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The economics of outsourcing: How should policy respond?

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The Levy Economics Institute of Bard College

Public Policy Brief

No. 89, 2007

THE ECONOMICS OF OUTSOURCING

How Should Policy Respond?

THOMAS I. PALLEY

Public Policy Brief

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OUTSOURCING**

How Should Policy Respond?

THOMAS I. PALLEY

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Preface

According to Research Associate Thomas A. Palley, global outsourcing represents a new economic challenge that calls for a new set of institutions. In this brief, he expands upon the problems of offshore outsourcing as outlined in Public Policy Brief no. 86 and focuses on the microeconomic foundations. He argues that outsourcing is a central element of globalization that is best understood as a new form of competition. Palley urges policymakers to understand the economic basis of outsourcing in order to develop effective policies, and suggests that they focus on enhancing national competitiveness and establishing new rules that govern the nature of global competition.

Palley notes that job loss is not the correct measure for assessing the impact of outsourcing, as outsourcing affects workers' sense of employment security and bargaining power. An institutional perspective sees outsourcing as the impetus for a new competitive regime in terms of both the structure of bargaining power and the margins of competition (i.e., those areas where companies and countries compete). According to this perspective, globalization (multinational corporation production in combination with global sourcing by retailers and manufacturers) has dramatically changed the structure of international competition. While outsourcing delivers low prices, it does so at the high cost of undermining the structure of income and demand generation.

The initial globalization era was one of classical free trade. The new era includes mobile capital and technology so that all countries have access to similar methods of production. As a result, cost arbitrage (especially wage arbitrage) is a critical driver of the system, leading to downward wage and benefit pressures in U.S. labor markets and rising income inequality. Additionally, Palley observes that export-led growth has contributed to a globally unbalanced economy (i.e., developing countries rely on the U.S. market,

resulting in an enormous U.S. trade deficit) and that this configuration carries the risk of global deflationary pressures.

Palley suggests that the economic thinking developed in the 1930s to solve the problems of the Depression era (i.e., the New Deal in combination with the adoption of Keynesian macroeconomic stabilization policies) and current European-style social and economic protections are relevant in the era of globalization. Today's task is to come up with an innovative set of institutional arrangements addressing the new challenges posed by globalization and outsourcing.

Palley observes that outsourcing undermines the effectiveness of many existing national arrangements and that there is a lack of effective institutions of international economic governance. He suggests that international solidarity is needed to establish a politics that will support new forms of international economic regulation, such as labor and environmental standards, capital controls, exchange rate coordination, and tax harmonization. The establishment of a floor under the global labor market would rule out retrograde competition, while unions would ensure the equitable sharing of productivity gains and income distribution that generates full employment. In addition, there should be new arrangements that discourage tax competition within and between countries, an increased investment in education that raises worker productivity, and a national health plan in the United States that is financed out of general tax revenues.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
January 2007

The Economics of Outsourcing

The Outsourcing Controversy

International outsourcing of production and employment has recently attracted enormous attention in both the United States and Europe. For many, it has raised fears about the impacts on domestic labor markets, including the possibility of a fresh wave of structural unemployment and the erosion of wages, benefits, employment security, and workplace conditions in the economy at large. Balanced against this, some (Mankiw and Swagel 2006) view offshore outsourcing as a favorable development in that it further extends the international division of labor and the application of comparative advantage. To this group, outsourcing promises significant future gains in wages and living standards without any adverse long-term employment effects.

Understanding offshore outsourcing requires two distinct exercises. The first involves defining the phenomenon, while the second assesses its likely empirical impact. The focus of this brief is on the former. Outsourcing is represented as a central element of globalization, and policy-makers need to understand its economic basis if they are to develop effective policy responses.

