Final Draft

BARRY BLUESTONE

Barry Bluestone is the Russell B. and Andrèe B. Stearns Trustee Professor of Political Economy and director of the Center for Urban and Regional Policy at Northeastern University in Boston, Massachusetts. Before assuming this new post, Bluestone spent twelve years at the University of Massachusetts Boston as the Frank L. Boyden Professor of Political Economy and as a Senior Fellow at the University's John W. McCormack Institute of Public Affairs. He was the founding director of UMass/Boston's Ph.D. Program in Public Policy. Before coming to UMass in the Fall of 1986, he taught economics at Boston College for fifteen years and was director of the University's Social Welfare Research Institute. Professor Bluestone was raised in Detroit, Michigan and attended the University of Michigan where he received his Ph.D. in 1974.

On partial leave from UMass/Boston in 1995, Bluestone served as a member of the senior policy staff of Congressman Richard Gephardt, the Democratic Leader of the U.S. House of Representatives.

As a political economist, Bluestone has written widely in the areas of income distribution, business and industrial policy, labor-management relations, higher education finance, and urban and regional economic development. He contributes regularly to academic, as well as popular journals, and is the author of nine books. In 1982, he published ***The Deindustrialization of America*** (co-authored with Bennett Harrison of the New School for Social Research) which analyzed the restructuring of American industry and its economic and social impact on workers and communities. A sequel published in 1988, ***The Great U-Turn: Corporate Restructuring and the Polarizing of America,*** also co-authored with Harrison, investigated how economic policies have contributed to growing inequality. In earlier books, Bluestone investigated the low-wage labor market, the aircraft industry, and the revolution in the retail trade sector. In 1992, ***Negotiating the Future: A Labor Perspective on American Business*** was published. Co-authored with his father, Irving Bluestone, the book traces the history of labor-management relations since World War II and offers the concept of the "Enterprise Compact" as an approach to industrial relations which can boost productivity, improve product quality and innovation, and enhance employment security. As of 1998, Korean, Spanish, and Japanese editions had been published. Working with Edith Rasell and Lawrence Mishel of the Economic Policy Institute, ***The Prosperity Gap: A Chartbook of American Living Standards*** is scheduled for publication in early 2000 by The New Press.

Bluestone has just completed two new books. The first of these, co-authored again with Harrison, and titled ***Growing Prosperity: The Battle for Growth with Equity in the 21st Century,*** investigates the prospects for faster economic growth in the U.S. It was published by Houghton Mifflin and The Century Foundation in January 2000. The second, **Boston Renaissance: Race, Space, and Economic Change in an American Metropolis,** to be published by the Russell Sage Foundation, is the culmination of nearly five years of research on the new Boston economy. It recounts the industrial and demographic revolution in post-World War II Boston and its impact on racial and ethnic attitudes, residential segregation, and the labor market success of whites, blacks, and Latinos.

As part of his work, Bluestone spends a considerable amount of time consulting with trade unions, with industry groups, and with various federal and state government agencies. He was executive adviser to the Governor's Commission on the Future of Mature Industries in Massachusetts and has worked with the economic development departments of various states. He has testified before Congressional committees and lectures regularly before university, labor, community, and business groups. As a founding member of the Nommos Consulting Group and working with Streamline Communications, he has been involved in the development of multimedia productions and CD-ROMs used in training sessions for labor/management groups and for public school teachers. Bluestone is also a founding member of the Economic Policy Institute, along with Robert Reich, Lester Thurow, Robert Kuttner, Ray Marshall, and Jeff Faux.

He is also a member of the Scientific Committee of the Rome, Italy-based Center for International Social Studies (CISS); a Senior Fellow of the Gorbachev Foundation; and a Research Associate of the Jerome Levy Economics Institute of Bard College.

In his spare time, he competes in team triathlons as a bicycle racer -- fortunately with a team otherwise comprised of orthopedic surgeons and an internist. He lives in Cambridge, Massachusetts with his wife Mary Ellen Colten and their son Joshua.

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Testimony of Barry Bluestone before the U.S. Trade Deficit Review Commission

The Regent Wall Street
New York City

March 13, 2000

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My name is Barry Bluestone and 1 am the Russell B. and Andrèe B. Stearns Trustee Professor of Political Economy and director of the Center for Urban and Regional Policy at Northeastern University in Boston, Massachusetts. I appreciate the opportunity to testify before this distinguished commission on the question of trade, globalization, and the trade deficit.

Today, I would like to address two critical issues. The first is the effect of trade on wage and income inequality. The second is the role that trade – and more generally, fiscal policy and public investment -- have played in the current era of rapid economic growth. In addressing these issues, I will try to make two points. One is that a combination of increasing globalization, expanded trade, and the ballooning trade deficit has been the major factor contributing to increased wage and income inequality in America. The second is that, despite the conventional wisdom, trade actually plays a relatively minor role in the dazzling economic growth we are now enjoying. Instead, public investment in basic research, education and training, and infrastructure has been responsible for the economic renaissance the U.S. has been enjoying. This leads me to the conclusion that while a completely laissez-faire trade policy inevitably contributes to increased inequality, modestly regulating free trade through international labor rights and international labor and environmental standards -- plus some regulation of international capital flows -- would not necessarily hamper economic growth, but it would improve the chances that growth will be shared more equitably. Moreover, a renewed federal commitment to public investment in basic research, education and training, and infrastructure could contribute to reducing the trade deficit as the result of maintaining America's world-wide lead in information technology and e-commerce.

