This is approximately one-sixth of the current rate of immigration.

In principle, the pay of high-end workers can be reduced by having the pay of less-educated workers increase, which would then be passed on in the form of higher inflation. If the wages of higher paid workers is then prevented from keeping pace with inflation, then their real wage will have fallen. However, this process could require a lengthy period of higher inflation, which could in turn lead the Fed to raise interest rates to slow the economy and reduce inflation. Even in this case, there is no guarantee in this story that the wages of high-end workers are held in check.<sup>9</sup>

In short, the surest route to reversing the upward redistribution of income over the last quarter century would be by embracing “free-trade.” This free-trade would be about subjecting our most highly educated workers to direct competition with counterparts in the developing world. This free trade offers the promise of both increasing efficiency and equality.

## Conclusion

To sum up, economists have been extraordinarily dishonest in their interventions in public debates over trade policy. They have not been straightforward on the implications of standard trade models.

First, they have acted to conceal the fact that a substantial group of workers, quite likely a majority of the workforce, can be expected to be losers from the recent path of trade liberalization. This is not an accidental outcome; it is literally the mechanism through which the economy experiences gains from trade. The vast majority of these workers will not actually lose their jobs as a direct result of trade. Rather they will receive lower wages in the same jobs. If no compensation is paid from winners to losers, then a large segment of the work force can be expected to be losers from the current trade agenda.

The second key point that has been largely concealed from public debate is that the gains from trade liberalization in a regime where the losers are compensated cannot be assumed. To cover lost tariff revenue and raise revenue to pay compensation to losers, it is necessary to raise other taxes. These taxes are by definition distortionary, and it is quite possible that the distortions created by these taxes are larger than the efficiency gains from reducing trade barriers. Since any compensation program will necessarily be imperfectly targeted, and incur administrative costs in addition to the compensation paid out, it is quite likely that the taxes necessary to pay for such a program will exceed the efficiency gains from trade liberalization.

Finally, economists have been very willing to ignore the trade barriers that protect the wages of highly educated professionals. For the most part, obstacles to trade in highly paid professional services do not even get discussed in the context of trade debates, even though the potential gains from reducing barriers in this area are likely to swamp the gains from removing the remaining barriers in merchandise trade. In this case, the effect of trade liberalization would be equalizing, since it would push down the wages of the most highly paid workers.

The views of economists have carried enormous weight in trade debates. Those who have opposed the trade agendas of recent administrations have routinely been denounced as

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<sup>9</sup> Increases in unemployment disproportionately affect the wages of less educated workers (Baker and Bernstein, 2004).

reactionary and ignorant by the media and other supposedly neutral experts. Such charges have been based on misperceptions of economic theory and its implications. Economists have been too willing to allow these misperceptions to persist and often helped to foster them.

Unfortunately the role that economists have played in debates over trade policy is typical of their role in public policy debates. The mainstream of the profession has taken positions that tend to support the existing economic and political power structure and effectively used its claim to expertise to deprive the public of the opportunity to freely debate policy options. In addition to trade, some of the other important areas in which this usurpation has occurred include Social Security, the relationship between Europe's welfare state and European unemployment, and the conduct of monetary policy. In these, and many other areas of public policy, the mainstream of the economics profession has sought to pronounce judgments that are not supported by their own theory and/or evidence, and thereby helped to impose certain policies on the larger public. It will be a huge step forward for democracy when economists no longer have this sort of power.

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