

# A Global Presence in Economics: The Case for Free Trade

by Patricia B. Gray

For those who like their nightly business news served well done with a bit of bluster on the side, Lou Dobbs is the man to watch. More than 500,000 viewers tune in to catch his show on CNN, which for the last two years has featured his nightly rants on what he considers to be the evils of outsourcing and free trade. Strong opinions make for good television—and so does sharp debate. Dobbs’s viewers recently got a heaping helping of both when the newsman butted up against an articulate adversary, Tuck’s Matt Slaughter.

Dobbs had invited the young economist on the program because of his extensive research into the impact of outsourcing and insourcing on the nation’s economy. More specifically, Dobbs wanted to pick a fight over Slaughter’s assertion that American multinationals actually created two jobs at home for every one sent overseas to a cheaper labor market. Dobbs’s first on-air jab at Slaughter was pretty direct: “So you think I’m entirely wrong to have placed my concern with working Americans?”

For the next two or three minutes, in the glare of the studio lights, Slaughter punctured Dobbs’s protectionist bombast so quickly and deftly that the newsman didn’t even hear the hiss of hot air. Outsourcing doesn’t always mean a loss of jobs and less prosperity for the U.S., Slaughter told Dobbs. In fact, he said, outsourcing often yields an increase in higher-paying jobs at home, such as white-collar managerial positions in accounting, management, and research. Lawmakers need to consider creative ways to aid those individual workers who lose their jobs to outsourcing, Slaughter conceded, but added that his research indicates that on the whole the U.S. enjoys “big gains when we have more trade, more foreign direct investment, more immigration.”

Dobbs was gracious in defeat. “Professor Matthew



Slaughter, I thought we were going to be arguing,” Dobbs conceded. “It turns out you and I agree on far more than I was led to believe.”

### A POWERHOUSE OF RESEARCH

Slaughter is one of a small group of international economists at Tuck and Dartmouth whose work is sparking intense interest in the U.S. and overseas. Armed with groundbreaking research and unafraid of the media crucible, they are helping shape the public debate—and, increasingly, public policy—on some of the most important and controversial issues of our time: the benefits and limits of free trade, child labor, globalization, and foreign investment in the U.S. In addition to Slaughter, associate professor of business administration at Tuck, the group includes Andrew Bernard, professor of international economics at Tuck, and Dartmouth Professors Nina Pavcnik, associate professor of economics; Douglas A. Irwin, professor of economics; Nancy P. Marion, professor of economics; and Jay Shambaugh, assistant professor of economics.