Growing Inequality in Wages and Incomes

During the post-World War II era "Glory Days" from 1947 through 1973, prosperity was widely distributed in America. In that first postwar generation, the poorest one-fifth of all families saw their real family incomes rise by 3 percent. The top one-fifth did not fare quite **as** well in percentage terms, their incomes rising at a **2.4** percent annual clip. As a result, by 1973, inequality had actually declined a little and the proportion of families in poverty nearly halved. This was truly an era of growth with greater equity. Sustained long run economic growth and the sometimes rocky but at the same time seemingly irreversible political commitment to broadening the social safety net and raising labor standards conjoined to produce a gradually narrowing gap between those with the most income and those with the least.

Unfortunately, the good times were not to last. As the economy faced increasing global competition, as the import share of GDP rose, and trade balance turned into a stubbornly expanding trade deficit, wages stopped growing and inequality surged. For the twenty years following 1973, most of the trend lines were dismal. Except for those at the very top of the income ladder, incomes stagnated or actually fell. Between 1973 and 1995, real hourly wages *fell* by 10 percent while median family income rose by a grand total of just 4 percent over the entire twenty-two year period -- despite the continued influx of women into the labor force.

Back in 1982, people in the top 10 percent of the work force earned 3.95 times as much in average hourly wages as those in the bottom 10 percent. By 1996, that ratio had grown to 4.72 times. If "total compensation" is counted — including the current cash value of such benefits as paid vacations, health insurance premiums, and pension contributions — the ratio rises from 4.56 in 1982 to 5.56 in 1996.'

Family incomes grew apart as a result. The top fifth of all families continued to see their incomes rise by 1.3 percent a year, but the poorest two-fifths saw their incomes actually decline while those in the middle went nowhere. [2] America was undergoing a "Great U-Turn" in living standards by almost any relevant measure — hourly, weekly, and annual individual earnings; household income; the black-white income gap; the incidence of poverty; and the distribution of personal wealth.[3] No other market economy, not even in the newly-developing world, and no socialist country, underwent such a sudden and dramatic surge in inequality.[4]

Why Inequality Grew

What, exactly, caused the shift toward greater inequality beginning in the 1970s? There are more than enough suspects to go round including: (1) technological change (2) deindustrialization (3) de-unionization (4) expanded global trade (5) acceleration in transnational capita1 mobility (6) increased immigration, and (7) the chronic U.S. trade deficit.[5]

Technology seems to be the inequality culprit at first blush, not trade, the trade deficit, or capita1 mobility. After all, high-tech regions like Silicon Valley seem to demand a disproportionate number of skilled workers who command high salaries in return for their specialized knowledge while there is little demand for those with limited schooling. So called "skill-biased' technological change supposedly drives a growing wedge between the skilled and unskilled, regardless of the nation's trade position.

But the more anyone tries to pin inequality on technology, the less it seems to be the guilty party. Part of the problem is that no one has any direct measure of the skill content of technology, and certain proof of this hypothesis requires not just skill-biased technological change, but its acceleration during the period in which inequality expanded. If technology is driving inequality, this would have to show up in a rapid shift in the skill mix of the labor force. But this does not seem to have occurred. After extensive research, New School economist David Howell concludes that there is no direct evidence whatsoever of an historically distinctive, much less an accelerating, shift in the skill mix of employment since the early 1980s in the U.S. or in most other major developed countries. Indeed, the change in skill mix is far greater in the decade prior to the onset of computerization -- the early 1980s -- in direct contradiction to the theory.[6]

The technological explanation for increased earnings inequality runs into an especially tricky problem when one simply looks at earnings growth between 1979 and 1995 across broad occupations. If technology is driving wage differentials, one would expect to find that those in science-related professions and technical specialties would have enjoyed the most wage growth. But according to a study from the Educational Testing Service? this is not the case at all. Science-related professional men with a Bachelor's degree or more saw their real earnings decline by 2 percent between 1979 and 1995 while "science technicians" with a completed college education enjoyed only a 6 percent increase. The real winners in the earnings derby were not those who were on the forefront of the new computerized technologies, but medical doctors (+43%), lawyers (24%), sales representatives and brokers (+24%), and managers (+15%).[7]

On this subject, Alan Greenspan is in agreement. In his remarks to the 1998 meeting of the Fed governors at Jackson Hole, Wyoming, Greenspan observed that "the considerable diversity of experiences across countries as well as the finding that earnings inequality has also increased *within* groups of workers with similar measured skills and experience suggest that we may need to look deeper than skill-biased technological change if we are to fully understand widening wage dispersion. "[8]

If technology didn't do it, then we need to consider other possible explanations. One obvious suspect is the shift from goods-producing sectors into services -- deindustrialization. Between 1963 and 1987, the earnings ratio between college graduates and high school dropouts working in the goods-producing sector widened from 2.11 to 2.42 -- an increase of 15 percent. At the same time, the school-related earnings ratio in services moved from 2.20 to 3.52 -- a 60 percent increase. [9] That virtually all of the employment growth during the 1980s came in the sector polarizing four times faster than manufacturing could therefore explain at least part of the increase in earnings inequality.

