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Trade, Development, and Inequality

URI DADUSH

To trade or not to trade? Judging by the narrow vote by the US Congress in June 2015 to grant President Barack Obama fast-track negotiating authority for trade agreements, the answer today remains in the affirmative, as it has for decades—but resistance is on the rise. According to the many opponents of such deals, trade is a bitter medicine to be taken only in small doses while guarding carefully against its dangerous side effects. If new trade deals are to go ahead at all, the critics say, they should include strict safeguards, such as provisions to uphold environmental and labor standards, and penalties for currency manipulation. Although the trade debate in the United States, the architect of the postwar global trading system, tends to draw the spotlight, the hand-wringing over trade is even more intense in the developing world. Since developing countries protect their home markets more comprehensively than the United States does, the stakes in their trade debates are higher.

Yet this is an era of hyper-globalization in which consumers have become accustomed to searching online for the best-priced merchandise from all over the world. Trade has surged from 25 percent to 60 percent of world GDP in the past 50 years. Why is it still so controversial? The unemployment and dislocation caused by the global financial crisis provide only part of the explanation.

In the United States, the great crisis of 2008–9 came on the heels of 30 years of stagnant incomes for the vast majority of households, a period that also saw nearly all of the nation’s very considerable income gains accrue at the top of the income and wealth pyramid. Trade, especially with China and other low-income countries, is often blamed for the very high and rising inequality in the United States. Such high inequality contributes to a number of ills, including extremely limited opportunity for the children of poor families, bad health outcomes, crime, capture of the legislative process and of government agencies by moneyed interests, and profound political divisions that impede the formulation and execution of economic reforms.

Rising income inequality is not only an American problem. With few exceptions, it has been a common trend around the world, in both advanced and developing countries—most notably in many of the largest developing countries such as China and India. A recent International Monetary Fund report found that over the past 30 years, inequality has risen in every region of the world except Latin America, which nonetheless still has several countries with levels of inequality surpassed only in South Africa.

There is broad agreement among economists that unskilled-labor-saving technologies, not trade, have played the central role in increasing inequality. Many believe that the ongoing information and communications technology revolution all but guarantees that this trend will continue. I share these views. I also believe, however, that trade, interacting in a mutually reinforcing fashion with these technologies, has significantly contributed to the inequality trend in both advanced and developing countries. And yet, since technology and trade also lie at the root of the unprecedented postwar advance in average living standards around the world, the sensible policy response is not to try to suppress or reverse trade (or technology, for that matter), even if that were possible, but to adapt to it and to mitigate its effects on the most vulnerable.

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Dozens of trade deals are being negotiated around the world today, including giant "mega-regional" arrangements such as the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). A TPP deal has just been struck, but it needs to be ratified by national legislatures. These new trade deals are as necessary to sustaining economic growth as previous trade deals were in the past. They may or may not lead to even more inequality, depending on the way they are configured, on other reforms that accompany them, and on the specific circumstances of each country or bloc.

The United States and the European Union are unlikely to see much additional effect on inequality from trade deals, simply because they are already very open economies. Trade deals are likely to have a bigger impact on inequality in developing countries, especially those that have the highest trade barriers, such as India and Brazil. Yet these are also the countries that are most likely to see the highest growth dividends from new trade openings, and where unskilled workers are more likely to be net gainers from trade, even if they are losers relative to their most affluent compatriots.

An enormous unfinished trade agenda lies within national borders.

Ancient arguments

The debate over trade is not new: Aristotle and Plato might have been in opposing camps. According to the late economic historian Murray Rothbard, "Aristotle, in the Greek tradition, was scornful of moneymaking and scarcely a partisan of laissez-faire . . . [yet] he denounced Plato's goal of the perfect unity of the state . . . pointing out that such extreme unity runs against the diversity of mankind, and against the reciprocal advantage that everyone reaps through market exchange."

Two thousand years later, Adam Smith and David Ricardo, writing at a time when Britain had established its commercial preeminence and was leading the Industrial Revolution, conducted systematic analyses of the gains from trade. Smith's analysis of the welfare-enhancing "invisible hand" of markets and his arguments in favor of the international division of labor and the economies of scale to be gained in world markets, together with Ricardo's advocacy of specialization along the lines of comparative advantage, laid the foundations of modern economics.