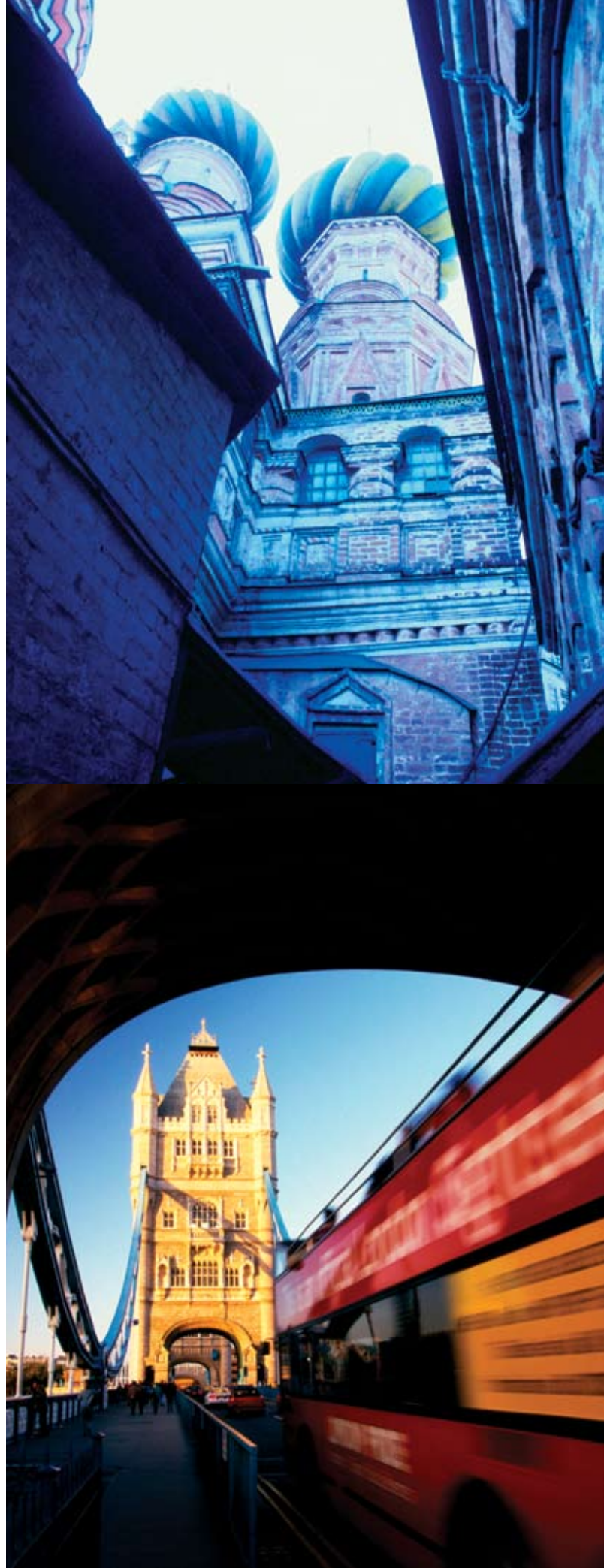
Although each has distinct areas of expertise, the group is generally united in their view that free trade is good for the U.S. Their influence is far-reaching. In September, President George W. Bush nominated Slaughter to the Council of Economic Advisers (see page 13). As an adviser to the president, Slaughter will offer objective analysis and advice on a wide range of economic issues. Bernard’s research on multinationals has sparked a flurry of articles in such respected business publications as *The Economist*. In October, the 500 or so economists at the annual meeting of the Latin American and Caribbean Economic Association in Paris were buzzing about his most recent study on transfer pricing. (Transfer pricing is

a hot topic in corporate America because of a crackdown on these tax-minimizing schemes by the Internal Revenue Service.) Irwin's 2002 book, *Free Trade Under Fire*, is required reading at a number of colleges and universities and recently unleashed a firestorm among readers of *The Wall Street Journal* reacting to his opinion piece on how outsourcing is beneficial for the U.S.

Pavcnik's research on child labor in Vietnam created headlines around the world in early 2004. Her coauthor on the study was Eric V. Edmonds, also a Dartmouth economist. Their conclusion: globalization may reduce child labor in developing nations. Marion's research on international reserve holdings has influenced a generation of finance ministers of emerging economies; many of them have sought her counsel after hearing her speak at forums sponsored by the International Monetary Fund. She's currently working on examining the causes of financial crises in emerging markets. Jay Shambaugh's work on exchange rates and their impact on monetary policy was cited in a speech by Ben S. Bernanke, who succeeded Alan Greenspan as chairman of the Fed in February.

Working collaboratively on various projects for nearly a decade, the group has established a powerhouse of provocative economic research in Hanover. Such long-term collaborations between business-school professors and college professors at a single institution are rare in academia. Rarer still is the campus that can boast of so many renowned researchers on such a specialized subject. "I came here because Tuck and Dartmouth work together to maintain a vibrant worldwide presence in the study of international economics," Bernard says. "I left Yale because I was an island there."

The Tuck and Dartmouth professors hold monthly workshops to discuss ongoing projects and get updates on important new work being done at other institutions. Since 2001, the group from Tuck and Dartmouth has also hosted the weeklong Summer Camp in International Economics—partly sponsored by Tuck's Center for International Business—which a dozen or so leading researchers from around the world are invited to attend. Marion first proposed the camp in the late 1990s. Since then, her Dart-



mouth and Tuck colleagues have shared the responsibility of planning and hosting the event.

