Regionalism, Multilateralism, and Globalization

A Memo Prepared for the Conference

"The Political Economy of Globalization:
How Firms, Workers, Voters, and Policymakers Are Responding to Global Economic Integration"

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As the organizers of this project launch the construction of a survey of consumers, business managers, politicians and other relevant parties, I was invited two months ago to write a five-page "memo" on issues in the perceptions and preferences of these agents regarding regionalism, multilateralism, and globalization. In particular, the invitation suggested that this short paper should "address the ways in which the new surveys might gather data to address core theoretical questions about globalization."

My comments in this brief memo are offered in the spirit of helping to frame questions for constructing such a survey. Obviously, since I can best offer guidance from the perspective of my own research, in several sections my perspectives are (blatantly) shaped by my on-going research in those areas. To make my comments tractable, I organize my thoughts around three issues: (i) the importance of multinational enterprises vs. national enterprises in the functioning of international trade and investment in a global economy; (ii) goods vs. services in the economics of regionalism vs. multilateralism; and (iii) the potential importance of taking a panel-data approach in the project. At the outset, I note that I claim little expertise in the "politics" of political economy; instead, I will focus more on the economics of firms and workers relevant to issues on regionalism, multilateralism, and globalization.

I. International Trade, Foreign Direct Investment, and Multinational Enterprises
(or, "Can We Survey Preferences About Globalization If We Don't Yet Know **What** Globalization Is?")

The original October 2004 (Weatherhead Initiative) Conference Proposal – henceforth, Estevez-Abe et al. (2004) – noted that the proposed project has five "core (survey) components": firm leaders, workers, trade associations, labor unions, and legislators. Regarding firms, the current objective is to survey in each country 500 firms that have 200 or more employees each, i.e., "large" firms, as in Bauer, de sola Pool, and Dexter, *American Business and Public Policy: The Politics of Foreign Trade* (1963). At this stage, the stated intention of the core's survey of firms is to focus on the following:

> Survey questions will focus on firms' preferences with respect to aspects of a range of related policies – covering trade issues, immigration, foreign investment, labor market regulations, and environmental laws. Questions will address the degree to which firms are concerned about greater exposure to world markets, and whether and how they have responded. The survey will ask about firms' decisions to invest abroad and outsource, expenditures on research and development, and training and hiring practices. (p. 20)

As this survey's structure evolves, it is important to consider more modern views of the firm – in particular, recent developments in multinational firms' vs. national firms' behaviors – than is typically

assumed in the standard political economy approaches. The baseline economic model, of course, is the standard two-good, two-factor Heckscher-Ohlin (or factor-proportions) theory of trade, with the corollary Stolper-Samuelson theorem, using perfectly competitive firms and internationally immobile factors. As Estevez-Abe (2004, p. 4) state, the "alternative approach" is the *specific-factors* model which allows costly (perhaps, short-run) movement of factors between industries (but not internationally). As Estevez-Abe (2004) conclude correctly, "Much of the leading theoretical work on the political economy of trade now assumes that the specific-factors approach is the most appropriate way to think about trade policy preferences, at least in the contemporary context in the advanced economies (see Grossman and Helpman, 1994; Rodrik, 1995), but this core debate is far from settled" (p. 4).[1]

However, as is well known, this model is limited by several assumptions that – while analytically useful – might inhibit the construction of a survey of leaders of large – especially multinational – firms regarding trade and investment behavior, and might undermine the potential gains from this survey. While several limiting assumptions exist, consider just three. First, all firms are *national enterprises* (NEs); this model precludes the existence of multinational firms that can endogenously supply a market through foreign direct investment rather than trade. Second, "specific factors" are generally interpreted almost casually as either physical or human capital. There is little distinction between these assets even though, in reality, human and physical capital have considerably different purposes, especially in multinational firms. For instance, human capital tends to be used relatively intensively in the production of *firm-specific headquarters assets*, which themselves are internationally immobile but whose services can be costly transferred internationally. By contrast, physical capital tends to be used relatively intensively in the production of *plant-specific assets*. The returns to owners of these two different forms of assets may well differ, influencing responses on a survey. Third, these models typically assume a *small open economy*, even though results may differ for large economies, for which this survey seems predominantly oriented.