Reinforcing this conclusion, some suggest, has been the decline in unionization. Unions have historically negotiated wage packages that narrow earnings differentials. This is one of the reasons for the lower wage dispersion found in manufacturing. That unions have made only modest inroads into the service economy may explain in part why earnings inequality in this sector outstrips that elsewhere. Still, the proportion of workers in unions is so small, it is hard to imagine that de-unionization itself can explain more than a fraction of the rise in earnings inequality

Yet, even more fundamental to the recent restructuring of the labor market -- and a likely proximate cause of deindustrialization and de-unionization -- is the trend toward global free trade. In theory, free trade itself can generate skill-based inequality. According to "factor price equalization" theory, the simple fact of increased international trade -- in an environment characterized by no tariffs or quotas, no significant differences across countries in consumer "tastes" or production techniques, and trivial cost barriers in transportation and communications -- is sufficient by itself to induce the price of each input factor (for example, the wages of unskilled workers) to equalize across trading countries. In a world of plentiful unskilled workers and a relative scarcity of well-educated labor, this converts to *inequality* between different factors (i.e. between skilled and unskilled workers.)

Textbook factor price equalization will of course not occur. The underlying assumptions are manifestly invalid. Trade is *not* literally "free." Nevertheless, the trend is definitely toward increasingly deregulated global commerce. Moreover, providing for the unrestricted movement of investment capital across borders inevitably speeds this process up. Modern transportation and communications technologies, combined with fewer government restrictions on foreign capital investment, have clearly led to increased multinational capital flows between countries. To the extent companies move specifically to take advantage of cheaper unskilled labor, or outsource domestic production to cheaper offshore sites, transnational investment adds to the effective supply of low-skilled labor available to American firms, accelerating the entire disequalizing process.

Increased immigration has potentially the same effect, if a disproportionate share of new immigrants enter with limited skills and schooling. At least among legal immigrants, we know this is true. In the U.S., the typical legal immigrant today has nearly a year less of schooling than native born citizens. Undocumented immigrants, coming now from Mexico, the Philippines, Korea, Cuba, Vietnam, India, the Dominican Republic, China, Jamaica, and Iran, almost surely have less. With such little schooling, these new labor market entrants almost surely enter at the very bottom of the occupational ladder, adding to the disparity in earnings.

Finally, the continuing surplus of manufactured imports over manufactured exports may be culpable to the extent that the trade deficit itself has contributed to the decline in those sectors of the economy that have in the past helped to keep earnings inequality in check. That is, deindustrialization and de-unionization are directly related to the imbalance between exports and imports.

Quantitatively parsing out the relative impact of this broad array of forces on the wage distribution is fraught with enormous difficulty. Still, Richard Freeman and Lawrence Katz have attempted to do just that. Drawing on their research and that of others, including George Borjas, we can summarize their findings in **Table 1.**

Table 1

Sources of Inequality

(Factors responsible for the increase in male college/high school wage differential during the 1980s)

Technological Change	7% - 25%
Deindustrialization	25% - 33%
Deunionization	20%
Trade and Immigration	15% - 20%
Trade Deficit	15%

Source: Richard B. Freeman and Lawrence F. Katz, "Rising Wage Inequality: The United States vs. Other Advanced Countries," in Richard Freeman Freeman (ed.) Working Under Different Rules (New York: Russell Sage, 1994).

If the Freeman and Katz estimates are anywhere near in the right ballpark, the answer to what caused the polarization of wages and incomes is a combination of deindustrialization and de-unionization, in large measure driven by increased trade, immigration, and the growing trade deficit. Indeed, these factors combined may explain anywhere from 75 to 93 percent of the growing wage gap between college and high school educated men.

None of these trends show any sign of weakening. On the whole, companies seem to be shifting toward greater reliance on high-skilled workers and new technology. The passage of the North American Free Trade Agreement (NAFTA), the formation of the European Union (EU), the successful completion of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), and the creation of the World Trade Organization (WTO) all contributed to freer international trade and increased transnational capital investment. Immigration, both legal and illegal, has not slowed. Mass layoffs and plant closings in the manufacturing sector -- now fashionable even among profitable firms -- perpetuates the trend toward services and away from goods production. The ranks of organized labor continue to shrink. The trade deficit continues to swell. Under this set of conditions, it would have been almost unavoidable that the high level of wage and income inequality of the 1980s and early 1990s would continue to persist. A great powerful force would be needed to reverse it. No wonder there was such outrage in Seattle in response to the perception that strengthening the World Trade Organization would exacerbate inequality even further.

Economic Growth and Free Trade

If globablization, trade liberalization, and the trade deficit have contributed so much to wage and income inequality, why is there such a political commitment in Washington to expanding free trade still further?

