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Free Trade Theory and Reality: How Economists Have Ignored Their Own Evidence for 100 Years

Jeff Ferry [Coalition for a Prosperous America]

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For the last 90 years, the United States has pursued and advocated free trade. For the last 60 of those 90 years, American workers and other observers have watched America lose high-paying jobs to imports and asked: can this really be good for the American economy?

Professional economists have answered, virtually unanimously, that yes, it is good, due to something called the Law of Comparative Advantage.

They are wrong. Their free trade theory, based on the so-called Law of Comparative Advantage, does not work for the U.S. or for many other countries. We know this because dozens of economists have published studies of the empirical results of import penetration showing that the Law of Comparative Advantage, and the modern economic theory built around it is outmoded and inapplicable to high wage nations like the U.S. Indeed, it can actually worsen the performance of high wage nations.

Economists advocate free trade theory less because they actually believe it than because of what Nobel laureate economist Paul Romer has called "a sense of academic group identity grounded in a common defense of [a] dogmatic position."[1] In other words, economists use this dogmatic theory as a weapon to win jobs, influence, and consulting contracts.

In fact, free trade theory fails to correspond to reality, as the evidence published by economists for at least 100 years has shown. This is not an argument that free trade is insufficiently compassionate, or that it creates short-term problems. Rather, it is an argument that the theory itself is wrong because it is outdated and fails to recognize important features of modern high-wage economies. I should add that I consider myself a conventional economist. I consider the two greatest economists of the 20th century to be John Maynard Keynes and Paul Samuelson. I believe if they were here today, they would agree with what follows.

First, a quick summary of what we mean by free trade. As first explained in 1817 by David Ricardo in his foundational text, Principles of Political Economy and Taxation[2], a free trade event, such as the abolition of tariffs between two countries, should make all workers and capitalists better off in both countries as workers and companies take advantage of the cheaper imports to move to industries where they can be more productive. In modern economics, this was generalized and mathematicised to say much the same thing: each worker will increase her "marginal product" and wages by moving into higher-productivity industries as imports provide lower-productivity goods and services.

[1] Paul Romer, *Mathiness and Academic Identity,* May 27, 2015.

[2] David Ricardo, *Principles of Political Economy and Taxation*, Dover Publications, 2004 (1817).

This view of an economy was reasonably accurate in David Ricardo's time, because workers across Europe were paid at close to subsistence wages, with specialized craft workers earning slightly more.

But this wage structure has not been true since the rise of the Industrial Revolution in the late 1800s. It is even more inaccurate today, with devastating consequences for free trade theory. The assumption that wages are independent of a worker's industry and depend only on something called "marginal product" (which is in turn often proxied by years of experience) is a little-appreciated but critical assumption on which all free trade economics rests. The theory asserts, and requires, that when workers change industries their wages remain the same, or rise slightly because they are supposedly moving to a more productive industry.

There are reams of evidence disproving this assumption. One set of studies disproving it is known as worker dislocation studies. Empirical labor economists began to publish hard evidence of the damage to wage levels from import penetration back in 1992[3]. Economists Jacobson, LaLonde and Sullivan gained access to Pennsylvania state employment records and studied a sample of over 9,000 workers who had suffered "mass layoff events" between 1980 and 1986. They found that 6 years after job loss, the workers who found a new job in a different sector suffered earnings losses averaging 38%. Regarding all workers, they concluded that:

> "Earnings loss represents 25 percent of workers' pre-displacement earnings…Further, because the estimated losses do not decline significantly after the third year following separation, there is little evidence that displaced workers' earnings will ever return to their expected levels."[4]

Since then, dozens of other studies have found similar results. These studies have consistently found a double-digit percent loss in earnings for workers who suffered mass layoffs. Some of the studies followed workers' data for twenty years after layoff and no study to date has found groups of U.S. workers who achieved pre-layoff earnings levels. This contradicts a fundamental assumption of free trade doctrine which holds that if two countries move from autonomy to free trade, both will gain.