With the survey intended presently to be given to leaders of large firms, greater consideration might be given to considering a broader array of firm structures. The typical leader of the representative ("large") firm in this sample will likely supervise a multinational firm (MNE), which may be horizontally integrated, vertically integrated, or a "hybrid." Horizontally-integrated MNEs basically substitute investment abroad for trade due to the relative trade costs, relative investment costs, and the relative importance of headquarters vs. plant setup costs (perhaps interpretable as the relative importance of alternative "specific factors"); horizontal MNEs are concerned with market access. Vertically-integrated MNEs rely instead upon relative cost differences, with headquarters in one country (usually, a developed country) and plants in another country (usually, a developing country). Recent work has emphasized the "knowledge-capital" model of MNEs, which is hybrid model of both structures. Vertically-integrated MNEs seem to be the types of MNEs epitomized in this proposal.[2]

However, to date considerable cross-sectional evidence suggests that most MNEs are horizontally integrated, having plants setup abroad for market access, instead of serving countries with

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[1]See also, for instance, Goldberg and Maggi (1999), Gawande and Bandyopadhyay (2000), and Mitra, Thomakos and Ulubasoglu (2002).

[2]Excellent summaries of the state-of-the-art of international trade, foreign direct investment, and multinational firm behavior are found in Caves (1996), Markusen (2002), and Barba Navaretti and Venables (2004). On "hybrid" MNEs, see Grossman, Helpman and Szeidl (2003).

exports. Analogously, representative firms in the foreign surveys are most likely horizontally integrated with production facilities in the United States substituting for imports. In fact, one of the very few empirical evaluations of the recent formal models of multinational firm behavior (using a sample of countries of similar character as those proposed in this project) rejects the "knowledge-capital" model (a hybrid of horizontally- and vertically–integrated models), as well as a pure vertically-integrated model, of multinational firm behavior in favor of the "horizontally-integrated" model.[3]

Partly motivated by my own experiences teaching in executive MBA and executive development programs in a business school, I conjecture that the typical firm leader's perceptions and preferences regarding globalization will be shaped by, among other factors, the importance of R&D and "branding" costs (which are largely influenced by skilled labor inputs and headquarters' fixed costs) relative to the importance of the actual cost of a foreign direct investment (which is largely influenced by physical capital inputs and plants' fixed costs), and by transportation versus investment costs. On the former, political economy models lump physical and human capital stocks together as some "specific asset." However, the relative usages of these factors for fixed costs versus production costs matter. Human (physical) capital is likely relatively more important in the "setup" of a firm (plant), whereas evidence suggests that human and physical capital are relative *complements* in the production of final goods. Are issues like this accounted for in the survey? Moreover, standard trade models treat both physical and human capital as immobile. However, physical and human capital differ in their degrees of "mobility" across countries. In an "ownership" sense, physical and human capital may be immobile internationally; however, in a geographic sense, physical (human) capital is relatively mobile (immobile). For instance, firms actually transport equipment physically and quasi-permanently across national borders.