This brief maintains that outsourcing should be viewed as a qualitative phenomenon that is best understood as a new form of competition. Responding to it calls for the development of policies that enhance national competitiveness and establish new rules governing the nature of global competition. Viewing outsourcing through the lens of competition connects it with early 20th-century American institutional economics. The policy challenge is to construct institutions that limit retrograde competition while preserving incentives for economic action. At the same time, these institutions must promote stable flows of demand and income, thereby addressing the Keynesian problem of inadequate aggregate demand. This

approach was embedded in President Franklin D. Roosevelt's New Deal, and it gave rise to a wave of economic prosperity after World War II. Global outsourcing represents a new economic challenge that calls for a new set of institutions. Such challenges are always difficult, but the challenge of global outsourcing is compounded by the lack of global regulatory institutions and by changes in the balance of political power that make it difficult to enact needed reforms.

Lastly, global outsourcing is facilitated by technological innovations associated with computing, electronic communication, and the Internet. However, it is important to recognize that the debate surrounding outsourcing is not about the benefits of technology. It is about the nature of competition and what constitutes appropriate rules for governing competition within and between countries. Failure to recognize this can distract and confuse the issue, erroneously turning it into a debate about technology rather than rules of competition.

The Economics of Outsourcing

Global outsourcing is an empirically and theoretically contested phenomenon. At the empirical level, the problem is how to assess its significance. Mankiw and Swagel adopt a "job count" approach in their assessment of the impact of outsourcing on the U.S. economy and argue that the number of jobs outsourced is relatively small compared to the total stock of jobs. For instance, they cite a Forrester Research report (McCarthy 2004) estimating that 830,000 U.S. jobs would move offshore by the end of 2005 and a Goldman Sachs calculation that between 15,000 and 30,000 jobs are currently moving offshore monthly. They claim that these numbers are small relative to total U.S. employment (almost 135 million) and therefore conclude that the significance of employment moving offshore has been blown massively out of proportion.

There are two problems with this naive job-count approach. The first and less important of the two is that the volume of outsourcing may increase significantly as firms become more globally active. This possibility was noted in the Forrester Research report, particularly in regard to services. It has also been emphasized by Blinder (2006), who documents the potentially wide array of future offshore jobs.

The second, more important problem is that job loss is not the right measure for assessing the impact of offshore locations. Over time, the economy tends to recover some of the jobs lost, and the volume of employment almost always dominates the volume of unemployment. By definition, that means the stock of jobs is likely to be large relative to flow turnover. Yet outsourcing can still have significant effects on wage levels and employment conditions by affecting workers' sense of employment security and bargaining power. These impacts need not show up in job flows. All that is needed is that workers sense a changed economic environment. Bronfenbrenner (2000) has clearly documented such bargaining-power effects with regard to U.S. union workers. The problem is that these effects have been denied by mainstream trade economists who assert that labor markets are competitive, workers are paid their worth (i.e., their marginal product), and labor market competition for scarce labor protects workers from exploitation.

These observations lead to the theoretical controversy surrounding offshore outsourcing. Supporters of outsourcing interpret it as a natural extension of the motivation for trade. Just as the boundary between domestic market and nonmarket activities may change over time owing to technological innovations, the boundary between internationally traded and nontraded goods may also change. From this perspective, technological advances have made previously nontradable goods and services tradable internationally. The international application of the principle of comparative advantage to the production of newly tradable goods and services can yield additional gains from trade.

This conclusion regarding the benefits of outsourcing and gains from trade has been challenged by Gomory and Baumol (2000) and Samuelson (2004), as outlined in Public Policy Brief no. 86. These authors use pure trade theory to examine the question of international catch-up and conclude that a country can lose if the catch-up takes place in the export industry of the advanced country. In such case, the advanced country suffers an adverse terms-of-trade effect because the global supply of its exported product increases.

Though logically watertight, one problem with this critique is that it focuses on export sector-related developments, whereas most of the concern about outsourcing seems to relate to potential developments in the service sector. Another problem is that the critique is static in nature,

focusing on changes in equilibrium patterns. An alternative, institutional approach views outsourcing through the lens of competition, which changes the competitive process governing trade and gives rise to a new competitive regime in terms of both the structure of bargaining power and the margins of competition (i.e., those areas where companies and countries compete).