Why would economists ignore the overwhelming mass of evidence that some workers lose from the import penetration following a free trade event? After all, the theory is quite explicit. It says workers move to higher productivity (and therefore higher wage) jobs. In fact, studies show many move to lower productivity and wage jobs. The standard model in economic theory assumes workers are paid according to their contribution to the output of their employer's business and their contribution is determined solely by their experience, skill, and/or age levels. The precise criteria chosen matter less than the fact that they must be simple and be determined outside of the model. If wage levels are determined by factors within the model, then the model may not lead to a solution. This is made explicit in a widely used current textbook on trade economics, *International Trade, Theory and Policy*[5], written by Nobel laureate Paul Krugman and two other highly respected trade economists. On page 72, they say: "*The*

[3] Louis Jacobson, Robert J. LaLonde, Daniel G. Sullivan, *Earnings Losses of Displaced Workers*, Upjohn Institute Staff Working Paper 92-11, February 1992.

[4] Ibid, pg. 9.

[5] Paul Krugman, Maurice Obstfeld, Marc Melitz, International Trade, Theory and Policy, 10th edition, Pearson, 2017.

proposition that trade is beneficial is unqualified. That is, there is no requirement that a country be competitive or that the trade be `fair'."[6] The book goes on in this vein for many pages. They state explicitly that wages are equal across all industries[7].

This analysis was the basis on which 300 economists signed a letter to President Clinton in 1993 endorsing the NAFTA agreement with Mexico and Canada. Actually, whenever 300 economists agree on something, it is a safe bet that it is wrong.[8]

In the real world, wages are not the same across industries even if skills are equal. Moreover, the U.S. has higher wages than almost every other country in the world. These large wage differentials (inter-industry and international) explain why the worker dislocation studies of 1992 and afterward found such large earnings declines following mass layoffs. It's because the layoffs were taking place predominantly in high-wage industries. In many cases the layoffs were due to imports and the imports came from nations that had lower wages and lower costs than the U.S. If and when those displaced workers found another job, it paid less, because usually, even for the same skill level, the pay in the new industry was less than that in the previous industry.

In the real world, free trade is a vehicle that allows highly competitive, well-managed foreign companies or countries to target high-wage U.S. industries and drive the companies out of business and the workers out of a job. In many cases, the foreign government subsidized those exporting industries. In some cases, the U.S. industries that lost market share and jobs were not highly paid by U.S. standards, but certainly were by international standards. The key point is that the "standard trade model" does not allow that to happen. So, a change in industry CANNOT reduce an employee's wage in the model even if it does so in fact.

It is not just the dozens of worker dislocation studies that disprove the validity of free trade theory. Before those studies, there were decades of studies of inter-industry wages that found that wages varied widely by industry. The extensive literature on inter-industry wages was summarized in an important article published in 1986 by Alan Krueger and Larry Summers[9] (both staunch free traders). It documented in detail the vast differences in wages earned by different types of workers over the preceding 60 years and found clear, persistent evidence that wages vary by industry. Here's their conclusion:

> "The inter-industry wage structure is remarkably similar in different eras, in different countries, and among different types of workers. Industries with high capital-to-labor ratios, monopoly power and high profits pay relatively high wages. We conclude that the competitive model cannot without

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[6] Op. cit., pg. 72.

[7] The assumption that wages are fixed outside the model and cannot go down can be found on pg. 82 of Krugman, Obstfeld, Melitz where it says: "*The wage rate w must be the same in both sectors because of the assumption that labor is freely mobile."*

[8] Previous examples include a 1930s economists' letter protesting Franklin Roosevelt's New Deal and another in the 1980s in Britain protesting Margaret Thatcher's anti-inflationary policies. Today, both of those leaders are highly respected and both sets of policies are broadly considered to have been successful or at least the best available option at the time.

[9] Alan B. Krueger, Lawrence H. Summers, *Reflections on the Inter-Industry Wage Structure*, NBER Working Paper No. 1968, June 1986.

