**“Trade, Inequality & the Election,”
*Clair Wilcox Lecture, Swarthmore College*, *October 24, 2016*

Jeffrey Frankel,
Harpel Professor of Capital Formation & Growth, Harvard Kennedy School**

* **Who was Clair Wilcox?**
	+ The most important thing he did, of course, was to teach at Swarthmore for 40 years,
		- from 1927 to 1968;
		- and to chair the Economics Department for 24 of those years.
	+ But the other very important thing he did was to lead the effort after WWII to establish the International Trade Organization (ITO),
		- as chair of the International Trade Conference that produced the General Agreement on Tariffs & Trade (GATT) signed in 1947;
		- & US negotiator in 1948 when 56 countries agreed the Havana Charter, to establish the ITO.
	+ You may never have heard of the ITO; isolationists in the US Senate blocked ratification.
		- Much as other noble US-led international agreements have died in the Senate over the last century
			* League of Nations (1919).
			* SALT II (1979)
			* Law of the Sea (1982)
			* Kyoto Protocol on Global Climate Change (1997) & perhaps Paris Agreement (2015).
	+ The GATT served in place of the ITO until finally, in 1994, the envisioned organization came into being as the World Trade Organization.
* **Overview**
	+ Trade, in general, is good for economic growth, as measured by GDP.
	+ The doubts concern trade’s effects on *other* things we care about in addition to income. E.g., inequality and the environment.
	+ The feared connection between trade and inequality, in particular, has received intense interest in this strange presidential election year, which includes such un-foreseen phenomena as the Republicans selecting Donald Trump as their candidate.
		- The conventional-wisdom storyline: the reason that Trump’s success caught us “elites” so much by surprise is that we hadn’t adequately realized how deep was the economic hardship and political anger of those who had been left behind by globalization.
		- “Trade has led to inequality, and inequality has led to Trump. “
	+ Analogous stories in Europe:
		- e.g., how the UK elites were caught by surprise by the Brexit vote last June.
		- Walloons blocked a long-negotiated EU-Canada trade agreement last week.
	+ I will talk
		- about trade;
		- then inequality, which unquestionably has risen within the US;
		- then a bit about the election and why I don’t see that we should have predicted that the issue of inequality would work to help Trump politicall.
* **Widely agreed: trade openness is good *for economic growth***
	+ Trade theory. Four waves, over the last two centuries:
		- Classical comparative advantage (e.g., Ricardo) => theory implies that trade is so good (for everyone) that countries should liberalize even if they have to do it unilaterally.
			* It left out some things, by assuming perfect competition, constant returns to scale, and that everyone within a country was the same.
			* Heckscher-Ohlin differentiated labor vs. capital. Put aside for now.
		- Modern theories of trade based on:
			* imperfect competition (Krugman) => if everyone agrees to remove trade barriers we will be better off, because of access to variety and scale economies.
			* & differences in firms, re productivity (Melitz) => trade is a source of productivity growth, as exports give more-productive firms the opportunity to expand.
	+ Empirically: many econometric studies.
		- E.g., one estimate: every .01 increase in a country’s trade/GDP ratio raises income 3 ½ % (over next 20 yrs.).
			* Frankel & Romer (1999)
			* Can we say that “correlation is causality”? We think so, in this case.
	+ Most Americans seem to agree:
		- Polls show surprisingly high support for trade. (Appendix 2)
* But grave doubts about trade are front and center in the political process.
They tend to have to do with things we care about *other than* increasing total GDP. Especially the division of the pie, that is, the issue of inequality.
* The first thing we should note is that trade (and globalization more generally) has helped bring about a monumental historic ***reduction* in inequality since 1970**…
-- **if you measure it across the entire global population**.
	+ Poverty has fallen especially rapidly in such countries as China, Indonesia & India.
		- Between 1981 and 2010 China lifted 680m out of poverty
			* which alone ≈ ¾ global fall in extreme poverty during these years.
	+ Stats: The global poverty rate was cut in half in two decades.
		- In 1990, **43%** of the population of developing countries lived in extreme poverty (then defined as subsisting on $1 a day);
			* the absolute number = **1.9 billion people**.
		- **By 2010 it was 21%** = **1.2 billion.
		(T**he poverty line was then $1.25, the average of the 15 poorest countries’ own poverty lines in 2005 prices, adjusted for differences in purchasing power.)