Their profound insights made little impression in the United States at the time. The great emerging nation of the era comprehensively protected its infant manufacturing sector while relentlessly copying European technology, a policy that it pursued quite consistently throughout the nineteenth century and well into the twentieth. This protectionism culminated in the trade-suffocating Smoot-Hawley tariff hike during the worst of the Great Depression.

It was only as World War II drew to a close that the United States, having achieved a dominant position as the world's leading industrial power, took up the banner of free trade. At the Bretton Woods conference in 1944, the United States insisted that Britain dismantle its system of imperial preferences, a demand the British strenuously resisted. The disagreement over imperialism was a major reason behind their failure to agree on launching an international trade organization along with the World Bank and International Monetary Fund. The trade wing of what came to be called the Bretton Woods system emerged later, first in the shape of the General Agreement on Tariffs and Trade, which took effect in 1948, and then as the World Trade Organization (WTO), launched in Marrakesh at the end of 1994.

Boom times

In the immediate postwar years, it was the turn of the newly independent developing countries to become the champions of import substitution, to resist protection of intellectual property, and to adopt industrial policies designed to pick market winners and protect the politically powerful—precisely the policies to which the United States had resorted during its developmental phase. Those policies may or may not have worked well for the young giant—we have no way to be sure whether America might have grown even faster under free trade. What we do know, however, is that import substitution did not yield the desired results in developing countries. Soon enough, a turn toward exports and much freer imports ensued.

That big shift toward more outward-looking economic regimes was initially inspired by the extraordinary export-fueled growth of a small number of developing economies in Asia. This trend gained momentum in the wake of the oil shocks of the 1970s, when countries had to look for ways to cover their surging energy bills. Subsequently, the Latin American debt crises of the 1980s discredited import substitution, and the belief in central planning was undermined by stagnating living standards and lagging technologies across the communist bloc. As many observers predicted at the time, the fall of the Berlin Wall heralded the mother of all trade booms, lasting through the 1990s and early 2000s. The intensification of globalization was accompanied by spectacular growth in many developing countries, led by China, which surpassed the United States and Germany to become the world's largest exporter.

During this period, many economists became convinced that, in addition to the efficiency effects stressed by Smith and Ricardo, trade brought potentially even greater benefits, especially to developing nations, by inducing backward firms and economies to learn from those on the technological frontier. This thinking may have been formalized first by Alexander Gerschenkron in a seminal 1951 essay entitled "Economic Backwardness in Historical Perspective."

The focus on learning encouraged development agencies such as the United Nations Conference on Trade and Development (UNCTAD) and the World Bank to view foreign direct investment (FDI) more as a source of new techniques than as a finance vehicle. FDI, which grew even faster than trade, distributed the value chains of the most advanced manufacturers and service providers to cheaper locations or closer to the largest markets, and in the process created millions of jobs in the developing world. According to UNCTAD, the sales of foreign subsidiaries of multinational enterprises in their host countries today exceed world exports by a wide margin. The techniques and methods employed by these state-of-the-art overseas factories and service centers are systematically emulated or copied by less productive local enterprises. Not surprisingly, countries compete fiercely to attract FDI.

FALLING TARIFFS

The advance toward an open and predictable trading system has been nothing short of remarkable, and it has been matched by the rise of average incomes around the world. Real average per capita income in the United States has more than tripled since 1950, and incomes in developing countries have grown much faster. Over a billion people have been lifted out of absolute poverty in the past 15 years.

At the same time, high tariff structures have been dismantled. The average tariff in the advanced countries is now around 2-3 percent, and cannot be raised without violating WTO rules. Moreover, countries must apply the most favored nation (MFN) clause, meaning that all WTO members—which account for 97 percent of world trade—must accord each other at least the same tariff treatment, or treat them more favorably under certain specified circumstances. Quotas and subsidies have been outlawed, except (mainly at the insistence of advanced countries) in agriculture, which remains a heavily protected sector across the world.

MFN tariffs in developing countries are on average near 10 percent, much higher than in the advanced countries but about one-third their level during the height of import substitution. For the most part, however, these tariffs are not limited by the WTO or are subject to limits set at very high levels. Therefore, unless they are bound by a bilateral or regional agreement, most developing countries have plenty of room to legally raise their MFN tariffs should they decide to do so. (China is a notable exception on account of its demanding WTO accession protocol.)