According to the model of economic growth now in vogue at both ends of Pennsylvania Avenue in Washington and on New York's Wall Street, the recent stunning recovery of the American economy is based on two critical factors: the absence of inflationary pressure and the increase in the aggregate savings rate. The rationale for this conclusion goes something like this. When the federal government was piling up deficits during the 1970s and 1980s and inflation was rampant or at least threatening, America's growth rate slumped because public borrowing and the threat of inflation forced up interest rates leading the private sector to cut back on borrowing. Consequently, investment was sluggish, productivity suffered, and America's growth rate slumped. Only when President Clinton and the Congress aggressively attacked the deficit, beginning in the early 1990s – and inflation was brought under control by global competition and Federal Reserve Board vigilance -- did this vicious cycle reverse. And the more we cut the deficit and the more inflation was kept at bay, the more the economy grew.

In this story of growth, free trade matters less because of the export markets it fosters than because of the check on inflation it provides. Increased international competition undermines the ability of domestic firms to raise prices. In the old days, for example, before Japanese, German, and other foreign-made automobiles gained widespread access to the U.S. market, General Motors, Ford, and Chrysler could implicitly collude to raise prices with the intent of meeting pre-arranged profit targets. Oligopoly -- markets with few sellers -- dominated large segments of the American economy. As a result, it was fairly easy for producers to raise prices without fear of retaliation or competition. When prices rise in a few key industries, inflationary pressure begins to build. If enough sectors are characterized by limited competition, inflation can take off.

The key point, made by most advocates of free trade, is that nothing so undermines domestic oligopoly as the elimination of tariffs, quotas, and other barriers to the global exchange of goods and services. The more competitors there are -- foreign and domestic -- the harder it is for industries to engage in collusive pricing and the greater the potential for excess capacity which forces all companies to raise productivity, cut costs, and pass these cost reductions onto the consumer in the form of lower prices -- or go out Of business. [10]

As such, free trade has become a key component of the anti-inflationary thrust associated with the Wall Street growth model. Its most trumpeted role in export promotion is actually less important than the downward pressure it puts on prices. In 1997, with the Asian financial crisis developing at the end of the year, the impact on prices was particularly significant. Prices for all foreign goods *fell* by 6.1 percent in the year ending in January 1998." Now that one-seventh of U.S. consumption is comprised of imports, it is not surprising that such a dramatic decline in import prices would bring overall domestic inflation to record-setting low levels -- exactly in line with the Wall Street growth model." It would seem then that we interfere with laissez-faire free trade at great peril -- if this model provides the true explanation for the economic growth we now enjoy.

What Really Brought on the American Economic Renaissance

The logic of the Wall Street Model seems unimpeachable and the timing seems exquisite. Nonetheless, the story this model tells about growth is largely wrong. Hard as it may be to believe, deficit reduction and free trade have had very little to do with the current economic recovery.

The reason why we are growing so rapidly today has instead everything to do with the technological revolution that has been underway for nearly three decades. Historical data tell us that whenever there has been a fundamental breakthrough in technology -- say, the introduction of the steam engine or the introduction of electricity -- the initial impact on productivity growth is minuscule or even negative. This is not surprising, for when a revolutionary new technology is introduced, it takes a long time to figure out how best to use the new innovations, to work out its bugs, to train workers to operate it, and to diffuse it to more and more industries and applications.

What was true of steam power and electricity is true for the information revolution as well. It is not surprising that productivity slumped in the 1970s near the beginning of the computer revolution, nor that productivity began to pick up during the 1980s as more and more industries learned how to use computers and software more effectively. And it is not surprising that the full-scale productivity premium is just now being realized. With or without such sharp deficit reduction, with or without NAFTA and the World Trade Organization, the U.S. economy would be in pretty good shape today.

This does not mean, however, that government policy is irrelevant to growth. Indeed, the technological revolution we are undergoing today was spawned by the federal government's past investments in basic research, in education and training, and in public infrastructure. If the government had not invested enormous resources into radar and sonar during World War II, we might have delayed improvements in communications and television by another decade or so. If we had not built thousands of miles of interstate highways beginning in the 1950s, the blossoming of the post-World War II auto industry would have been stunted.

More recently, it was the need for massive computing power to run modern defense systems that helped fund the design and construction of powerful mainframe computers. The requirement of miniaturized guidance systems for ICBMs and NASA rockets led the government to underwrite a good portion of the development costs of microprocessors and the software for programming them. It was the federal government's investment in the ARPANET that led to the modern day internet and the World Wide Web. Without these investments, today's ubiquitous E-commerce would never have come about – or would have been delayed by perhaps decades. The latest theoretical breakthroughs in miniaturization, which could make future computers a 100 billion times faster than the fastest personal computer available today, have just been announced by UCLA and Hewlett-Packard. This miraculous work is going on in university and private company labs, but almost all its funding has come from the Pentagon.

No wonder, then, that the U.S. is doing so well today in computers and information technology relative to even our most advanced trading partners. The massive investments the federal government made in these technologies has put American firms from Intel and Microsoft to Sun, Dell, Apple, Hewlett-Packard, and Compaq well ahead of the global pack. Similarly, medical research emanating from government-funded laboratories has provided us with a leg-up in biotechnology, scanning devices, and a range of pharmaceuticals.

Building a Future of Growth with Equity

What does all this mean? Simply this: the current political economic regime of laissez-faire free trade and huge trade deficits is responsible in substantial measure for growing inequality but only partially, at best, for the expanding economy. Is it possible, therefore, to conceive of a set of policies that would help sustain economic growth while at the same time doing something about wage and income inequality. I believe it is.