	+ **It could be cut in half again over the next two decades.**
* But we are in a US election, and most voters and commentators talk as if only the **Americans’ economic welfare** matters. So let’s put aside any benefits of trade for those living in other countries. And let’s even put aside the important geopolitical arguments (which are probably the most important ones in TPP, for example).
	+ I will focus on the economic welfare of US citizens.
	+ And, having already established that trade increases the total American pie, will focus on the distribution of the pie within the US.
* As noted, after the surprise of Trump’s nomination typical explanations go as follows: globalization => inequality => anger among those left behind => so they support radical changes.
To summarize my take on this:
	+ Inequality has indeed risen, esp. in US;
	+ Trade & immigration probably play roles, along with a long list of other factors.
	+ There are good answers to “How can we address the wellbeing of workers who have been left behind?”
* Needless to say, trade creates both **winners and losers**.
	+ So does every change.
	+ E.g., putting up tariffs would create both winners and losers, and the losers would be concentrated in firms that had been exporting and firms that use imported inputs.
	+ If we economists require Pareto superiority before recommending one policy over another, then we can never make any recommendations, because there is always somebody who loses.
	+ Economists *can* make win-win policy recommendations if we express the distributional consideration in terms of a desired measure of overall inequality. We can approve a policy that, while raising total income, also reduces the Gini coefficient, or lowers the poverty rate, or raises median income.
		- Examples of such win-win policies would be universal pre-school, or infrastructure construction, or eliminating payroll taxes on low-income workers;
		- and funding such measures by curtailing the mortgage interest deduction, or eliminating oil subsidies, or raising the gas tax.
			* Actually those last two are win-win-win because they would also help the environment.
	+ So what about trade?
		- (1) Eventually I want to get to the Second Welfare Theorem of Economics. It suggests that free trade increases the size of the pie by enough that the winners could compensate the losers so that everyone comes out ahead, in theory.
		- (2) But, we need to consider, first: are the losers from trade concentrated in the lower segments of the income distribution?
	+ A simple common sense encapsulation includes three effects --
		- (+) Consumption: the opportunity to import at lower prices and with greater variety works to raise real income for all. My guess is that this helps lower-income families (inexpensive made-in-China consumer goods sold at Wall-Mart) at least as much as the rich (luxury imports like French wine).
		- (-) Imports tend to hurt those in import-competing sectors. (=> Owners of the import-competing firms suffer lost sales and lost profits. More importantly, workers in these firms suffer lost jobs in the short run, lower wages in the long run.)
		- (+) The losses to those in import-competing sectors are offset by the fact that the increase in exports help those in exporting sectors. (=> Owners of the exporting firms gain sales and profits. More importantly, workers gain additional jobs in the short run, higher wages in the long run. Export jobs pay an estimate 18% more than other jobs.).
	+ What does trade theory say about income distribution? Ironically, the trade theory that dominated academic research during the decades when America’s support for free trade was the strongest -- roughly the 1950s-70s – was a theory that gives solidly respectable grounds for fearing it would hurt American workers even in absolute terms. That is the Heckscher-Ohlin-Samuelson theory
		- It divides the population into “Unskilled” workers vs. others (owners of capital or land, or skilled workers)
		- The Stolper-Samuelson theorem specifically predicts that workers in a capital-abundant country will lose from trade (wages fall), even though total real national income goes up.
		- 1955-1980: From Rybczynski, 1955, *Economica,* "Factor Endowment….”
		[to Krugman, *AER,* “Scale economies…”]
		- The H-O-S theory never did fit the facts very well empirically, and it does not include the theoretical advances in trade theory since 1980, some of which predict ongoing productivity growth beyond the [one-time] gains of comparative advantage.
* What about NAFTA? Didn’t it devastate workers? No.
	+ Listening to those who take it as obvious that NAFTA hurt American workers, you would never guess that the half-decade after NAFTA went into effect
		- featured the most job creation and greatest rise in real wages in the last 40 years
		- 1996-2000: GDP gr. averaged 4.3%, prodcty gr. 2.5%, unempl. < 4% by end-2000.
	+ It’s the one half-decade since the 1970s when
		- * lower-income workers shared fully in the gains: real compensatn/hr 2.2%,
			* median family income: $25,000 1993 to $32,000 in 1999 [in real $1999]
			* and the poverty rate steadily declined (31.3% 1993 to 21.9% 1999)
* Personally, I am not entirely sure what the net effect of trade has been on lower-income American workers. I can well believe trade – and in particular the entry of China into the system -- has contributed to inequality in the US
	+ especially if one’s criterion is the rich-versus-poor gap,
	+ rather than the absolute real income of those on the bottom.