According to a recent WTO/OECD paper, the movement toward freer trade has continued despite the ill-fated multilateral trade negotiations launched at Doha in 2001. Over the past 20 years, the applied tariffs of WTO members have declined by 15 percent on average, and the share of developing-country exports that now enter advanced countries duty-free has increased from 55 percent to 80 percent. Unilateral trade liberalization, more generous preference regimes, regional trade deals, and the delayed effects of past multilateral trade rounds have all played a role.

BEHIND THE BORDER

There is still a long way to go before we secure world free trade, by which I mean zero tariffs on all goods, no quotas or subsidies, and complete freedom of entry in service sectors across the world, as well as equal treatment for foreign investors and suppliers, all bound by international treaty in the WTO. In addition to this admittedly distant or even utopian vision, an enormous unfinished trade agenda lies within national borders: reforming domestic regulations and practices that have the effect, sometimes intended but more often unintended, of restricting trade.

The cost of complying with these regulations, together with the cost of transportation and customs duties, and of distribution through wholesalers and retailers, adds up to "trade costs," which, it is estimated, can easily amount to one or two times the price of the product at the factory door. Economists have identified excessive trade costs (due to inappropriate regulations, inadequate transportation infrastructure, inefficient customs, bribes, and so forth) as a much more important barrier to trade today than tariffs. Numerous ongoing bilateral and regional trade negotiations are designed to address them. The Bali Trade Facilitation Agreement, which still requires ratification by two-thirds of members to take effect under the WTO, deals with a relatively narrow set of these behind-the-border issues, namely customs and regulations affecting international transportation and logistics, but arguably these are the issues of most immediate concern to exporters and importers alike.

Naturally, developing and advanced countries have different agendas for addressing the largest remaining impediments to trade. Within each group there is a wide spectrum of interests that often cross over the dividing line. Developing countries aim to reduce the hugely distorting tariffs, quotas, and subsidies in advanced countries that limit their agricultural exports. They are also looking to limit the relatively high tariffs that advanced countries apply to labor-intensive manufactures, such as garments and shoes. In the context of North-South regional deals, such as the Central American Free Trade Agreement or the EU's Mediterranean agreements, developing countries are the parties most interested in less restrictive rules of origin, which are designed to guard against simple transshipment of goods from third parties but are often so complex and restrictive that exporters prefer to pay the full duty rather than try to document their right to preferential treatment.

Advanced countries, for their part, seek to limit tariffs in developing countries across the manufacturing sector. Many of them also wish to improve access for their (subsidized) agricultural and processed food exports, and to secure access to markets in services such as retailing, finance, and insurance. In addition, advanced countries are the ones most concerned with behind-the-border impediments to trade, such as subsidies or licenses accorded to state-owned enterprises, discrimination in government procurement and treatment of foreign investment, lax protection of intellectual property, and slow or unfair settlement of judicial disputes.

MEGA-REGIONAL DEALS

The United States, together with the European Union, spearheaded the adoption of WTO rules through most of the postwar period, but it has recently taken a very different turn. A decade ago, the twin thrusts of American trade policy consisted of a quest for a comprehensive WTO-driven multilateral trade round in the shape of the Doha agenda and the pursuit of a number of relatively minor bilateral trade agreements intended to spur "competitive liberalization." The idea was to induce countries to engage in bilateral deals and the Doha process to avoid being left out.

Trade both stimulates economic growth and increases income inequality.

Today, American trade policy has pretty much written Doha off on account of what Washington perceives as unbridgeable differences between advanced and developing countries. Instead of small bilateral deals, the Obama administration is pursuing two so-called mega-regionals, the TPP for the Pacific and the TTIP with the EU. These deals explicitly aim to rewrite trade rules for the twenty-first century, effectively bypassing the unwieldy WTO. The TTIP has a long way to go, while a deal on the TPP was struck in October.

Given the number of partners involved and its comprehensive scope—it will cover about 40 percent of global GDP—the TPP is one of the most complex free trade agreements ever negotiated. Eleven countries initially joined the negotiations: Australia, Brunei, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States, and Vietnam. Japan is a more recent and hugely important addition, and South Korea is a possible partner in the future. As in the case of the TTIP, trade is already largely free among this group; the aim is a high-standard agreement that will go deep behind the border to enhance trade and investment prospects across the board.