First, we need to consider how to level the global playing field for both America and our trading partners. In a global economy, we need more than just domestic regulation. The international movement of enterprise from one nation to another and the hypermobility of finance capital has become a universal source of anxiety. Negotiations over creating a Multilateral Agreement on Investment (MIA) would further take control over a country's domestic development plans out of its hands, giving ever greater power to multinational corporations. What is needed is the creation of a "fair trade" regime and a new global economic architecture analogous to what the leading nations of the world developed at the end of World War II. Instead, we are getting a further devolution of power from each and every individual government to the private sector and growing international economic chaos. What is to be done?

Taking ***labor rights and standards global.*** Workers' representatives in nearly all developed countries have sought to establish international labor rights and to regulate global labor standards, The goal is to "bring up the bottom" in defense of the higher standards of living of workers in developing countries while helping to protect against a race to the bottom for their own.

Unions have for years lobbied international organizations to heed their call. In December of 1996, 123 of the world's trading countries convened in Singapore for the first annual meeting of the new World Trade Organization (WTO). This was the new entity that was to continue the work of the General Agreement on Tariffs and Trade, the GATT. Despite efforts by the Clinton administration under pressure from the labor wing of the Democratic Party, along with representatives of the French government, the WTO delegates soundly defeated a proposal to include labor standards in the next round of negotiations. Everyone "agreed" that the International Labour Organization (ILO) was already doing a "good job" of worrying about labor standards, and should be allowed to continue its work -- even though the IL0 has absolutely no enforcement power whatsoever. [13]

Principal opposition came from the delegates from the developing countries, led by Pakistan, India, and Malaysia. They feared that the developed countries were only trying to protect the relatively higher wages and workplace standards enjoyed by their citizens, compared with conditions in the developing world. In short, they feared that the proposal to legislate global labor standards was a thinly veiled attempt to institutionalize protection against the exports of goods made in low income countries - further helping the workers in developed countries at the expense of those in the developing world.

The real question is whether the WTO could adopt something stronger than existing protections against slavery, forced labor, the suppression of union organizing, and the exploitation of child labor -- without undermining the incentive for multinationals to invest in developing nations. That is, is it possible to institute both some form of international rights and freedoms and at the same time set some minimum form of international labor standards regarding minimum wages, hours of work, health and safety, and the provision of employee benefits without doing harm to poor countries?[14]

Answering this question involves making two distinctions: one over rights vs. standards, the other over how standards would be set. Many would agree that establishing enforceable international labor *rights* is a necessary condition for these rights to exist in any single country. In the new global economy with its enormous capital flows, there are no economic islands. If companies in particular countries are permitted the unregulated use of child labor or have the right to unilaterally and brazenly shut out unions, then it becomes more difficult for other countries to enforce their own child labor laws or encourage union organization. The same is true when it comes to environmental standards. Private companies can punish "progressive" countries by threatening to move their capital and their operations elsewhere. This will be true particularly in lower wage manufacturing industries, but increasingly applies to a range of services including low level computer programming done quite cheaply now in countries like India and Pakistan. Developing ways to impose trade sanctions on countries that refuse to regulate child labor, prison labor, and slave labor – and which deny workers the basic democratic right to join trade unions – is one direction such policy might take.[15]

The question of labor standards is much tougher. For example, setting a fixed minimum wage which applies to all countries clearly has the problem that countries are at very different levels of development. A $5.15 minimum wage in the United States is arguably too low for American workers, yet such a level in Thailand would bankrupt many small businesses. One way to avoid this problem is to have the WTO set minimums for wages, health and safety standards, and employee benefits tied to the level of per capita income in each country. As per capita income grows, the standards increase. The other alternative is to tie minimum wage increases not to an absolute level but to improvements in the measured productivity of a nation. For example, as U.S. companies have placed modern factories in Mexico, the productivity of Mexican workers in those factories has soared. Their wages, however, have not kept pace with increases in productivity. Setting a standard which provided that no sanctions would be placed on countries based on the level of their wages, but only when wages failed to rise with productivity could solve this problem. Future trade agreements could be drawn up so that the speed of tariff reduction was tied not to a fixed timetable spread over many years, as is the case for NAFTA, but conditioned on the rate at which wage growth converged with productivity growth. There is, of course, always the problem of measurement, but presumably WTO investigators and the IL0 could produce statistics reliable enough to stand up in international court.

Civilizing the globalization of capital - One of the central tenets of the Wall Street model, almost by definition, is that America's economic rebound is premised on the development of financial institutions which permit the accumulation of huge stocks of capital and provide for a totally unlimited free flow of this vital resource between industries, regions, and nations

To be sure, raising huge sums of investment capital and directing these resources to new business ventures is crucial to economic growth. But we have learned that when capital flows turn "hypermobile," constructive financial institutions can turn destructive. Virtually instantaneous capital inflows into an enterprise can help it grow quickly as we have seen with the almost overnight creation of enormous enterprises like America On-Line and Amazon.com. Yet the same institutions that direct huge amounts of capital to a new startup venture can just as instantaneously lead a retreat of funds, creating enormous economic instability. If Wall Street decides a firm has not met its profit targets, it can punish that company's stock in a matter of minutes on the New York Stock Exchange or NASDAQ -- forcing the company to take extreme measures to get back in the good graces of investors. Many a company has announced huge layoffs of employees, simply to signal to Wall Street that it is willing to take Draconian action to become "lean and mean" so as to meet the Street's demand for expected profit.