	+ Recent research by Autor et al shows the long-lasting negative effects on import-competing sectors (though it doesn’t look at the gains in export sectors).
* But there are many other reasons for increased inequality, in addition to trade.
I will list seven.
	+ - **Technological change** that raises overall demand for “skilled” workers, i.e., college educated. [E.g., computer programmers vs. cashiers.]
		- A slowdown in the expansion of **education**, so that the supply of skilled workers has been lagging the demand. Strong evidence of this excess demand for skilled workers is the widening gap between the earnings of those with college degrees and those without.
		- **“Winner-take-all” labor markets**.
		- “Best surgeon in NYC.”-- *NY Magazine* and then the internet.
		- Taylor Swift earned $170 million last year,
			* making her the highest paid celebrity in the world (according to *Forbes)*.
		- **“Assortative mating”.** Crudely put: highly educated [and highly paid] male professionals used to marry their secretaries but now are more likely to marry highly educated [and (relatively) highly paid] women and the couple passes on their advantages to their children.
		- **Reduced corporate competition** and increased monopoly rents. [The CEA offers evidence for this hypothesis].
		- Astounding levels of **executive compensation** and compensation in finance more generally.
			* Excessive compensation? What is “excessive”?
			* Some studies show, counterintuitively, that executive compensation is what one would expect from a competitive market.
			* Others argue that it is rents, capture of compensation boards. I find that plausible.
		- We could add an 8th hypothesis, made very famous by Thomas **Piketty**, that the rate of return to capital exceeds the growth rate of other income, so that the wealth of the wealthier accumulates with each generation.
* For each of these 7 non-globalization diagnoses, one might think of a targeted policy response:
	+ - **Technology and** **education**
		- Obvious response: make college more accessible to lower-income students
			* and I don’t mean huge debts to go to sub-par for-profit schools.
		- **“Winner-take-all” labor markets**.
		- The appropriate policy response is less clear here. An increase in income taxes and payroll taxes for the upper 1% and especially the upper 0.1% seems a good response.
		- **“Assortative mating”.**
		- Education again, especially universal pre-school
		and better primary & secondary schools.
		- **Reduced corporate competition** and increased monopoly rents .
		- The most obvious policy response is more aggressive anti-trust action.
		- **Executive compensation, esp. in finance**
		- Reforms such as “say on pay,” separating the function of CEO and Chairman of the Board, “clawback provisions,” and so on;
		- Also financial reform, begun under Dodd-Frank and in need of continuation
			* e.g., Hillary’s risk-tax on large financial institutions;
		- Regardless, even if it is all earned legitimately, a good response is higher tax rates on the upper 0.1% and, very specifically, eliminating the carried-interest deduction.
		- **Piketty’s wealth accumulation**: Here, it seems to me, that a significant inheritance tax, at least on estates above $5 million, would be especially important.
* What **weights** should we place on each of these 8 factors in explaining increased inequality?
	+ - Trade, technology, education, winner-take-all, assortative mating, rents, executive compensation, or Piketty’s wealth accumulation?
		- I don’t know. Probably all or most of them merit some weight.
		- “Surely one must diagnose the cause before deciding on the corresponding remedy?”
		- No, I don’t think one has to.
* A fundamental proposition in economics holds that when individuals are free to engage in trade, the size of the economic pie increases enough that the winners could in theory compensate the losers, in which case everyone would be better off. Formally it is a case of [what economists call] the Second Fundamental Welfare Theorem.
	+ (The proposition requires that there be no market failures like monopolies or pollution externalities.)
* Skeptics of globalization may understand this theorem and yet, quite reasonably, point out that the compensation in practice tends to remain hypothetical.
	+ Some of the skeptics suggest that we should recognize political reality, take the failure to compensate losers as given, and so work on trying to slow down or roll back globalization.
	+ But an alternative would be the reverse strategy: to take *globalization* as given and instead work on trying to help those left behind.
	+ The second strategy is the sensible one, not the first.
* For one thing, it would be difficult to reverse globalization even if we wanted to.
	+ Presumably the policies would include attempting to renegotiate NAFTA or TPP (or, for Britain, the EU), or dropping out of the World Trade Organization, or else unilaterally imposing tariffs and quotas even though they violate existing international agreements.
