

Ballad of the global worker *The Economist* 20 September 1997

In a market economy, not everyone prospers.

As America's continuing debates over NAFTA, trade with China, trade with Japan and trade with the EU show, trade policy is the most politically sensitive of all the issues raised by globalization. The effects of international market forces on taxes, public spending, financial markets and supranational governance are all rather subtle compared with their effect (at least as people perceive it) on jobs and wages. And if globalization is tending, however slightly, to reduce the capacity of the state when it comes to taxes and spending, it is enlarging the demands on the state when it comes to the labor market. That is why some argue that capitalism is heading for a crisis similar to that of the 1930s: the gap between what it can do and what it must do is growing intolerably wide.

Undoubtedly, the advanced economies have an urgent and seemingly intractable problem on their hands: what to do about their unskilled workers. In America the problem takes the form of poverty wages, in Europe of unemployment. The underlying cause appears to be the same. There are more unskilled workers than jobs at decent wages for them to do. In America, wages are allowed to fall far enough to match the demand for unskilled labor with the supply. Unemployment is low and millions of new jobs have been created; but low-wage workers earn too little to live comfortably, and their incomes in real terms have fallen for 20 years. In Europe, wages and other employment costs are buoyed by minimum-wage laws and comparatively generous welfare benefits, so unskilled workers are less poor than in America; but unemployment is far higher.

Trade is widely blamed, especially in America, for this downward pressure on the employment prospects of the unskilled. How can workers in the West compete with those in the third world who are paid a tenth of rich-country wages and who, these days, are using rich-country capital and technology? And yet, in this form, fear of trade is quite misguided. Across the world, the relationship between pay and productivity is very strong. Developing-country workers who are paid a tenth of rich-country wages usually turn out to be about a tenth as productive as well. As their productivity rises, their pay will go up too. So the trade problem, if there is one, has nothing to do with disparities between pay and productivity – that is, with competitiveness – in North or South.

But another possible connection between trade and wages needs to be taken more seriously. The developing countries' comparative advantage is in unskilled labor; America and Europe, relatively speaking, are much better supplied with skilled workers and capital. The effect of imports from poor countries is therefore akin to expanding the supply of unskilled labor in the West, which causes its price there to fall. If this is so, then trade with the developing world may make the advanced economies as a whole better off, but at the expense of lower pay for the unskilled.

There is nothing wrong with this argument in principle. Note that the case for liberal trade does not depend on its being false. If low-cost imports had indeed driven the wages of the unskilled lower, that would be nowhere near enough to establish the case for increased trade protection – any more than finding that technological progress had widened the gap between skilled and unskilled workers would make it right to ban technological progress. Raising barriers to imports, which would make both rich countries and poor countries worse off in the aggregate, would be an insanely costly way to deal with the problem of the low-paid.

Simple but untrue

Surprisingly, the consensus among the economists who have examined the matter is that, plausible as the simple trade-and-wages story sounds, it is not in fact true. The reason, as Jagdish Bhagwati of Columbia University was the first to point out, is that a crucial link in the supposed series of events is missing. If low-cost imports had been the cause of falling wages for the unskilled, those imports must first have lowered the relative price of the competing American-made goods. That is the channel through which, according to the plausible theory just outlined, trade would drive wages down. But, as several studies have found, the relative prices of those goods have not in fact fallen.

So if there is a connection between trade and rising wage inequality in the United States, it must work in some other way. The issue has suffered no lack of scrutiny in recent years, but unhelpfully the range of estimates for the effect of trade on wage inequality now runs from almost none at the low end to 100% at the other.

Adrian Wood of the University of Sussex argues for the upper extreme. He says that import competition has already driven many low-wage activities out of existence, so checking the prices of goods made in the North to see whether they are lower than they used to be rather misses the point. He also points out that import competition has spurred the introduction of labor-saving technology, another effect missed by the conventional theory.

Those who go for the lower end of the spectrum argue that trade between the United States and the third world remains very small in relation to America's overall output (which is the relevant measure for judging trends in national wages). They criticize trade-and-wage pessimists for making it sound as though the United States and other rich countries were small economies, opening up to a new world of trading opportunities with the South. The opposite is closer to the truth: the United States is the economic giant, and the South, even in the aggregate, too small to have much effect.