What is true for individual firms is equally true for entire nations, as we saw with the meltdown of Southeast Asian economies in 1998. When bankers and global currency speculators began to sour on the economic prospects of Indonesia, currency speculators bet against the country's currency and finance capital fled the area. While the political "domino theory" tragically led the U.S. deeper and deeper into the Vietnam War in the 1960s, its economic variant in the 1990s has proven more reliable. Within days speculators not only punished Indonesia, but attacked Thailand and South Korea before turning their attention to Latin America.

By the fall of 1998, all but the most diehard free traders were acknowledging that unregulated cross-border finance — the globalization of the Wall Street model -- was a dangerous menace to worldwide economic stability. While the experts disagreed on the relative merits and political feasibility of debt-forgiveness, limited exchange rate controls, taxes on speculative transactions, and the creation of international bankruptcy procedures, there was widespread agreement that capital hypermobility was nor necessarily leading to higher standards of living, or rewarding good productivity performance. Instead, it was threatening to bring the entire world economic system crashing in upon itself.[16] Only through the adroit handling of the Southeast Asian financial crisis by the U.S. Treasury Secretary and the Federal Reserve Board Chairman was more damage avoided.

To rein in the hypermobility of finance capital, we should consider limited re-regulation of capital markets. To be sure, part of such a program of "civilizing" globalization will entail reforming and re-directing the key Bretton Woods organizations: the World Bank and especially the IMF. But literally going back to the old Bretton Woods system is neither possible nor desirable. After all, as Cambridge University economist John Eatwell reminds us, the Bretton Woods system was implicitly erected on the principle of the U.S. as global hegemon. It was governed by a system of gold-dollar fixed exchange rates, not by policy coordination among governments. It was never a multilateral system in the first place (which is why it broke down when the key currency -- the dollar -- was battered by speculators toward the end of the Vietnam era when the U.S. government attempted to enjoy both "guns and butter" without raising taxes to pay for them.)" A "new Bretton Woods" will have to be, as Eatwell suggests,

> a genuine multilateral arrangement.. .dominated by the leaders of the world's three main currency blocks: Germany, Japan, and the United States. At the core of that new system should be a renewed commitment to securing the currency stability that is necessary to underwrite the coordinated international expansion needed to avert worldwide recession. The present largely ceremonial summits of the G7 would need to be replaced with meetings that actually deal with substantive issues. A permanent secretariat should be created with the skills and authority to manage the international payments system.[18]

Contrary to much casual observation, the power of nation states to make policy has *not been* completely undone by globalization. Thus, believes Eatwell, "while the speculators may be able to borrow very large sums for short periods of time, the central banks, as the creators of currency, can, collectively, provide indefinitely large sums for just as long." Morever, the very technological developments that have made finance hypermobile — the computer, the fax, the cell phone, the Internet — actually facilitate monitoring speculative currency flows in the public interest. The fact that trading today is typically by electronic transfer makes effective monitoring easier than ever before. Hence, with a set of international agreements, it would not be too difficult to link the legal right to trade to the requirement to accept appropriate monitoring. In this way, effective monitoring could be the starting point for more effective management of the global finance system. [19]

One of the specific ways to manage the global system more effectively would be to impose a "Tobin Tax" on financial transactions. Initially proposed by the Nobel economist James Tobin in his 1972 Janeway Lectures at Princeton, a small and presumably variable levy (Tobin originally suggested 0.2 percent) would be imposed on each individual international financial transaction in stock, bond, and foreign exchange markets. By raising transaction costs in this way, speculative excesses would be dampened. Those who trade most frequently would be penalized most heavily, which should make investments somewhat more "patient." The tax would accrue to the U.S. Treasury, which could put it to any number of uses (including assisting developing countries to restructure their outstanding debt.) Those who trade infrequently would hardly notice such a tax. Estimated revenues would depend on the extent to which any particular level of the tax limited short-term financial trade in the same way that the size of tax revenues from new tobacco levies will be lower the more effective the levy is at reducing smoking. But the chief purpose of the tax is not to generate revenues; it is to reduce the volume of speculative transactions." The Tobin tax was never popular with the mainstream economics and policy communities, but it has become of increasing genera1 interest in the context of the current wave of globalization.

In sum, there are, after all, policy designs and tools available to deal with the destabilizing aspects of globalized hypermobile finance capital. It will take great leadership from the big powers, especially the U.S., and a degree of unprecedented multilateral coordination and cooperation. What could emerge over time would be a new regime — a new system of governance — made up of elements of the Bretton Woods system plus a set of well-tuned taxes and regulations. It is fruitless and fanciful to imagine literally stopping globalization. We need and want continually expanding trade. But we also want to civilize the process.