The United States already has established free trade agreements with six of the other eleven countries negotiating the TPP, and since it has a very open economy, the new trade liberalization that will be required of it under the deal is minimal. Accordingly, formal studies of the gains that the United States is likely to derive from tariff reductions under the TPP have come up with very small numbers—0.1 percent or 0.2 percent of GDP. Gains from removing nontariff barriers are potentially much larger, but very difficult to quantify.

The TPP, which excludes China, is motivated by political and security concerns as well as by economics. Yet despite the powerful political motivation behind the TPP (it is seen as a key part of the Obama administration's "pivot to Asia"), the diversity of interests among its prospective members has resulted in lengthy delays. The original deadline for completing the deal—the end of 2013—proved wildly optimistic. Although many expect the TPP to be concluded now that Obama has been granted fast-track trade promotion authority, it faces a tough ratification fight in the US Congress.

Trade deals are likely to have a bigger impact on inequality in developing countries.

The resistance to the TPP in the US Congress and the virulent criticisms leveled against it by civil society groups are difficult for its proponents to understand. They see only the deal's strategic importance and the advantage that the United States must commit to very little new liberalization, while its negotiating partners will have to do most of the hard work to reduce their tariff and nontariff barriers. But this is missing the point: At its core, the powerful resistance to new trade agreements in any shape or form is driven by the conviction that they hurt workers and benefit only the privileged few.

TECHNOLOGY AND INEQUALITY

The traditional view of trade is that it is triggered by variations in endowments of factors (resources such as land, labor, and capital). In a standard model with two factors, labor and capital, traditional trade theory predicts that a labor-abundant country will export labor-intensive products and see inequality decline as wages rise, while a capital-rich country will see inequality increase as it exports products that are capital-intensive and the return to its capital increases. This traditional model was adequately descriptive of trade in past centuries, when, as in Ricardo's famous example, England exported clothing and Portugal exported wine. Capital was scarcely mobile across borders, and technologies spread gradually.

Today, though, the traditional theory fails the empirical test. Contrary to its predictions, what we observe is that trade takes place predominantly between economies with similar endowments, namely advanced countries exporting to each other highly differentiated products in the same industry, such as cars and machine tools. Crucially, increased trade has been associated with higher inequality not just in advanced but also in developing countries.

Prompted to explain this reality, economists have come up with a number of alternative narratives in recent years, only some of which have been tested econometrically or using case studies. Economists now broadly agree that the most powerful underlying force driving increased inequality is not trade by itself but skill-biased technological change—that is, machines and methods that reduce the need for unskilled labor and boost demand for more specialized and skilled workers. Economists have also shown definitively that changes in aggregate or sectoral exports and imports are far too small relative to the size of the economy to account for the large shifts in industrial structure, employment, relative wages, and inequality that we observe. However, even though trade on its own cannot account for these changes in economic structure and inequality, the new stories tell us that the mutually reinforcing effects of trade on skill-biased technological change can increase inequality.

Take, for example, the case of an advanced country that opens up trade with a large low-wage economy. Firms in the advanced countries that compete in international trade are heterogeneous—they may operate in the same industry but they produce diverse products and vary greatly in their efficiency. Trade quickly kills the least efficient firms in sectors where the low-wage economy has an advantage, namely those that produce standardized products and which are highly labor-intensive. Those firms that survive do so on the basis of three complementary strategies:

They automate so as to save on labor, they outsource their most labor-intensive activities to the low-wage economy, and they move upmarket into highly differentiated or technologically advanced niches.

Under all these scenarios, the demand for unskilled labor declines and the demand for skilled labor and capital increases. The dislocation of unskilled labor that results is larger than could be anticipated from the traditional static two-factor model, since trade encourages reduced employment of unskilled labor over time through multiple channels. Outsourcing of unskilled-labor-intensive activities results in less investment and growth in those activities in the future. While the sectors that compete with imports or engage in exporting lead in automation, those techniques are likely to spread throughout the economy, reducing the demand for unskilled labor even further. The fall in their wages prompts increased demand for unskilled workers in the non-traded service sector, but not enough to compensate.

