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BARGE ECONOMICS: THE NEW ECONOMICS OF GLOBALIZATION

Chairman Miller, Ranking Member Sensenbrenner, Members of the Committee, thank you for the opportunity to contribute to this hearing.

My name is Thomas Palley and I am an economist. One of the subjects I have studied extensively is globalization and its impact on the American economy. This subject is at the heart of the issues you are considering today as globalization threatens to permanently dissolve the social contract that has historically supported shared prosperity.

How our government responds to globalization will significantly impact the future opportunities of American workers and their families to participate in the American dream. Designing an appropriate policy response requires understanding globalization. That can appear a frustrating academic exercise, but it is critical as we are unlikely to adopt the right policies without understanding.

I Globalization is more than trade

The past twenty-five years have witnessed a stunning increase in the degree of U.S. integration into the global economy, and there is every indication this integration will deepen as globalization impacts previously untouched sectors.

For some, globalization is equivalent to trade, and outsourcing is merely an extension of trade – a further application of the principle of comparative advantage. For this group, outsourcing promises significant future gains without any long-term costs for society as a whole, although individuals may be economically injured.

An alternative view that I subscribe to is that globalization is a qualitatively new phenomenon, with outsourcing being the latest evolution. Trade is a central part of globalization, and globalization and outsourcing could not proceed without trade. However, globalization is far more than trade. The problem is we have treated globalization as if it was trade, which explains why our policies have come up short.

II Barge economics: the new economics of globalization

U.S. international economic policy has long been guided by the theory of comparative advantage that recommends free trade. In combination with tremendous technical innovations that have lowered transportation and communication costs, that policy has spurred U.S. integration into the global economy.

Yet paradoxically, global integration has undermined the relevance of comparative advantage theory and left the US economically vulnerable. This is because our policy approach remains stuck in the past and based on an obsolete view of the world.

Classical free trade theory claims that all can benefit when countries specialize in producing those things in which they have comparative advantage. The necessary requirement is that the means of production (capital and technology) are internationally immobile and stuck in each country. That is what globalization has undone.

Several years ago Jack Welch, former CEO of General Electric, captured the new reality when he talked of ideally having “every plant you own on a barge”. His economic logic was that factories should float between countries to take advantage of lowest costs, be they due to under-valued exchange rates, low taxes, subsidies, or a surfeit of cheap labor.

Globalization has made Welch's barge a reality, creating a new world of "barge economics". This new world is marked by global corporations that participate in flexible production and sourcing networks that are the global economy's shipping lanes.

In this new world, capital mobility rather than comparative advantage has become the engine of trade. And with this change, so-called "free trade" increasingly trades jobs and promotes downward equalization of wages and standards.

This is because barge economics fundamentally changes the structure of competition, changing the balance of bargaining power between workers and corporations, and changing the margins of competition between countries.

Think of two swimming pools, with the U.S. being represented by the pool with a higher water level. Barge economics joins the pools together, causing the water to equalize at a lower level.

Outsourcing is an evolution of barge economics that amplifies the problem. Previously, companies could shift production to different countries, but they owned the facilities and workers were in competition with just one country. Now, companies can use global sourcing techniques that put contracts out for bid, thereby placing workers in permanent competition with workers everywhere.

Wal-Mart pioneered this strategy. It owns no production facilities, and when wages start to rise in a country it can shift its buying to another cheaper country. Moreover, rather than creating competition in one product, its "big box" stores create global competition for almost everything it sells. That places large swathes of workers in global competition.

III Old Style competitiveness policies are not enough

The U.S. response to barge economics has been competitiveness policy that advocates measures such as increased education spending to improve skills; lower corporate tax rates; and investment and R&D incentives. The thinking is increased competitiveness can make the US more attractive to businesses.

The problem is competitiveness policy is not up to the task of anchoring the barge. For instance, government can subsidize R&D spending, but the resulting innovations may simply end up in new offshore factories.

Moreover, competitiveness policy can be counter-productive because it easily degenerates into a race to the bottom. For instance, if the US cuts corporation taxes, other countries may match to stay competitive. The result is no gain for the US, while profit taxes are lowered and tax burdens shifted on to wages, which widens income inequality.

IV Barge economics creates new policy challenges

Not only does barge economics undermine earlier policy tools, it also creates completely new challenges that reveal how different globalization is from the old world of free trade theory.

Thus, barge economics further incentivizes countries to adopt unfair policies to increase their relative business attractiveness. These policies include disregard of environmental damage; suppression of labor to keep wages low; direct subsidies; and under-valued exchange rates. All are visible in China, which is the poster-child for such abuses.

Another new challenge is the creation of a “corporation versus country” divide. Previously, when corporations were nationally based, profit maximization by business contributed to national economic success by ensuring efficient resource use. Today,

corporations still maximize profits, but they do so from the standpoint of their global operations. That is good for corporations, but it may not be good for countries.

When companies raise profits by rearranging production according to global cost patterns, those shifts can lower country income. For instance, when Boeing transfers production to China, the US loses high value adding jobs and national income can fall. Moreover, though Boeing makes larger short-run profits on its Chinese production, even it may lose in the long run if it inadvertently creates a rival Chinese aircraft producer.