Promoting Exports through Public Investment

Getting our trade regime right is one way to deal with income inequality and the instability associated with speculative capita1 flows. But there is another arena where government could indirectly, but powerfully, assist in export promotion and thus trade deficit reduction: committing the U.S. to provide greater investment in basic research, education and training, and public infrastructure. In what has become almost a fatal obsession with the Wall Street mode1 and building up the federal surplus, the nation has been cutting its investment in these critical areas. President Clinton's recent announcement of more money for the National Science Foundation and DOD research hardly puts a dent in this downward trend in government funding of basic research.

Since 1979, the share of federal investment in public nondefense infrastructure, education, and research has fallen steadily. At the end of the 1970s, the federal **government** was investing in basic research, education, and physical capital at a rate equal to 2.5 percent of GDP. By the early 1990s, spending on these functions was down to only 1.7 percent of GDP. Worse yet, by 1998, the rate of spending had fallen further to only about 1.5 percent. Moreover, such investments is destined to decline further in the new millennium under the Clinton budget and the Congressionally imposed spending caps. This spending is part of what the government calls “total discretionary federal funding” – that is the budget excluding Social Security, Medicare, Medicaid, and interest on the federal debt. Back in 1968, discretionary funding was 13.6 percent of GDP. Even as late as 1986, it amounted to 10 percent of GDP. Twelve years later, it was down to 6.6 percent and is scheduled to fall to only 5.5 percent by 2004 according to the latest budget estimates. Hence, by the middle of the next decade, the federal government’s role in underwriting economic activity will have declined by more than half. The steepest declines in the budget are for precisely what has been so important to growth in the past. According to the National Science Foundation (NSF), the federal share of support for the nation’s R&D first fell below 50 percent in 1979, and it remained between 45 and 50 percent until 1988. After then, it fell steadily, dropping from 44.9 percent in 1988 to only 26.7 percent projected for 1999. This is the lowest it has ever been since the start of the time series in 1953.

We may not see the impact of this neglect of public investment for a number of years to come, but if history has anything to say on the subject, we will pay for our fiscal conservatism dearly. What technological innovations might be missed or postponed, we will never know. But it is clear from an increasing amount of economic research that the single most important factor behind long cycles of prosperity is the level of technological advance – not whether we balance the federal budget. If, by ignoring investment in basic research, we slow down the development efforts of the private sector, we will also pay for this myopic policy of underinvestment in reduced exports and a higher trade deficit.

Summing Up

Trade is good for any economy and it is to be encouraged for the variety of goods and services it permits a nation's people to enjoy. But to ignore the impact of totally unregulated trade and capital mobility on the distribution of wages and incomes is economically and politically foolhardy. Moreover, given the technological basis for contemporary economic growth, we can afford to put modest regulations on trade and global capital flows without damaging the prospects for continued prosperity. With the appropriate combination of international rights and standards and modest regulations on capital flows, we can have both continued economic growth and enjoy its fruits more equitably.

And we could do even more for growth with equity, if we put our mind to it. Even with the modest measures for regulating free trade envisioned here, inequality in earnings and incomes will be difficult to rein in. Continued improvements in the Earned Income Tax Credit (EITC) could shore up incomes at the bottom. And spending some of the federal surplus we are now generating to increase government investments in basic research, education and training, and infrastructure should not be ruled out of order. After all, if we want to sustain prosperity with equity into the future and if we want to deal with the trade deficit, we must not destroy the public-private sector partnership that has so successfully brought us the technological revolution, the fruits of which we now enjoy. Indeed, what we now need more than ever is a broad national debate over which policies contribute to growth with equity and which do not. I applaud this Commission for helping to begin just such a dialogue and appreciate the opportunity you have given me to join it.

Endnotes

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[1] Peter Passell, "Benefits Dwindle Along With Wages for the Unskilled," New York Times, Sunday, June 14, 1998, p. Al.

[2] Rasell, Bluestone, and Mishel, The Prosperity Gap, op.cit., pp. 9, 13, 15. In addition, a recent study by the Washington-based Center on Budget and Policy Priorities reports that in New York State, where inequality is the highest among the fifty states, an average family with children in the top fifth of the income distribution now receives 29.5 *times* the income of the average family in the bottom fifth, up from 12.6 times in the mid-1980s (which was bad enough!). See Kathryn Larin and Elizabeth C. McNichol, Pulling Apart: A State-by-State Analysis of Income Trends (Washington, D.C.: Center on Budget and Policy Priorities, December 16, 1997), Table 2.

[3] Measuring inequality within the work force was hard to do prior to the 1960s, until the U.S. Bureau of the Census and the U.S. Department of Labor launched the annual March Current Population Survey, in which some 55,000 households are interviewed. The figure below reproduces one of the key graphs from our own earlier research on those numbers, showing the path of annual individual earnings inequality from 1963 (the earliest year for which such a calculation is possible) through 1986. The sharp and steady drop in earnings inequality until the bottom of the 1975 recession is the main story to be told by this graph. Its message has since been reproduced and reported by dozens of other scholars and journalists. Income inequality seems to decline when the economy grows for a sustained period. See Bennett Harrison and Barry Bluestone, The Great U-Turn: Corporate Restructuring and the Polarizing of America (New York: Basic Books, 1988).