From an institutional perspective, globalization has dramatically changed the structure of international competition. In many regards, the beginnings of this change can be traced to the 1950s and 1960s, and the emergence of multinational corporation (MNC) production. Initially, this output was primarily for local markets, as evidenced by the activities of companies such as Ford Europe and General Motors Europe, which manufactured for the European, rather than the U.S., market. However, in the 1980s and 1990s, the pattern changed significantly, as MNC production was increasingly targeted for export back to the United States. This change is exemplified in Mexico and China, which have become MNC production platforms.

There are two important economic features about the MNC revolution. First, MNC manufacturing provided an important arena for business to learn how to render state-of-the-art technology and production methods globally mobile. Second, MNC activities offered a first margin within which capital was able to put American labor in international competition, and this competition has had significant adverse impacts on manufacturing wages, employment, and union membership (Bronfenbrenner 2000 and Bronfenbrenner and Luce 2004).

The MNC revolution has received considerable attention. While it was taking place, however, a parallel and equally important revolution was occurring in the U.S. retail sector. This retail shake-up was linked to a new sourcing model based on big-box discount stores.¹

Stage one of the U.S. retail revolution started 40 years ago with the emergence of large volume discount stores like Wal-Mart, which was founded in 1962. Initially, the business model was based on national sourcing, with the big-box stores buying from the cheapest national manufacturer. Such stores pitted producers against one another nationally, so that companies in New York were forced to compete with those in California. This new national rivalry provided lower prices and was largely beneficial because all suppliers were located in the United States and operated under broadly

similar laws. However, even then there were negative effects, as the new competition encouraged manufacturers to move south to nonunion, “right-to-work” states, where labor costs were lower and it was more difficult to organize workers.

Stage two of the retail revolution began in the 1980s, when the big-box discount stores started going global with their sourcing model. As a result, U.S. suppliers were not just placed in national competition, but in international competition. No longer was New York competing only with California, for example, but with companies in Mexico, Indonesia, and China. The economic logic of this global sourcing model is simple: scour the world for the cheapest supplier and lowest cost—the so-called “China price”—and then require U.S. manufacturers and workers to match the price if they wish to keep your business.

This new global sourcing retail model has had profound effects. The commercial success of the model means that, once one retailer adopts it, others are compelled to adopt it also in order to remain competitive. Consequently, big-box discounting has spread to every corner of retailing and has put the entire consumer goods manufacturing sector in international competition. Additionally, the model pressures domestic companies to pursue offshore production (i.e., become multinational) in order to compete with foreign suppliers. These dynamics, though originating in the retail sector, have thereby eroded manufacturing jobs and wages. The model does indeed deliver low prices, but it does so at high costs.

Outsourcing can be viewed as an application of the retail sector’s global sourcing model to manufacturing. In effect, manufacturers are also looking to source globally and ask suppliers to meet the China price. The development of global sourcing is exemplified by Visteon and Delphi—American auto component giants. Initially spun off from Ford and General Motors, respectively, Visteon and Delphi engaged in national competition. In 2005, Ford and General Motors both announced that they were shifting to a global sourcing model and that their spin-offs would have to meet the China price if they wished to keep their business. Given higher union wages and benefits, Visteon and Delphi have therefore had to shed jobs and shift production offshore (including China). Nonetheless, these spin-off companies have found it increasingly difficult to compete, and Delphi filed for Chapter 11 bankruptcy in October 2005.

It is becoming clear that the global sourcing business model can also be applied to the service sector. Owing to improvements in electronic communication and the Internet, many services that were previously nontradable have become tradable. These services include basic computer systems maintenance and software programming, tax preparation and accounting, architectural planning, and telephone call centers. Even retail sales are potentially tradable, as indicated by the success of the Amazon.com business model. As the global sourcing model is applied to more services, this sector will experience corresponding effects on compensation and employment security.