From an American worker perspective, the global economy has always had abundant supplies of cheap labor. In the past American workers were still able to compete and benefit from trade. The critical difference today is American corporations are taking their capital and technology offshore and equipping low-wage foreign workers. Those investments undermine American workers because that foreign production is often either intended for the US market or competes with US production.

V The costs of globalization and outsourcing

Much attention has focused on job losses which have been significantly concentrated in manufacturing. These losses become very large if measured in terms of “lost job opportunities” – that is in terms of the manufacturing jobs implicitly embodied in the trade deficit. Since manufacturing is key for productivity growth and for producing goods to exchange with other countries, these losses put our future prosperity at risk.

Looking ahead, many more sectors will be subject to job losses as the competitive threat from off-shore outsourcing matures.

More importantly, job loss is not an adequate metric for measuring the impact of globalization and outsourcing on workers. Even if no jobs are lost, outsourcing can still

have significant effects on wage levels by impacting workers' sense of employment security and bargaining power. Jobs do not have to move for globalization to have big effects. All that is needed is that the threat to move be credible.

Clearly, globalization is not responsible for all the wage stagnation, rising income inequality, and rising job insecurity. However, there is now widespread recognition that its affect on income inequality and insecurity has been negative. Moreover, because globalization creates the economic threat of exit, it can discourage implementing policies that would ameliorate inequality even if due to other forces. That is a problem which is likely to grow.

So far, the macroeconomic consequences of rising inequality have been muted by rising debt and asset price bubbles that have compensated to sustain consumer demand. However, there are indications that many households have reached their borrowing limits, which augurs lower future growth.

Finally, our engagement with globalization has been implemented without regard to the trade deficit and its macroeconomic impact. As a result we are now paying a huge price in the form of the housing slump and the likelihood of a prolonged period of recession and slow growth. This is because the large trade deficits of recent years distorted the economic expansion by undermining investment and manufacturing, and that prompted the Federal Reserve to foster a compensating housing boom, which has now ended in a dangerous and costly bust.

VI Policy implications of different economic perspectives

What does this mean for policy?

First, we need to continue with the collection of policies that have been known as competitiveness policy. That means investing in public infrastructure, investing in education, and encouraging R & D spending.

Second, we also need to continue with traditional trade enforcement policies that must be enforced vigorously, and we should expand and strengthen policies like trade adjustment assistance.

However, the critical implication is that we must recognize that these older policies are not enough. Therein is the split between those who interpret “globalization as trade” versus those who interpret “globalization as barge economics”.

Put bluntly, barge economics undermines the effectiveness of competitiveness policy, while increased assistance to displaced workers treats the symptom but not the cause.

Barge economics increases temptations for unfair policy, and creates a wedge between corporate and national interests. These are the challenges that must be addressed, and if they cannot be addressed the future of the American dream looks grim.

Preventing unfair competition calls for global rules against unfair competition, which is where exchange rate rules and robust labor and environment standards enter. Corporations know that a global economy needs global rules, which is why they have worked so hard to create global property rights. However, they have consistently opposed global rules that help workers and advance social concerns.

Countries must be prevented from systematic policies of export-led growth whereby they grow by relying on demand in other countries rather than building their own domestic markets. Instead of export-led growth we need internationally coordinated

economic policies as a global economy needs internationally consistent economic policies.

Closing the wedge between corporation and country calls for such measures as ending preferential tax treatment of profits earned offshore; making it illegal for corporations to reincorporate outside the US to escape US tax laws; and new tax arrangements that encourage jobs and value creation within the US.

Finally, we must reconsider how we finance our government, social security, and health insurance. Under current arrangements VAT taxes are refunded on exports. Other countries have VAT systems, while the US does not, which disadvantages the US. Either the U.S. should adopt a VAT or VAT rebates should be abolished.

With regard to social security and health insurance, these vital arrangements are financed through payroll taxes and wage benefits. Such financing increases job costs, which encourages firms to shift jobs offshore. That suggests shifting to other forms of financing that detach these costs from employment.

VII The New Deal as inspiration

The New Deal can provide intellectual inspiration to meet this challenge. In many regards the New Deal witnessed the completion of the process of creating an integrated national economy. During that period we created national economic regulations and governance that prevented unfair competition between regions. Congress explicitly recognized the danger of unfair competition, which is why we have a national minimum wage. Financial market regulation was also applied nationally. That strategy worked and created the basis for fifty years of prosperity.

Now we face an analog challenge, this time to create economic arrangements that can support shared prosperity in a globalized economy. The intellectual and political challenge is formidable, as were the challenges of the New Deal era.

There are many things we can do alone, and we will also need to work cooperatively with other countries. Additionally, if other countries will not join us, we must have in place measures that can protect us. One certainty is that our existing trade policy frame is not up to the task because globalization is far more than trade.

In closing I request that the Chairman admit into the record as part of my testimony a report attached to this written statement titled “The Economics of Outsourcing: How Should Policy Respond?”

Thank you. I will be glad to answer any questions the committee members may have regarding my testimony.