[4] Peter Gottschalk and Timothy Smeeding, "Cross-National Comparisons of Earnings and Income Inequality, " Journal of Economic Literature, Vol. XXXV, June 1997, pp. 633-687.

[5] The following builds upon a formulation originally published as Barry Bluestone, "The Inequality Express, " The American Prospect, November 1994.

[6] David R. Howell, Margaret Duncan and Bennett Harrison, "Low Wages in the U.S. and High Unemployment in Europe: A Critical Assessment of the Conventional Wisdom," Center for Economic Policy Analysis, The New School, N.Y., Working Paper No. 5, February 1998, p. 3. For a thorough history of this thesis, and a further demonstration of why it just cannot be that important, see Lawrence Mishel, Jared Bernstein, and John Schmitt, The State of Working America: 1998-99 (Washington, D.C.: Economic Policy Institute, 1998, pp. 197-207.

[7] See Anthony P. Carnevale and Stephen J. Rose, "Education for What? The New Office Economy: Technical Report" (Princeton, N.J..: Education Testing Service, 1998), Table 14, p. 45.

[8] Alan Greenspan, "Remarks on Income Inequality, " Symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, WY, August 28, 1998.

[9] See Barry Bluestone, "The Great U-Turn Revisited: Economic Restructuring, Jobs, and the Redistribution of Earnings in John D. Kasarda (ed.) Jobs, Earnings and Employment Growth Policies in the United States (Boston: Kluwer Academic Publishers, 1990).

[10] See Lester Thurow, "Gazing into the Crystal Ball: Pressures of Globalization May Help Keep Boom Going," Boston Globe, May 14, 1998, p. D4.

[11] See Elizabeth Daerr and Jacob B. Schlesinger, "Import Prices Declined 1.3 % in January," Wall Street Journal, February 17, 1998, p. A2.

". Trade has already had its impact on *domestic* prices in those industries most subject to import penetration. The following table, reprinted from the Wall Street Journal indicates the 1997 inflation (deflation) rate in key manufacturing industries

Industry	Total Imports (billions)	Import Penetration %	Inflation Rate %
Motor Vehicles	$140.9	31.2	-0.6
Food and Beverages	39.1	5.1	1.7
Apparel	34.5	51.3	1.0
Toys	17.5	58.1	-1.4
Furniture	14.8	15.1	-0.3
Jewelry	13.5	32.2	-2.7
TVs and VCRs	10.5	43.3	-4.6
Audio Products	8.4	27.2	-2.0
Household Appliances	5.8	20.0	-3.5
Glassware and Cookware	5.1	17.8	0.1

Source: G. Gascal Zachary, "Asian Exports Haven't Flooded the U.S., But American Consumers Still Benefit from Lower Prices," Wall Street Journal, April 14, 1998, p. A2.

[13] The IL0 was created after World War I, together with the League of Nations. The League is of course long gone, while the IL0 has become an important forum for discussion about labor issues, and a much-needed source of research and technical assistance, especially in and for emerging nations. Much of this would not be conducted, or even commissioned, if the IL0 did not exist.

But as an adjudicator of international disputes on labor issues, the IL0 is toothless. It is not a court and cannot impose penalties. It has been suggested that some kind of joint ILO-WTO monitoring and enforcement with respect to fair labor practices and mutually negotiated rights might be possible. Christopher L. Erickson and Daniel J.B. Mitchell, "Labor Standards and Trade Agreements: U. S Experience, " Comparative Labor Law and Policy Journal 19, no.

2 (Winter 1998): 145-183. See also Werner Sengenberger and Duncan Campbell, eds., International Labour Standards and Economic Interdependence (Geneva: International Institute for Labour Studies, ILO, 1994).

[14] Robert B. Reich, "Keynote Address," in International Labor Standards and Global Economic Integration: Proceedings of a Symposium (Washington, D.C.: U.S. Department of Labor, July 1994).

[15] Congressman Richard Gephardt has been a leading proponent of adding labor rights and labor standards to trade agreements such as NAFTA. His argument for such language in trade bills is well articulated in Richard Gephardt and Michael Wessel, An Even Better Place: America in the 21st Century (New York: Public Affairs, 1999), esp. pp. 89-107.

[16] For a sample of mainstream opinions, see "Special Report: How to Reshape the World Financial System," Business Week, Oct. 12, 1998. Harvard's Jeffrey Sachs — himself the original architect of the "shock treatment" to Eastern Europe that arguably profoundly hampered that region's ability to restructure patiently with the passing of communism— was calling for expansion of the G7 to a group that would include Russia and eight developing countries. A major feature of any new regime proposed by this "G16" would be widespread debt-forgiveness. Jeffrey Sachs, "Global Capitalism: Making it Work," The Economist, Sept. 12, 1998, p. 23.

[17] John Eatwell, "Unemployment on a World Scale," in Eatwell, ed., Global Unemployment (Armonk, N.Y.: M.E. Sharpe, 1996).

[18] Ibid., p. 15.

[19] Ibid., pp. 15-16.

[20] Mahbub Ul Haq, Inge Kaul, and Isabelle Grunberg, eds., The Tobin Tax: Coping With Financial Volatility (Oxford: Oxford University Press, 1997).