The maturation of globalization can be viewed as combining the developments of the last several decades into a highly synergistic system. There are four elements to this mature system. The first element is the global sourcing model discussed above, which was initially developed in the retail sector and is now applied everywhere. The second element is the mobility of capital, technology, and methods of production. The third element is international economic policies that have dismantled trade barriers and promoted international economic integration. Whereas the initial globalization era was one of classical free trade involving the movement of goods across international boundaries, the new era also includes mobile capital and technology. Consequently, as all countries have access to similar methods of production, cost arbitrage (especially wage arbitrage) becomes a critical driver of the system. The fourth element of mature globalization is the addition of two billion workers to the global labor market, given the end of economic isolationism in India, China, and the former Soviet bloc countries.²

Putting the pieces together, changed competition (the Wal-Mart business model) plus changed technological conditions and policy (globalization of production) plus two billion new workers (the end of economic isolationism) add up to downward wage and benefit pressures in U.S. labor markets and rising income inequality. The economic logic is simple. When two swimming pools are joined together, the contrasting water levels will equalize.

Free trade theorists (Stolper and Samuelson 1941) have long acknowledged that when a rich, capital-abundant country engages in free trade with a poor, labor-abundant country, wages fall in the rich country. By combining global sourcing with globalization of production, the new system puts the Stolper-Samuelson effect into hyperdrive.

Macroeconomic Consequences of Changing Global Competition

The changing microeconomic competitive conditions associated with globalization have significant macroeconomic implications. One concerns income inequality, which has increased in almost all countries (Milanovic 2005). Within the United States, this increase has occurred in two stages. During the 1980s and 1990s, the wage-profit share was largely unchanged, but family income inequality increased, suggesting changes in the distribution of wages favorable to upper-income managerial workers. Since 2000, there has been a significant increase in the profit share.³

A second implication concerns the structure of global demand. The new global sourcing model encourages companies to shift production offshore and export back to their home base. In developing countries, there is an incentive to keep wages down, despite productivity growth, in order to retain international competitiveness (e.g., in Mexico, real wages have stagnated over the past 20 years). These pressures retard domestic demand and the emergence of a large middle class. Consequently, developing countries are compelled to rely on export-led manufacturing growth, whereby they sell to developed countries rather than develop domestic consumption markets—a configuration that poses significant macroeconomic dangers.

The worsening of income distribution in developed countries poses long-run problems for maintaining a level of aggregate demand capable of generating full employment. Internationally, the extensive reliance on export-led growth has already contributed to a globally unbalanced economy in which developing countries rely on the U.S. market. This imbalance is reflected in the enormous U.S. trade deficit. The danger is that, if the U.S. economy slows, the entire global economy will slow too.

Though the new global microeconomic structure has contributed to low prices that have benefited Northern consumers, it has also adversely transformed the structure of income and the generation of aggregate demand. In the United States, there has been a gradual hollowing out of the middle class. In developing countries, surplus labor combined with South-South competition for Northern export markets has retarded wage growth that could provide the future foundation for global aggregate demand. With global supply expanding as a result of export-led manufacturing growth, this configuration carries the risk of global deflationary pressures.⁴

Thus far, these adverse macroeconomic developments have been kept at bay by rolling stock market and housing price bubbles, and by increasing access to credit for consumers. In the United States, particularly, these developments have enabled households to maintain consumption spending, thereby maintaining global aggregate demand. However, neither rising debt-to-income ratios nor asset price inflation significantly in excess of the general inflation rate are sustainable, suggesting that these trends must slow or even reverse. When that happens, the global economy could suffer a severe recession owing to accumulated financial imbalances and inadequate aggregate demand. Moreover, recovery from such a recession could prove difficult because of large debt overhangs and permanently atrophied structures of income and demand generation.

How Should Policy Respond? Rediscovering Keynesian and Institutional Economics

The current model of globalization brings low consumer prices as advertised. However, it delivers low prices at the high cost of undermining the structure of income and demand generation. Today's economic conditions have hints of the 1920s, a decade marked by a credit-driven boom in the United States and relative stagnation in the rest of the world. Meanwhile, income and wealth inequality in the United States have returned to levels that prevailed in the 1920s. These trends raise the possibility of a new era of global economic stagnation that, in a worst-case scenario, could trigger problems similar to those afflicting the global economy in the 1930s.

The problems of the Depression era were solved after World War II by applying new economic ideas originally developed in the 1930s. These ideas are relevant in the era of globalization. Unfortunately, the economic success that ensued for 30 years after the war contributed to the belief that U.S. economic problems were permanently solved and that post-Depression policies and institutions were no longer needed. As a result, economic theory has drifted back to the pre-Depression era. Carried by this tide, economic policymakers have been persuaded to create a modern variant of the pre-Depression economy under the rubric of globalization.