	+ Even leaving aside the negative effects of trade wars on overall economic growth, and the geopolitical damage,
	+ anything that a president does would be very unlikely to bring trade back down to the levels of 50 years ago, and still less likely to bring the number of jobs in steel and clothing back up to the levels of 50 years ago.
* **Globalization is a fact.**
	+ We are not going back to 1950
		- when manufacturing jobs were 32% of the national total
		- versus down to 13% by 2002.
		- any more than we can go back to 1790 when farmers were 90% of national employment, vs. 2% today.
		- Some of the lost jobs are in the auto and steel industries,
		- two industries where those northern workers who lacked a college education but were lucky enough to get a job were able to earn an income far higher than other unskilled workers.
		- The number of jobs in sectors like steel fell by ½;
			* while the number of jobs in health care increased six-fold.
	+ International trade was one factor helped put an end to those high-paying jobs (along with productivity growth and relocation from the north to the south)
		- while improving the reliability, fuel efficiency and affordability of cars for all of us.
	+ Regardless, it is hard to see how that could be reversed.
* That we can’t turn back the clock on globalization is understood fairly widely. But a second point is less often made. In the context of US presidential elections, the choice between the two parties is less a referendum on globalization than it is a choice whether to adopt the specific policies that would help those who are in danger of being left behind.
	+ Much is new and different in the 2016 election, but not that.
* Policies to help those who are left behind [to compensate the losers] are precisely where the two parties disagree. The most effective measures, as I see it, are ones that one party tries to push and that the other party tries to block.
	+ The main program to help specifically those who have lost their jobs due to trade is Trade Adjustment Assistance (which the Democrats try to expand and the Republicans block).
		- But why help only the small number of workers who have identifiably lost their jobs due to trade agreements? **Wouldn’t it be better to help those who have been left behind regardless if the cause is trade, technology, or something else?**
	+ Sensible policies to do that include:
		- Wage insurance (as proposed by Obama in SoTU)
		- A more progressive income tax system (a central part of Hillary Clinton’s economic plan)
			* including an expanded Earned Income Tax Credit
			* and more progressive payroll tax rates too;
		- and Universal health insurance (e.g., Obamacare, and beyond).
		- Universal quality pre-school education (again, as favored by Obama & Clinton),
		- infrastructure investment spending.
		- Financial regulation, such as Dodd-Frank and beyond (e.g. Hillary Clinton’s proposal to impose a risk free on large financial institutions).
	+ These are all policies favored by most members of one party .
		- Most have been opposed by the other party, often successfully.
		- They argue that such policies are government overreach
			* which impeded overall growth.
		- Still, one hopes that even if a second President Clinton once again had to deal with a Republican Congress, the two might be able to find common ground in the EITC and infrastructure investment.
* The American political situation at the moment has an advantage [that the Brits lack]: ability for voters to choose between two starkly different choices for what is to be the national policy orientation.
	+ The choice between the two parties is in some ways the same this year as usual.
	+ The Democrats still favor policies like wage insurance and universal health insurance and the Republicans still oppose them. So American voters in 2016 are still able to make the relevant choice, either for or against policies that deal with the reality of globalization by helping those who are left behind.

**Appendix 1: Polls show support for trade among US voters.**

* A [survey last month](http://www.people-press.org/2016/08/18/clinton-trump-supporters-have-starkly-different-views-of-a-changing-nation/) by the nonpartisan Pew Research Center found
	+ Americans by 50 to 42 % said trade agreements had been “a good thing” for the US.
* July[Washington Post-ABC News poll](https://www.washingtonpost.com/apps/g/page/politics/washington-post-abc-news-national-poll-july-11-14/2061/). Asked if they wanted the next president to support trade agreements or oppose them,
	+ 75 % of respondents said they wanted a supporter
	+ Vs. 17 percent favored an opponent.
* A [Gallup poll](http://www.gallup.com/poll/191135/americans-split-idea-withdrawing-trade-treaties.aspx) early this year found that
	+ 58 percent of Americans viewed
	trade as an economic opportunity,
	+ 34 percent as a threat.
* Similarly, in [a July poll for NBC News](http://www.nbcnews.com/storyline/2016-conventions/majority-voters-support-free-trade-immigration-poll-n611176),
	+ 55 percent of registered voters agreed with a statement that trade was good “because it opens up new markets and we cannot avoid the fact that it is a global economy,”
	+ while 38 % agreed that trade was bad “because it has hurt manufacturing and other key industries.”