These issues have nontrivial concerns for the income-distribution effects of liberalization that likely influence political outcomes. For instance, in the context of a three-factor, three-good, three-country model of national and multinational firms with trade, FDI, and outsourcing, one can show that the impacts of changes in relative economic size on income distributions is sensitive to distinguishing carefully between physical and human capital in fixed and (marginal) production costs. For example, in a world with sufficiently low barriers to FDI (hence, allowing the endogenous creation of MNEs), suppose one developed country, i, is much larger than the other, j, for a given economic size in the developing *ROW*. In a world with three factors – mobile physical capital (relatively important for plant setups), immobile skilled labor (relatively important for firm setups), and immobile unskilled labor – as i's (j's) economic size decreases (increases), due to an exogenous reallocation of absolute factor endowments, the increased setup of plants owned by i's MNEs causes foreign direct investment of physical capital. However, due to the mobility of (physical) capital, the shift can actually lower the relative price of skilled labor (in terms of unskilled labor or physical capital). By contrast, in a world with only two factors – skilled (relatively important for firm *and* plant setups) and unskilled labor – the relative price of skills rises sharply in country i due to the need to serve j and *ROW* with plants rather than trade, driving national firms out of i's market (releasing workers) and sharply increasing FDI between the two countries and the importance (and employment) of MNEs. Figure 1 illustrates the large negative impact on aggregate trade in the presence of multinational firms (VTY) as country i's share of GDP decreases (moving horizontally from the RHS to LHS), with arguably large short-term impacts on employment and national firms. By contrast, Figure 2 illustrates the *positive* initial impact on aggregate trade (in final or intermediate goods) as country i's share of GDP decreases (from the RHS to LHS). The

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[3]See, for example, Carr, Markusen, and Maskus (2003), Blonigen, Davies and Head (2003), and Markusen and Maskus (2002).

same GDP-share change in the two models has a pronounced destructive impact on national firms, their employment levels, and trade in Figure 1. Thus, relative factor returns can differ sharply depending upon the subtle distinctions between physical and human capital in these models.[4]

My message in this section is that a useful survey of firm managers should account for the complexity of firm structures that likely dominate large firms in the global economy today. Trade economists have largely focused on "globalization" in the superficial context commanded by where the – *customs* – data has most conveniently (or with least cost) led them: *international trade*. However, the scope raised in this project is appropriately broader: international trade, international investment, immigration – the movement of goods, capital, and labor. This is certainly a more appropriate breadth for understanding globalization. However, at this juncture, the proposal seems still constrained by two important issues. First, globalization goes beyond the integration of goods, capital and labor markets; it is the full integration of two "societies," in terms of political, social, and cultural norms. Second, and the point emphasized in previous pages, we have accrued a fairly rigorous understanding of international trade and evidence to confirm it. Our knowledge of the *simultaneous* determination of trade, capital, and labor flows (especially, by MNEs) is weaker; however, much of that knowledge could be incorporated more fully and productively into framing the questions for the survey of firms.

II. Goods and Services, Regionalism and Multilateralism
   (or "Do We Really Know Much about *Trade Costs*?")

Since the end of World War II under the GATT and WTO, trade policy has *never* been "first-best." One might argue that the multilateral liberalization of international trade under several rounds of GATT has been first-best, and consequently, by construction, has been preferable to the flurry of regional integration agreements over the past 30 years, but I would argue that the rounds of multilateral liberalizations have been essentially second-best approaches. As Lawrence (1996) has noted:

> The postwar experience with both multilateralism and regionalism has been mixed. On the one hand, the multilateral trading system has enjoyed spectacular success in lowering trade barriers on *industrial products*. . . . As the focus has shifted away from the relatively easy task of reducing barriers protecting industrial products, achieving agreement has become more difficult. . . . In many important areas, *such as services* and agriculture, liberalization has remained fairly limited. (p. 5; italics added)

Put simply, regionalism has been a second-best policy that has generally sought greater sectoral breadth and depth of integration across goods and services than multilateralism, but has limited itself geographically. By contrast, multilateralism has been a second-best policy that has sought a wider array of countries, but has been more limited in terms of sectoral breadth and depth.

While this appraisal may well be accepted readily by some, for the purposes of constructing a sharper set of survey questions for firms, it might be useful to have a somewhat more rigorous representation of this argument. Consider a world with four countries, two on each of two continents. Countries on the same continent are separated physically by an "intracontinental" transport (or, more generally, transactions) cost, while countries on different continents are separated by an additional

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[4]See Bergstrand and Egger (2005) for details.

"intercontinental" transport cost. The model is very similar to the geography-based economic model in Jeffrey Frankel's book, *Regional Trading Blocs* (1997).[5] However, our model extends this to two sectors, goods and services, allowing asymmetries between these two *industries*. There are two notable distinctions between goods and services industrial structures relevant to regionalism, multilateralism, and globalization: relative transportability and relative national regulations. These factors should be addressed in any survey.