Among the notables who have attended is Harvard's Marc Melitz, a rising star in the microeconomics of international trade. Galina Borisova Hale, a Yale economist and a visiting scholar at the Federal Reserve Bank of New York, who attended the camp in summer 2004, says, "Dartmouth's summer camp has become a great tradition in the academic community. The camp attracts some of the biggest names in economics, and it gives us an opportunity to interact in an informal setting. I found it to be a very fruitful experience." Douglas R. Nelson, professor of economics at Tulane University in New Orleans, attended the camp in the late 1990s. His curiosity was sparked after he heard another economist present his analysis of free-trade zones. Nelson later wrote a paper that analyzed the benefits of the controversial North American Free Trade Agreement (NAFTA). "Dartmouth and Tuck have created a really fun environment that combines work and socializing," Nelson recalls. "Professionally and personally, I found it very beneficial."

Another major fan of the event is Guillermo Calvo, director of the Center for International Economics at the University of Maryland and chief economist of the Inter-American Development Bank. Calvo was so taken by his experience at the camp that he vowed to launch a similar event in his native Argentina. Calvo's camp celebrated its seventh annual session in December 2005.

## SLAYING DRAGONS WITH STATISTICS

Andrew Bernard is a pioneer in economics. In 1991, armed with a new doctorate in economics from Stanford University, he veered off academia's grooved track and opted for the road not taken. With a handful of other young academics, Bernard launched a new field of research into the microeconomics of international trade. More specifically, he began to examine what kinds of U.S. companies exported and whether they benefited from exporting. His early research began to attract attention. In the mid-1990s, for instance, he found that while only one-fifth of the

nation's manufacturers were exporting, those companies tended to be bigger, stronger, and more technologically savvy than their nonexporting peers.

In mid-2004, Bernard made waves with a provocative study entitled "Facing the Dragon." The study was coauthored with J. Bradford Jensen, deputy director of the Institute for Institutional Economics, a private research institution in Washington, D.C., and Peter K. Schott, assistant professor of economics at the Yale School of Management in New Haven, Conn. The paper began with the unnerving question: "Will everything be made in China in 2011?"

There was little surprise in its first finding: U.S. manufacturing imports from China and other countries with very low wages had nearly quadrupled to 15 percent of the total between 1981 and 2001. Far more unsettling was their projection of things to come: By 2011, China and the low-wage countries will account for 24 percent of manufacturing imports to the U.S. However, those firms that face the greatest threat from Chinese imports are in low-wage, low-skill, low-employment industries: apparel, footwear, furniture, printing, plastics, and fabricated metal. But the trio also made a point that would be very reassuring to those who fret about the potential for economic damage from free trade: high-skill, high-wage, high-employment industries such as the transportation, chemical, and petroleum industries will face little competition from low-wage imports.

More recently, Bernard and Jensen challenged conventional wisdom with a study that examined the widely held notion that multinational manufacturers are fickle corporate citizens, quick to pick up and move when they see better opportunities elsewhere. The two economists found that factories owned by multinationals tend to remain operating longer than locally owned factories because they were larger, more competitive, more productive, and more capital-intensive and offered workers better wages and working conditions. In comparing factories of the same size and efficiency, however, the two found multinationals were indeed more likely to pull up stakes. "Fodder for protectionists?" *The Economist* asked in a report on the

study. Probably not, the editors conceded, adding that the benefits probably outweighed the costs.

Now Bernard is tackling a topic likely to cause fireworks internationally: transfer pricing. This is the method by which multinationals value goods and services bought and sold among subsidiaries and is a key determinant of how much the companies pay in taxes to the countries in which they do business. As more companies have gone global, transfer pricing has become a big, throbbing headache for them and for government tax authorities. The two are increasingly at odds. Billions are at stake. (Two years ago, the IRS slapped Britain's GlaxoSmithKline with a \$5.2 billion tax bill, charging the pharmaceutical giant with underpaying corporate taxes on its profitable ulcer drug Zantac.) Bernard's study hasn't yet been published, but he hints that it is likely to be controversial. "We're dropping a big stone into the pond this time," he says.