* Source: *NY Times* Sept.21, 2016 “[Who Hates Free Trade Treaties? Surprisingly, Not Voters](http://www.nytimes.com/2016/09/22/us/politics/who-hates-trade-treaties-surprisingly-not-voters.html?_r=0)”

**Appendix 2: Effects of trade on the environment**

* Example of negative effects:
	+ “Race to the bottom” in environmental regulation among national governments pursuing of cost-competitiveness.
* Example of positive effects:
	+ Trade in environmental goods & services.
		- US ended 1980s tariffs & quotas on fuel-efficient Japanese autos, benefiting both consumer pocketbooks & air quality.
		- Almost ¾ of EU trade-remedy barriers currently target imports
		of products used for renewable energy! (Kasteng, 2013; Wu, 2014)
		- AD remedies currently block trade in solar power inputs:
			* US has AD tariffs on imports of Chinese solar panels (2012, 2014, 2015).
			* China has them against imports of polysilicon from US & EU (2012 & 2016);
			* EU has penalties on imports of Chinese solar glass & panels (2013, 2015).
* Which effects tend to dominate in practice? Econometric estimates depend on environmental criterion
	+ Frankel & Rose, *Review of Ec. & Stats. (*2004).
	+ For SO2
		- Trade seems to be beneficial
		- “Environmental Kuznets Curve” => at higher incomes, people want to clean the environment.
	+ For CO2
		- Even at high levels of income, trade continues to hurt.
		- The “free rider” problem => popular desire for environmental quality cannot be enacted at the national level, absent an effective multilateral treaty à la Paris Agreement.

**Appendix 3: TPP**

* Specific examples of American sectors that are likely to gain exports are in:
	+ Agriculture
	-- dairy to Canada, poultry to Vietnam; beef, pork, soy & wine to Japan.
	+ Services – engineering, education, software, express delivery services…
	+ Manufactures – ICT hardware (& autos, machinery…)
* **TPP differs from past agreements**, as both supporters & detractors point out.
	+ So-called “deep integration
	+ Most prominently, it addresses:
		- some areas of particular concern to the left, such as
			* **the environment**
			* **and labor rights**
		- and some areas of particular concern to the right, such as
			* **IPR**
			* **and investor-state dispute settlement.**
	+ Of course TPP is politically unpopular, especially in this election year,
		- in part, because many workers feel left behind by modern trends.
	+ But, very few of the critics know what is actually in the agreement.
		- as opposed to a fact-free cartoon version of TPP.
			* Of which the extreme case is Donald Trump
				+ who says the deal is terrible because it is designed to let China manipulate its exchange rate.
* **Environmental (Chapter 20)**
	+ Steps to help implement at the national level bans on **trade in endangered wildlife**
		- – under CITES (Conventn. On Int. Trade in Endangered Species)
		- but insufficiently enforced until now.
		- E.g., rhinos, elephants, tropical birds, and rare reptiles.
	+ Steps to protect the ocean environment from **ship pollution**.
	+ & **to limit subsidies for fishing fleets**,
		- which subsidize depletion of tuna, & swordfish…
	+ For the 1st time in a regional agreement, these provisions are **subject to a dispute settlement process backed up by threat of trade penalties.**
* **Labor practices (Chapter 19)**
	+ Including steps to promote union rights in **Vietnam**
		- **allowing independent labor unions for the first time**
		- VN agreed bilaterally to make labor regulations consistent with the US, or forfeit tariff concessions on clothing & textiles.
	+ As with enviro, dispute settlement & trade penalty threat backs up commitment to labor provisions.
* In two particular areas, critics were afraid that the final agreement would give too much to US corporations such as tobacco and pharmaceuticals.
	+ This could have happened, given that Pres. Obama needed Republican votes for TPA.
		- But these industries did not get all they wanted.
	+ **ISDS,** e.g.,
		- might have interfered unreasonably with countries’ anti-smoking campaigns.
		- But, no. Australia is free to ban brand name logos on cig. packs.
	+ **IPR,** e.g.,
		- TPP might have extended to other countries our 12-year protection for data on new drugs from our pharma and bio-tech. companies.
		- But, no, the most they get is 8 years in some countries
			* (5 years in others, with other measures).