To the extent that national consumers' welfare matters to policy makers, the proclivity towards regionalism vs. multilateralism can be readily seen by accounting for three factors. First, services are relatively more expensive to transport than goods. Second, services provided by foreign firms tend to be regulated at a higher level of intensity than domestic firms. Services trade is protected almost exclusively by nontariff barriers, as surveyed in McCulloch (1988), Sapir and Winter (1994), UNCTAD (1994), Fieleke (1995), Hoekman and Primo Braga (1997), and Hoekman (1999). As Fieleke (1995) writes:

> Examples of these barriers are rife. By way of illustration, suppliers are impeded from traveling to receivers by limits on the inflow of temporary workers for construction projects, or by limits on domestic practicing by foreign professionals, such as physicians. Receivers are hindered from going to suppliers by measures that obstruct their traveling abroad for purposes such as tourism or education. Cross-border movement of services themselves is restricted by limitations on foreign content in radio and television broadcasting and in the cinema. As for the provision of services through affiliates, many governments have strictly controlled direct investment by foreigners in sensitive domestic industries such as transportation, telecommunications, banking and advertising. (p. 33).

Finally, as has been noted earlier in the context of Lawrence (1996), goods' trade barriers (tariffs) have been relatively less costly to liberalize multilaterally than services' (nontariff) trade barriers.

The relatively greater transportability of goods and the relatively lower trade restrictions on goods – combined with the relatively lower cost of negotiating goods' trade liberalization – has pronounced potential implications for the relative benefits of *regionalism* in goods and services vs. *multilateralism* in goods. Figure 3 illustrates that at higher relative transport costs for services compared with goods, a regional free trade agreement (FTA) in goods and services is welfare superior to a multilateral free trade agreement in goods alone. The combination of these three factors can help explain the relative growth of regionalism vs. multilateralism.[6]

It would be very useful to find from managers' perspectives if these factors have been important in their views of regionalism vs. multilateralism. Many perceptions of regionalism, multilateralism, and globalization will hinge upon "relative trade costs." As Anderson and van Wincoop (2004) have noted, these costs are likely even much higher than most have conjectured, even with regard to trading *goods* – much less services. The survey needs to solicit information about these costs. How high do managers think these costs are for "natural" trade costs? For "artificial" (policy-induced) trade costs? There is likely enormous heterogeneity in such costs between goods and services industries, not to mention *across* industries within each group. How have these costs impinged upon managers' views of globalization?

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[5]For details, see Baier and Bergstrand (2001).

[6]This argument is in the spirit of a "transaction-cost perspective," cf., Dixit (1996).

III. Why Are We Asking These Questions?
     (or, "The Importance of Panel Data")

This project is likely to have much more impact if it can be constructed as a *panel study*, akin to the *Panel Study on Income Dynamics* (PSID), which studies income distribution issues across many countries. No mention of panel vs. cross-section was mentioned in the Project Description. Why is this so critical?

One of the startling – and most limiting – aspects of the Bauer, de Sola Pool, and Dexter study, *American Business and Public Policy: The Politics of Foreign Trade* (Bauer et al., 1963), the stated forerunner of the present project, was the focus on a cross-section of observations. I think the first question one must ask in launching this program, before establishing *what* questions to ask, is: *Why* are we asking these questions? The answer is, I expect, to evaluate empirically our *causal* theories. As suggested in the introduction, we are gathering information to address core theoretical questions about globalization.