Reviewing the many different studies, Bill Cline of the Institute for International Economics in Washington, D.C., finds that many estimates of the worsening effect of trade on American wage inequality cluster around 10-20%. His own new calculations put the figure much higher, at 50%; but in tossing this figure into the ring, Mr Cline makes a simple and important point that other observers seem to have neglected up to

now.

All these estimates measure the effect of trade against the change in American wage inequality. But that change is itself the net outcome of forces pushing in opposite directions: forces tending to increase inequality, such as trade, immigration, the relative decline of the minimum wage, weaker trade unions, technological change and others; and forces tending to reduce inequality, notably the dramatically expanded supply of skilled workers. As unskilled workers become a smaller proportion of the workforce, their relative wage should rise to reflect their scarcity. Clearly, if the effect of trade is to be seen in its proper perspective, it should be measured not against the net change in equality, but against the gross disequalising forces.

Seen this way, even Mr Cline's bigger-than-average estimate of the effect of trade shrinks towards insignificance. His figure of 50% for the net effect of trade on inequality falls to just one-eighth when measured instead against all disequalising forces taken together. And the middle estimate of the earlier studies-that trade explains 10-20% of the net change-turns into an effect of just 2.5-5%.

All the same, the list of possible trade-and-labor linkages continues. Many non-economists, for instance, are convinced that international competition will cause a different kind of race to the bottom, driving down labor standards such as rules on working hours, safety in the workplace, trade-union recognition and so on. Yet this need not happen. To think it must is to accept a variant of the competitiveness fallacy discussed earlier.

From the employer's point of view, labor standards are just another labor cost. They can be afforded just as higher wages in the North can be afforded-that is, to the extent that they are justified by higher productivity. When a government enacts a new labor standard, it is in effect calling for other labor costs to be lowered enough to offset the extra burden. This could happen in several ways: lower wages, a depreciating currency, or subsidies to employers. Trade, or the economy's degree of openness, makes no difference.

Dani Rodrik of Harvard has recently questioned this argument, albeit in a rather narrow way. He maintains that trade exposes firms to more competition, which in turn makes them more sensitive to price, which in turn makes their demand for labor more sensitive to wages and other labor costs. This greater sensitivity – an increase in the elasticity of demand for labor-weakens workers' bargaining power. So when workers and employers come to divide any monopoly rents that may exist in the business (because, say, workers have accumulated job-specific skills), labor will get less and the owners more. Or if you think of employment standards as a tax on labor, trade will shift the incidence of the tax a little way towards workers rather than employers. Through its effect on elasticity, trade will also increase the volatility of employment, meaning more rapid turnover of jobs (a factor that other researchers have tied to rising inequality). As for how much any of this matters in practice, your guess is as good as Mr Rodrik's.

The machine that changed the world

Enough. The debate comes down to this: the popular arguments that say trade destroys jobs, lowers wages and forces down labor standards are economically illiterate. But there are subtler arguments to show that trade is likely to have some effect on the relative wages of the unskilled. According to most estimates, these effects are small compared with the other forces that have been driving the wages of the unskilled lower: a reasonable top limit for the effect of trade might be one-eighth of the total. Other forces, notably advancing technology, are likely to play a much larger role.

Yet, after all that, it really does not matter whether it is trade or technology that is pressing down on the wages of the unskilled. In every important respect, trade is just another kind of technology. Think of it as a machine that adds value to inputs. In America, trade is the machine that turns computer software, which America makes very well, into video recorders, basketballs and other things which it also wants, but does not make quite so well. Trade does this at a net gain to the economy as a whole. If somebody invented a contraption that could do this, it would be regarded as a miracle. Fortunately, trade has already been invented.

In the end, what gives the lie to protectionist proposals on trade, and to the academic studies that strain so hard to lend them respectability, is that there is no corresponding zeal to bring other kinds of technology to heel. This difference is purely one of politics, not economics. If trade is squeezing the wages of the unskilled, so are other sorts of advancing technology, only much more so. Yes, you might say, but to tax technological progress or put restrictions on labor-saving investment would be ridiculous: that would only make everybody worse off. Indeed it would, and exactly the same goes for trade-whether this superior technology is taxed (through tariffs) or over-regulated (in the form of international efforts to harmonize standards).

The only difference is that with trade, unlike other kinds of technology, it is just about possible to pretend that the only losers from restrictions will be foreigners. That fallacy was exploded a couple of centuries ago; but in politics its appeal remains undimmed.