> substantial modification provide an adequate explanation of the inter-industry wage structure."[10]

Note, this was not Krueger's and Summers' opinion. This was their summary of dozens of other studies, which by their volume and consistency across time and national boundaries, could not be disputed. What these studies found was that wage levels depend most of all on an industry's profitability. Interestingly, these studies found that the role of unionization and the presence of labor unions was a minor factor in wage levels. Profitability and monopoly power were consistently far more important.

The implications of this are crystal clear. If America competes with lower-wage countries, wages will converge to a global midpoint. I have been arguing for over a decade that globalization is regression to a global mean and this is bad news for the vast majority of high-wage nations like the U.S., Britain, France, and the Netherlands. This explains the anti-globalization votes in all those nations.

But the second point is equally important. Globalization provides a platform for poorer nations to take away our high-wage industries, condemning our workers to take the lower-wage jobs that remain, unless and until our wages get down to the global mean.

Globalization advocates repeatedly point to the lower prices that result from imports from low-wage countries. They have developed innovative mathematical methods to estimate (read: exaggerate) the benefits of lower prices to the American consumer. But a nation can only consume what it can pay for. All imports must ultimately be paid for with exports. If workers move out of high-productivity industries into lower-productivity industries, which is in fact what has happened here on average throughout the globalization years, the economy as a whole becomes less productive. We can only afford the imports we buy by borrowing more from foreign lenders. Robert Lighthizer explained this succinctly in a recent TV interview when he said: "We are transferring the wealth of our children overseas in exchange for TV sets and T-shirts."

Note the important difference between the impact of imports and technological change. Technological change replaces jobs in the U.S. with different jobs in the U.S. The rise of the Internet and Google swapped thousands of advertising jobs in traditional ad agencies for software jobs in Silicon Valley. But in the main, all the money, spending power, and jobs stayed at home, to be re-spent on more American goods and services. Imports are different. If a U.S.-made automobile is replaced with an import (and the former U.S. car-workers move to less productive jobs), then those jobs and revenue leave our nation for good. If the spending power comes back in the form of a loan, it creates no jobs but instead a financial obligation for future generations.

Most people do not appreciate this, for at least three reasons: first, economists continue to assert, in spite of all the evidence, that free trade increases national productivity. Second, they further obfuscate the reality by claiming that "winners" can compensate "losers." But as I have argued, if studies find thousands of people are losers from free trade and few studies find

[10] Ibid, pg. 1.

winners[11] then the nation as a whole is a loser, not a winner. (Of course, low wage nations are winners from this process.)

But there is a third important reason: since the early 2000s, the U.S. government, led by Federal Reserve president Ben Bernanke and others later, have taken action to stimulate our economy, so even if we are losing share in global markets and at home, our GDP rises. The effect of this is to stimulate industries that are insulated from global competition, industries where we have an effective national monopoly (such as Internet software), raise asset prices, and drastically shift our income distribution away from the middle class and towards the top 20%, 5%, 1% and 0.1%. This should not be surprising. The average U.S. textile worker once held a valuable job. Today if she exists at all, she is in competition with workers in Bangladesh or Guatemala. On the other hand, the average Google software engineer is primarily in competition only with other Americans. So inequality can only grow for a high-wage nation like the U.S.

The lower consumer prices that have resulted from globalization have made those workers insulated from global competition better off. But the long-term cost of this is a reduced growth rate as we lose high-growth industries and a growing share of our workforce moves into low-growth industries such as retail and restaurants in the private sector or education and social services in the public sector. The growing inequality of globalization, combined with the low-growth nature of the remaining jobs, and the no-growth future for hundreds of cities and towns that were once thriving manufacturing centers, especially in the middle of the country, are turning the U.S. into a powder keg of polarization and discontent. As labor economist David Autor told the New York Times last year: *"trade can have very, very disruptive effects…There's no amount of everyday low prices at Walmart that is going to make up for unemployment."*[12]

So where should the U.S. economy go from here? And where should the economics profession go from here?

In the real world, our prime goal must be long-term economic growth. Strong annual growth rates are what drove the prosperity, and the greater income equality of the American century, from 1870 to 1970. And far from being a global win-win situation, each nation must compete for the best high-wage jobs. High wages jobs are created by high-growth, high-profit, high-investment, industries. High wages are the result of those three factors. The empirical evidence is clear.