SKILLS IN DEMAND

What about the effect of trade on inequality in a low-wage or developing economy? As predicted by the traditional models, the demand for unskilled labor caused by opening up trade with high-wage economies will tend to raise the wages of the unskilled. However, there are three influences that can offset this effect and cause inequality to rise anyway.

First, as argued by the late development economist Arthur Lewis, an abundance of excess rural labor with a low reservation wage (the lowest wage at which a worker would accept a job) can slow the rise in wages of unskilled workers, especially at a time when hundreds of millions of unskilled workers are joining the global economy.

Second, as in an advanced economy, the opening of trade will favor a developing country's most efficient firms and those most able to adopt the higher standards demanded by world markets, with the capacity to meet precise specifications and timely delivery schedules. These requirements will often prompt the hiring of specialized workers and the purchase of sophisticated machines. According to the International Federation of Robotics, China is by far the world's fastest-growing market for industrial robots; its installations grew at a rate of about 25 percent a year between 2005 and 2012. Indeed, the import of such machines from advanced countries is the most direct channel through which trade spreads technology. Multinational enterprises from advanced countries invariably bring these advanced techniques with them as part of their outsourcing strategy.

Third, as in advanced countries, trade and foreign investment will stimulate the adoption of advanced techniques throughout the economy—not only in the traded sector. The combination of these effects leads to a sharp rise in the demand for skilled labor, which is relatively scarce in developing countries, as well as a rise in the demand for capital. Even though the demand for unskilled workers also rises, they may remain in plentiful supply for a long time, their wages rising relatively slowly, resulting in increased inequality.

The connecting thread in all these stories is that trade and, more broadly, international exchange prompt the spread of the most advanced technologies and encourage every firm exposed to increased competition, whether in advanced or developing countries, to become more efficient, thus raising the demand for skilled labor and for sophisticated capital goods. Moreover, since capital and, to a lesser extent, the most highly skilled professionals are more internationally mobile than unskilled workers, their rewards will tend to increase to match the best opportunities available anywhere in the world.

THE TRADE DILEMMA

The modern theory of how trade both stimulates economic growth and increases income inequality applies in both advanced and developing countries. There is, however, an important difference between the two groups. Not only are developing countries catching up technologically and growing much faster; in labor-abundant developing countries the wages of the unskilled are likely sooner or later to rise with increased trade, even if they lose ground in relative terms to the skilled cohort. In contrast, unskilled labor in advanced countries could be a net loser in both relative and absolute terms. The theory is consistent with what we have observed: rising wages in developing countries, stagnant wages of unskilled workers in advanced countries, and rising inequality in both groups.

If the theory is correct, it presents an acute dilemma. Should countries pursue trade deals and grow more rapidly or should they eschew them, grow more slowly, and avoid their inequality-intensifying effects? The dilemma is sharper for advanced countries whose unskilled laborers may lose outright.

The answer goes back to the minimum concept of efficiency developed at the turn of the twentieth century by the Italian economist Vilfredo Pareto: Countries should pursue the efficient solution (in this case, open trade), making the pie bigger, and then redivide it in favor of the losers so that no one is worse off. Politically, this is easier said than done, but the necessary economic policies are familiar and the instruments are well honed. As the IMF has stressed in a recent analysis, compensating the losers from labor-saving technology or trade need not result in a loss of efficiency. Investments in education, health, and infrastructure that boost the incomes of unskilled workers and level the playing field for their children are likely to enhance economic growth. More progressive income and wealth taxes can be achieved by closing the many tax loopholes and inequities that distort economic incentives. Cuts to subsidies that favor rich farmers, purchasers of large homes, or drivers of gas-guzzling vehicles are likely to both increase efficiency and reduce inequality.

Developing countries are least prepared to execute these policies because they have limited taxation and administrative capacity, but they—and their unskilled workers—are the most likely to benefit from new trade deals even if they increase inequality. Advanced countries such as the United States are already largely open and have little to fear from new trade deals, which can consolidate their export interests without causing an unacceptable further rise in inequality.

However, the United States is also the country with the most pressing need to help unskilled workers cope with the effects of advances in labor-saving technology and their mutually reinforcing interaction with globalization. It has all the tools to respond. Its failure to confront rising inequality presents a threat both to its continued economic growth and to its leadership of the open global trading system that Washington played such a large role in creating. ■