In the last 10 years, in empirical evaluations of determinants of trade and of trade policies, one of the most notable aspects has been the evolution from cross-sectional to panel analysis. This is not just because of the increased prevalence of panel data, but also increased knowledge of the *econometrics* of panel data, cf., Wooldridge (2002). For decades, economists (and likely political scientists) have used cross-sectional estimates of relationships to infer causality concerning long-run relationships between economic and/or political variables. In 1970, Robert Stern and Ed Leamer wrote an outstanding book titled *Quantitative International Economics*, which unfortunately was never updated (even though it is a classic). At that time, they distinguished between the *short-run* economic relationships likely identified by *time-series* analysis versus the *long-run equilibrium* economic relationships likely identified by *cross-section* analysis. Much of my own work in the 1980s on determinants of trade flows in the gravity equation (Bergstrand, 1985, 1989) was premised theoretically on long-run equilibrium economic relationships.

However, I have increasingly come to accept that the importance of *simultaneity bias, omitted variables bias,* and (in many relevant cases) *selection bias* simply results in very unreliable estimates of certain economic and political relationships using cross-sectional data. While my own work in the 1980s focused on long-run equilibrium relationships that should hold in cross section, I have been examining in detail more recently methodological issues associated with estimating *ex post* the (average treatment) *effects* of free trade agreements on trade flows. In the context of my own work with Scott Baier (2004a) and also the work of Ed Mansfield with Helen Milner and others (Mansfield et al., 2002, 2003, 2004), there is a growing literature on determinants of bilateral trade agreements, similar in spirit to earlier work on political and economic determinants of tariff rates. In Baier and Bergstrand (2004b), Scott and I found evidence of very significant *endogeneity bias* in the estimation of the effects of free trade agreements on trade flows, likely introduced by selection bias. That is, *unobservables* that influence trade flows likely also influence strongly the presence or absence of a free trade agreement. Consequently, there is an omitted variables/selection bias in the estimated effect of a free trade

agreement (dummy) on trade.[7] We provide evidence that – after accounting for selection bias – estimates of the effects of a free trade agreement on trade flows is at least *five times higher*. The OLS estimate of free trade agreements' impacts on trade flows in our paper is only *13 percent*. By contrast, including theoretically motivated fixed effects, the average effect of a free trade agreement rises to *97 percent.*

To anticipate my discussant on this short paper, Tomz, Goldstein, and Rivers (2005) recently found very similar justification for relying upon within variation, compared to between variation, of a panel. Interestingly, they find that the effect of a free trade agreement was biased upward in their sample. We note that they used the Andrew Rose data set including nearly 80 more countries (178 vs. our 100) and employed Rose's specification, which differed from ours. Yet, interestingly, once bilateral-pair ("dyad-specific") fixed effects were introduced – which eliminated several of the specification differences between Baier and Bergstand (2004b) and Tomz et al. (2005) – the average treatment effect (ATE) of a free trade agreement in Baier and Bergstand and in Tomz et al. essentially converged to identical values of approximately 100 percent (Baier and Bergstrand's coefficient estimate was 0.68, implying an ATE of 97 percent; Goldstein et al.'s coefficient estimate was 0.76, implying an ATE of 114 percent).

Moreover, a recent study on "Income and Democracy," Acemoglu et al. (2005), re-examines a long-held notion based upon cross-sectional analysis that higher per capita income "causes" democracy and underscores the importance of within vs. between variation. Acemoglu et al. (2005) run a battery of tests using panel data, and provide strong evidence that higher per capita income does not "cause" democracy, as has been found traditionally.

The point is: the potential importance of panel data and the use of fixed effects should not be underestimated. Proper estimation using panel techniques allowed studies such as mine and Tomz et al. to narrow dramatically the range of estimates of average treatment effects; by contrast, cross-section estimates of these same effects vary dramatically. The Acemoglu et al. (2005) study confirms the importance of panel estimates with regard to another standard issue. I conjecture that unobserved heterogeneity is likely *even more important* as we move to firm- , consumer-, and politician-specific measures, warranting the importance of a panel approach.

IV. Various and Sundry Issues

A. Quantity vs. Quality

The CATO Institute recently released an analysis of the voting records on 23 bills in the past (108th) U.S. Congress regarding trade policy, 12 votes in the House and 11 in the Senate, cf., "Free Trade, Free Markets: Rating the 108th Congress," (Griswold, 2005). In noting "clues" to the current (109th) Congress, the author discusses the three new senators. The website of Mel Martinez (R-FL) states:

> I support free trade measures that will create more jobs and provide new economic opportunities for Florida's workers. Trade must also be fair so that Florida's businesses and workers can compete on a level playing field in the global market (p. 15).