The U.S. must identify the industries that can deliver prosperity to a nation with 330 million people, and enable long-term persistent growth of domestic production, employment, and incomes. In most cases, these can be industries in which we are or have been technological leaders. We must change the policy framework to ensure that most or all of the entire supply

[11] Wonky footnote: by winners I mean people who become more productive. If your wage stays the same but imports become cheaper, you are better off but if you have not become any more productive, the nation cannot pay for those additional cheap imports you consume. It is foreign lending that masks the fact of declining national productivity. Great empires attract foreign capital. This is why empires, from the Dutch in the 1600s to the British in the 1800s to ours today, suffer this kind of decline: because financial powers seek to invest in them, accelerating their decline even while earning good financial rates of return.

[12] Quoted in Swanson, Ana, *In Washington, `Free Trade' Is No Longer Gospel,* New York Times, March 17, 2021.

chain is produced here, to enable the benefits of wealth creation in these industries to flow to their suppliers and a large number of workers, including those without college degrees and those from disadvantaged communities. The size and scale of our nation means this must include everything from steel, chemicals and cement through to high-tech products like semiconductors. And this argument is based purely on the needs of economic prosperity, before we even move onto national security concerns.

This strategy requires a degree of insulation from low-wage competitors. The government of every democratic nation has an obligation to its people to pursue the best growth path for its population. For high-wage nations, that means insulation. The end result will be nations with complementary growth strategies, instead of the race-to-the-bottom, least common denominator, growth and inequality forced on nations by unrestrained globalization.

It is not hard to identify growth or potential growth industries in the U.S. The four key characteristics can all be measured (high wages, profits, investment, and growth rate). Such industries have been the drivers of American prosperity from steel and railroads in the 19th century to software and Internet services today. The chief reason why our superstar industries today have not delivered prosperity more broadly is that most of their supply chains are located overseas. If Google's version of hardware-intensive search stimulated domestic demand for domestically produced equipment and components (as IBM's did 70 years ago), the U.S. would be both more prosperous and more egalitarian.

The significance of monopolistic competition is often misunderstood. Space limits the opportunity to go into detail here, but in a nutshell economic growth (and its handmaiden, greater income equality) has been driven in the U.S. and elsewhere by monopolistic competition (think: Ford Motor Co., GM, GE, Boeing, IBM, Xerox, etc.) The measure of a company's contribution to the national economy is its ability to increase wages directly and via its suppliers. Growth plays a vital role in enabling this. Growth companies like Google and Microsoft (and many more) could play this role if the demand they stimulated for hardware was produced domestically.

Some other dominant companies (i.e. participants in monopolistic competition) do not contribute to growth at all. Abbott Labs, in its efforts to cut costs in baby formula, is clearly not a growth company and not likely to increase wages or other key economic variables. Boeing may be in the same category today. These companies should be investigated with a view to creating a more competitive environment—out of which future growth companies are likely to arise.

Finally we must ask why economists still ignore the obvious reality that application of their standard free trade model failed to generate broad-based income gains. Why do many still turn a blind eye to the mounting evidence of the social, economic, and human costs of the globalization experiment? Some were genuinely misled by the fancy algebra. But many know their models are irrelevant. They were seduced by the surprising willingness of political leaders to believe their sophistries and appoint them to positions of money, power, and influence. The great economist Paul Samuelson, himself a lifelong skeptic of free trade, once said that economics advances funeral by funeral. Old economists find it hard to give up on the theories that made their careers.

I will give the final word to John Maynard Keynes, who was also a free trade skeptic:

> "Free trade assumes that if you throw men out of work in one direction you re-employ them in another. As soon as that link is broken the whole of the free trade argument breaks down."[13]

Author contact: jeff@prosperousamerica.org

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[13] Quoted in David Goodhart, *The Road to Somewhere,* preface, page xv (paperback edition), C. Hurst & Co., 2017.