## EPIPHANY AT THE AIRPORT

Slaughter has been fascinated by the economics and politics of globalization since he was an undergraduate at the University of Notre Dame in the late 1980s. In the past decade, as the pace of globalization has accelerated in the U.S., he has intensified his focus on the practices of outsourcing and insourcing. If he was looking for controversy, his timing was impeccable. By the late 1990s, U.S. firms were moving jobs by the millions to low-wage countries such as China and India. The public outcry was swift and shrill. Workers picketed companies that sent jobs overseas. Congress held hearings on the issue. Lawmakers tried to bar companies that outsourced from getting lucrative federal contracts. In 2003, federal authorities restricted the number of visas for skilled foreign workers, a move widely regarded as prompted by the backlash over outsourcing high-tech jobs to India.

One evening while watching television in an airport lounge, waiting for his flight to board, Slaughter realized the issue had reached the point of near-hysteria. That's when he saw a news program about factory workers who had lost their jobs when a company in the Midwest outsourced man-

ufacturing to China. The show was emotionally wrenching and devastatingly effective as antitrade propaganda. "No one could watch that show without getting the message that globalization is bad because good people, dedicated workers, lose their jobs," Slaughter recalls. "I know the show was based on anecdotes, not data. But anecdotes matter—especially in broadcast media—because they tug at the heartstrings of lawmakers and policymakers."

Slaughter's research contradicts the widespread notion that outsourcing weakens the nation's economy by exporting jobs. Slaughter used 10 years of data from the Bureau of Economic Analysis (a unit of the U.S. Department of Commerce), reported annually between 1991 and 2001, to study 2,500 multinational companies. That allowed him to analyze the spreading wave of globalization. According to his research, expansion overseas spurs growth at home, in part because of cost savings and in part because of increased access to foreign markets. "Hiring abroad does not mean firing at home," he says. In fact, his research shows that U.S. multinationals have been a major force in creating new jobs—more skilled and higher-paying jobs—in the last decade. "Between 1991 and 2001, American companies have created two jobs at home for every job sent overseas," Slaughter says. "Instead of lamenting foreign expansion of these companies, we should be encouraging it."

Slaughter isn't insensitive to those whose lives have been upended by outsourcing. "Job losses are real and individuals are hurt, but they are not representative of the whole economy," he says. "The greatest danger lies in creating policy that will affect the entire economy based on the pain of a few." Such policies can be harmful, he says, with long-lasting results that ripple through the economy in unpredictable ways.

While conducting research on outsourcing, Slaughter became increasingly fascinated by the flip side of the equation: insourcing. The term refers to foreign investment in operations in enterprises in the U.S. Insourcing is growing fast in the U.S. In 1987, foreign companies employed 2.6 million Americans in 1987. That number more than doubled to 5.4 million in 2002. That year, foreign companies were responsible for 5 percent of the total private-sector



employment in the U.S., according to statistics from the Bureau of Economic Analysis. Some experts think the trend is accelerating. Insourcing is almost as controversial a topic as outsourcing. Some critics argue that foreign companies are sucking profits out of the U.S., investing little in its people or communities.

Again, Slaughter's findings are counterintuitive. Far from draining the nation's economy, insourcing companies boost it with high-paying jobs, capital investment, and research and development. The average annual compensation at these companies was just over \$56,000—31 percent higher than the average private-sector paycheck in the U.S. Insourcing companies do not suck out profits, he found. In contrast, they invest heavily in research and development—14 percent of the total private-sector R&D. Insourcing companies accounted for a fifth of all exports from the U.S. in 2002. "These statistics help us shape national policy to ensure prosperity for the U.S.," Slaughter says. "Clearly, these global companies are assets to the U.S."

### FIRING BACK AT THE FLAMETHROWERS

When it comes to battling protectionism, Douglas Irwin comes out of the corner with his fists up, ready to fight. He is the Robert E. Maxwell '23 Professor of Arts and Sciences and professor of economics at Dartmouth, widely respected for his well-reasoned and jargon-free views on trade policy. *Free Trade Under Fire*, his second book, is in its second edition. Some 10,000 copies have sold to date, and the book is required reading for a generation of economics students. Point by point, Irwin elegantly dismantles just about every argument against free trade—and makes it fun to read.