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[7]To a limited extent, this emerging literature is similar, though not identical, to work on the simultaneity bias in estimates of tariff rates on multilateral trade volumes and of trade volumes on tariff rates.

More jobs. A higher number, not different higher-paying jobs. This statement is all too typical. After 85 years of the Heckscher-Ohlin model of international trade, I find the gap between individuals' knowledge of the potential economic gains from trade liberalization theoretically and practically startling. Good economists have argued for decades that the gains from international trade liberalization are efficiency gains, that is, the gains from increased specialization – *not more jobs!* The consistency of discussion of this across a wide spectrum of undergraduate (and graduate) international economics texts validates that there is scarce ambiguity in terms of the potential benefits of more liberalized trade (at least in the context of perfectly competitive and monopolistically competitive theoretical trade models).

So why is it that a politician elected to the most eminent elected body in the United States chooses to claim that trade liberalization will increase the *number of jobs* when this is simply in *stark contrast* to the perceived wisdom of international trade and trade policy. I feel this dichotomy is a *critical question* that needs to be confronted solidly in a survey soliciting perceptions of consumers, business leaders, politicians, union members, and trade association representatives.

B. The Quality of Jobs: Trade Liberalization vs. Technological Change

Assuming full-employment in the long-run, the benefits from trade liberalization arise for industrialized countries from increased specialization in the production of goods (and services) that use relatively intensively as inputs physical and human capital (these countries' relatively abundant factors). This increased specialization, of course, allows industrialized economies to consume even further beyond their production possibilities. However, technological change has very similar implications. Moreover, most technological change historically has been skill-biased, having *virtually identical* economic implications as trade liberalization, cf., Feenstra and Hanson (2003).

An anomaly is that trade liberalization generates much more opposition among consumers, business persons, and politicians than technological change. *A fundamental survey issue is: Why are these two forces viewed differently?* Is skill-biased technological change simply perceived as more "exogenous" than trade policies? Do consumers, business people, and politicians view these two sources of consumer welfare enhancement as different? Are the differential biases in perceptions due to the perceived relative unimportance of the gains from specialization?

C. Inside vs. Outside the PPF: The Asymmetry of Job Gains vs. Job Losses

Economists and political scientists have embraced the potential benefits of trade liberalization and globalization for decades. And while both are aware of the "short-run" costs of trade liberalization (i.e, unemployment), it is widely believed that these short-run costs are well worth the long-run benefits. *But are they?* Until recently, there have actually been quite few *reputable* studies of aggregate short-run adjustment costs relative to long-run benefits. An authoritative recent paper on this issue, Davidson and Matusz (2003), notes that estimates of *aggregate* (as opposed to industry-level) adjustment costs are *rare*. They cite well-known studies by Magee (1972) and Baldwin, Mutti, and Richardson (1980) that estimate the discounted value of such costs as roughly only 5 percent of the long-run gains.

However, methodological developments in the past couple of years suggest that many of the "short-run costs" such as the time and resource costs involved in re-training dislocated workers, the job-

search process, and other "adjustment" costs due to trade frictions, congestion externalities, and informational asymmetries associated with "equilibrium" unemployment. With time costs accounted for, the short-run adjustment costs have been estimated to be 10-15 percent of the long-run benefits. With time *and retraining* costs accounted for, short-run adjustment costs can be anywhere from *30 to 80 percent* of the long-run benefits. That is, the short-run costs might even offset the long-run benefits.

Is this the concern that households, politicians, and union leaders have about trade liberalization? What would these parties views about globalization be with more definitive knowledge about the potential *adjustment* costs? Have trade economists misguided the public?