One lasting contribution of the 1930s is associated with the British economist John Maynard Keynes, and that is the importance of aggregate

demand for determining the level of employment and output. In the Keynesian model, unemployment can result from reduced household and business spending. At best, free markets are slow to remedy such conditions; at worst, they can get trapped with permanent high unemployment.

Keynes recognized that the price system does not automatically generate sufficient demand and that what works in individual markets does not automatically work for the economy as a whole. In individual markets, lower prices make a good relatively cheaper, thereby providing an incentive to switch spending from elsewhere. However, this does not work for the economy as a whole because all prices are falling. Indeed, the process can even work in reverse because falling prices increase the debt-service burdens of businesses and households, thereby lowering total demand and potentially bankrupting the banking system. Consequently, there is a reason for policymakers to step in and stabilize demand through monetary (interest rate) and fiscal (government budget) policy.⁵

A second vital intellectual contribution came from American institutional economists, including such leading lights as John Commons, Thorsten Veblen, and Wesley Mitchell. These economists emphasized the importance of the nature of competition and the problem of destructive rivalry—what Commons (1909) termed the “competitive menace.” This idea resonates with today’s notion of the “race to the bottom.” What appears to maximize well-being from an individual perspective can be suboptimal once the competitive interplay of actions is taken into account.⁶

Institutional thinking constructs the policy problem in terms of “regimes of competition,” with some regimes promoting societal welfare better than others. In the 1930s, President Roosevelt’s New Deal policies embodied much institutional thinking. In combination with the adoption of a Keynesian macroeconomic stabilization policy, the New Deal eventually solved the crisis of the Depression and made way for the prosperity that followed World War II. The innovations of the period included new labor laws establishing the right to organize, the minimum wage, the 40-hour workweek, and the right to overtime pay. In the financial realm, creative reforms included the establishment of the Securities and Exchange Commission to oversee financial markets. Today’s challenge is to come up with a similarly innovative set of arrangements addressing globalization and outsourcing.

The New Deal incorporated a collection of bold policies that fashioned an acceptable regime of competition. Responding to global sourcing will also require an insightful array of policies. As with the New Deal, there is no silver bullet. With regard to the rules governing worldwide competition, international labor standards are key to establishing a floor under the global labor market and ruling out retrograde competition. At the same time, such standards are good for economic efficiency and development (Palley 2004, 2005). Concerning domestic issues, unions are key to ensuring that productivity gains are shared equitably and result in a distribution of income that generates full employment. This issue calls for labor law reform that gives real meaning to the legal right to organize.

There is also a need for new arrangements that discourage tax competition within and between countries. Such competition is generated by corporations shopping for tax abatements and lower tax rates as conditions of making investments. And when corporate tax avoidance strips the public purse of revenue, the result is either an unfair shift of the tax burden onto labor incomes or an underfunding of needed public investment and spending.

Exchange rates also require new institutional arrangements. There is a need to prevent countries from using undervalued exchange rates as a means of competing. Engaging in competitive devaluation is a form of beggar-thy-neighbor economics, wherein countries rely on demand in foreign markets rather than building demand in domestic markets. Undervalued exchange rates are unfair subsidies that distort the pattern of trade and risk global deflation by increasing exports without increasing global demand.

With regard to national competitiveness, countries need to invest in education that raises worker productivity. There is also a need for job-loss assistance and active labor market policies that help displaced workers cope with income losses and obtain training for productive future employment. In the United States, there is a special need to attend to the problem of health insurance, which is currently a job cost (since premiums are tied to employment). At General Motors, for example, the cost of each car made in the United States includes \$1,500 of worker health insurance. Health insurance coverage needs to be detached from jobs, and this separation suggests a national health plan financed out of general tax revenues.

Some Specific European Concerns

Global outsourcing is affecting the entire industrialized world, including Europe. In some regards, Europe is well positioned to meet the new challenge, owing to its existing institutional structure. Most European states have established systems of public provision of social services, including health care. This means that the associated costs are not directly tied to jobs and are not perceived as job costs, so there is less incentive to create jobs offshore.