That's probably why *The Wall Street Journal's* editors asked him to skirmish with two flamethrowing protectionists on its editorial page in early 2004. The war of words had been launched several weeks earlier by Paul Craig Roberts, a former assistant secretary of the treasury under President Ronald Reagan. "The United States will be a Third World country in 20 years," Roberts had fumed at a gathering of economists and policymakers in Washington, D.C. Then, in an op-ed article in *The New York Times*,

Roberts, the conservative, and Senator Charles Schumer, a liberal Democrat from New York, laid out a case to protect white-collar workers in the U.S. from losing their jobs to workers in India and Asia.

Irwin took them on in the *Journal*: “Fifty years ago, Detroit’s River Rouge plant sucked in iron and coal at one end and spat out an automobile at the other. Now, auto firms source component parts from a vast array of domestic and foreign suppliers. Has U.S. manufacturing been vaporized in the process? No.... The U.S. economy will face many challenges in coming decades, but as long as we do not stifle our dynamic economy...we need not fear that—as Mr. Roberts predicts—the U.S. will become a Third World nation.”

Irwin’s essay roused more than a few detractors, inflamed by his views on the economic necessity of outsourcing. His email was filled with a few smoke bombs for several weeks, mostly from jobless white-collar workers. “Trade has always been a contentious and controversial issue,” Irwin says reflectively now. “But since the end of World War II, people have come to realize that economic isolation doesn’t work. In the end, I’ll be right on this one.”

## THE PRICE OF RICE

Like her colleagues, Nina Pavcnik is willing to wade into controversy. There’s plenty of that—and heartbreak, too—in her specialty. Pavcnik is a specialist in the impact of globalization on child labor in developing countries. Born in Slovenia, Pavcnik first came to the U.S. as an exchange student in the mid-1980s. She came back to attend college at Yale and earned her doctorate in international economics from Princeton in 1999. As an associate professor of economics at Dartmouth, she has done much of her best-known research in collaboration with development economist Eric Edmonds, also an associate professor of economics at Dartmouth.

In an article published last year in the *Journal of Human Resources*, Edmonds disproved a popular misconception: that child labor was a function of parental neglect or ignorance about the benefits of education. (Based

on that notion, many countries had tried—unsuccessfully—to outlaw child labor with educational initiatives and laws.) Edmonds found that child labor was a direct result of poverty. Vietnam offered the best data. Some 3,000 households were studied from 1993 to 1998. That was a period of rapid economic growth for the nation, during which it became one of the world’s top rice exporters. In that five-year period, the number of working children fell by nearly a third, which the two professors attributed largely to rising incomes.

Only six months earlier, the two professors had published another headline-grabbing study that suggested globalization would help, not harm, the children of the Third World. In a research report for the National Bureau for Economic Research, Edmonds and Pavcnik said trade liberalization likely led to a drop in child labor in Vietnam. When the Vietnamese government lifted restrictions on the rice trade in the 1990s, prices jumped. The two professors found that higher rice prices led to higher income for rural families, who then pulled their children from the fields. Did these rural parents send their children to school? “We do not know the answer to that because we didn’t have appropriate data to examine this question,” Pavcnik says. “We can only hope.”

Policymakers took note. After the papers were published, Pavcnik and Edmonds were asked to discuss their findings with staffers at several international economic institutions, including the World Bank in Washington, D.C. and the Organisation for Economic Co-operation and Development in Paris.

Also like her colleagues, Pavcnik is a strong free-trade advocate, in part because her research shows it has potential to benefit those who are least powerful in societies: the children. These days, she is studying the impact of globalization on the children of India, where data also allow her to look at implications of trade reform for children’s school attendance and to examine whether short-term exposure to trade reform has lasting impacts on children’s educational attainment by affecting their literacy and school completion. She says her research will likely be published as a working paper later this year.