Additionally, Europe's public health care system appears to generate better outcomes per dollar spent than the U.S. system of private health care. However, Europe's system raises its tax burden. This burden could be reduced by taxing income on a worldwide, rather than a country, basis. The unrepatriated income of European corporations and citizens in low-tax foreign countries could help finance public expenditures, and European companies would have no incentive to locate offshore purely for tax reasons.

Another advantage for Europe is its commitment to a "common markets" approach to economic integration. Unlike the free trade approach of the United States, the European approach aims to standardize systems of market regulation and competition, thereby avoiding race-to-the-bottom tendencies. This contrasts with the U.S. approach, which removes tariffs and quotas without leveling the economic playing field across countries.

The common markets approach may help the European Union's (EU) new Eastern member countries. These countries have low-wage economies and full access to the European market, making them potentially attractive locations for outsourcing, even though they are higher-cost economies than China or India. Consequently, they may serve as a buffer for the EU, because outsourcing directed to them would have larger spillover effects in Europe than would comparable outsourcing in China or India. Although this redirection would diminish the adverse impacts of outsourcing, it could also amplify the impact on EU economies that are in direct competition with their Eastern member countries.

The competitive challenge posed by these new EU members is linked to the exchange rate question. As mentioned earlier, undervalued exchange rates are unfair in that they encourage outsourcing. Europe's adoption of the euro already poses some problems because of divergences in international competitiveness across member countries. Looking to the future,

Europe faces two additional exchange rate challenges: (1) the outsourcing challenge posed by new EU members would be aggravated if these countries maintained undervalued exchange rates or joined the euro system at undervalued parities; and (2) China's exchange rate represents a serious threat because it is linked to the dollar at an undervalued parity. Since the euro has appreciated against the dollar and may appreciate further, China's exchange rate is increasingly undervalued against the euro. This trend increases Europe's trade deficit with China and creates incentives for European companies to locate and outsource goods from there. These twin exchange rate problems are of special concern to those European economies (particularly Italy) that are most directly in competition with both Eastern EU countries and China.

Whereas Europe's common market philosophy confers an advantage in addressing outsourcing, Europe's Achilles heel is inadequate aggregate demand, which has been the root cause of high unemployment over the past 25 years (Palley 2006). Outsourcing and loss of international competitiveness can have significant adverse consequences for aggregate demand, and European policymakers have failed to address the problem. This ongoing failure means that there could be a further increase in unemployment, which could then be politically exploited to attack Europe's trade unions and unravel the social and employment protections within European institutions. This result would be a tragedy, as these institutions are even more vital in the era of globalization.

Conclusion: The Politics of Policy Response

The emergence of global outsourcing enormously complicates policy issues, both intellectually and politically. The ability to outsource worldwide calls for new forms of international regulation because it undermines the effectiveness of many existing national arrangements. Yet construction of an acceptable regime of international competition must be accomplished in a political environment that lacks effective institutions of international economic governance and in which national governments are weakened and corporations strengthened by the enhanced mobility of capital.

Historically, political economy has been constructed around the divide between capital and labor, with firms and workers at odds over the division

of the economic pie. Within this construct, labor is usually represented as a monolithic interest, yet the reality is that labor has always suffered from internal divisions—by race and occupational status, and along many other fault lines. Neoliberal globalization has, in many ways, sharpened these divisions to labor’s disadvantage and capital’s benefit.

One of the fault lines divides workers from themselves. Since workers are also consumers, they face a divide between their desires for higher wages and lower prices. This identity split has been exploited to divide union from nonunion workers, with antilabor advocates accusing union workers of causing higher prices. Globalization amplifies the divide between people’s interests as workers and consumers by promising ever-lower prices. Low prices do, indeed, yield benefits, but against these benefits there must be a balanced global impact on wages, work conditions, and the balance of political power.

Globalization also affects an economy unevenly, hitting some sectors first and others later. The process can be understood in terms of the hands of a clock. At one o’clock is the apparel sector; the textile, steel, and auto sectors are at two, three, and six o’clock, respectively. Workers in the apparel sector are the first to have their jobs shifted to lower-wage venues; at the same time, though, all other workers get price reductions. Next, the process picks off textile sector workers at two o’clock. Meanwhile, workers from three o’clock onward get price cuts, as do the apparel workers at one o’clock. Each time the hands of the clock move, the workers taking the hit are isolated. In this fashion, globalization moves around the clock—and labor is perennially divided.

Manufacturing was the first sector to experience this process, but technological innovations associated with the Internet are putting service and knowledge workers in the firing line as well. Online business models are making even retail workers vulnerable, as evidenced by Amazon.com, which has opened a customer support center and two technology development centers in India. The problem is that each time the hands on the globalization clock move forward, workers are divided: the majority is made slightly better off, while a minority is made much worse off.

Balanced against this process, globalization also impacts capital by creating a new split between big international and small national firms. Large multinational corporations benefit from cheap imports produced in their

foreign factories. Conversely, small businesses that remain domestically centered in terms of sales, production, and inputs are threatened by imports. In the United States, this division has been brought into sharp focus by the debate about the trade deficit and the overvalued dollar. In previous decades, U.S. manufacturing as a whole opposed trade deficits and an overvalued dollar because of the adverse impact of increased imports. Now, U.S. manufacturing is divided—multinational corporations support an overvalued dollar, while domestic manufacturers oppose it. A similar division within the ranks of business and capital likely exists in Europe.

This division opens up the possibility of a new alliance between labor and nationally based manufacturers and businesses. However, such an alliance will always be problematic because of underlying tensions between business and labor over the wage/profit division. Moreover, business may try to address its own internal division by promoting a domestic “competitiveness” agenda aimed at weakening regulations, reducing corporate legal liabilities, and lowering employee wages and benefits (e.g., reducing paid vacation time, which is designed to appeal to both nationally and internationally centered businesses, but at the expense of workers).

Solidarity has always been key to political and economic advances by working people and it is key to mastering the politics of globalization. Developing a coherent story about the economics of neoliberal globalization, around which working people can coalesce, is a key ingredient for solidarity. That is why economics is so important politically. Neoliberal economists tell stories about the economy, but there is a need for an alternative story with an institutional-Keynesian perspective.

Understanding how globalization divides labor helps counter cultural proclivities toward individualism, as well as other historic divides such as racism. However, as if this challenge were not difficult enough, globalization creates additional challenges. National political solutions that worked in the past are not adequate to the task of controlling international competition. That means the solidarity bar is raised higher because international solidarity is needed to support new forms of international economic regulation, such as labor and environmental standards, capital controls, exchange rate coordination, and tax harmonization.

Notes

1. The seminal article on the emergence of this sourcing model is Gereffi (1994). The use of this model by the retail sector is documented by Hamilton (2005).
2. Freeman (2004) has emphasized the significance of the addition of two billion workers to the global labor market. However, he believes that globalization is being driven by classical comparative advantage, so the wage effects of increased global labor supplies can potentially be offset by the production gains that come from reallocating global production in accordance with the principle of comparative advantage.
3. The increase in global income inequality within and between countries is documented by Milanovic (2005). The increase in U.S. family income inequality is documented by Mishel et al. (2005). Krugman (1995) attributes 10 percent of the increase in U.S. wage inequality in the 1970s and 1980s to trade. Cline (1997) attributes 37 percent of the increase in inequality to trade. Palley (1999a) examines overall income inequality (using the U.S. family income Gini coefficient) and finds that 24 percent of the increase in inequality between 1980 and 1997 is directly attributable to increased openness, and that this percentage rises to 34 percent if the negative effect of trade on union density is taken into account. Kletzer (2001) has documented the direct wage losses of workers who lost jobs to trade.
4. The global deflationary risks of export-led development are explored in Palley (2003) and Blecker and Razmi (2005).
5. Tobin (1975, 1980) and Palley (1999b) have examined why generalized price deflation can be unstable.
6. Atkinson (1997) has also emphasized the relevance of American institutional economic thinking to globalization.

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