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Figure 1: Markusen (2002), p. 99
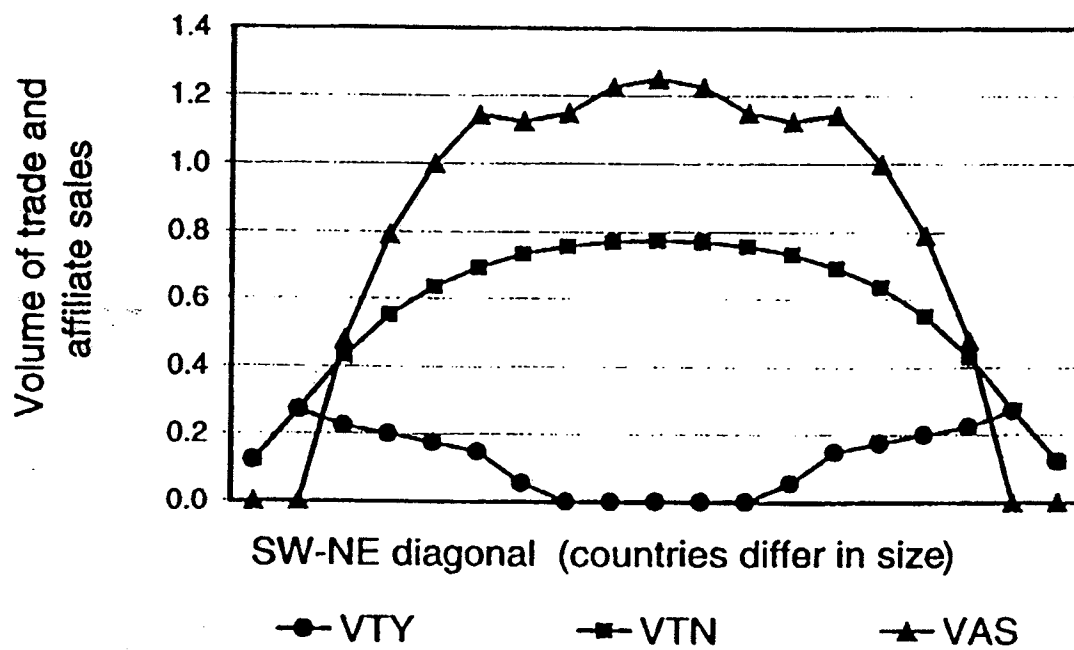

Figure 1: Markusen (2002), p. 99

Figure 2a: Volume of Final Goods Trade, Foreign Affiliate Sales and FDI (i and j Large, No Intermediate Goods Trade)
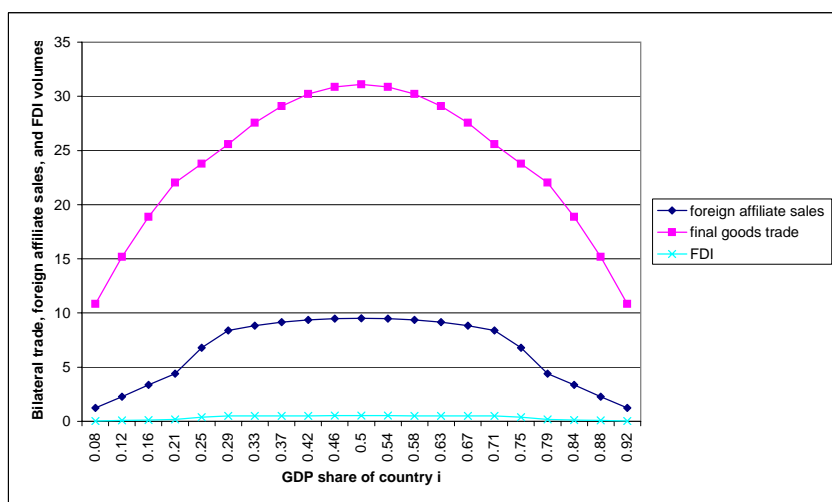

Figure 2b: Volume of Final Goods Trade, Foreign Affiliate Sales and FDI (i and j Small, No Intermediate Goods Trade)
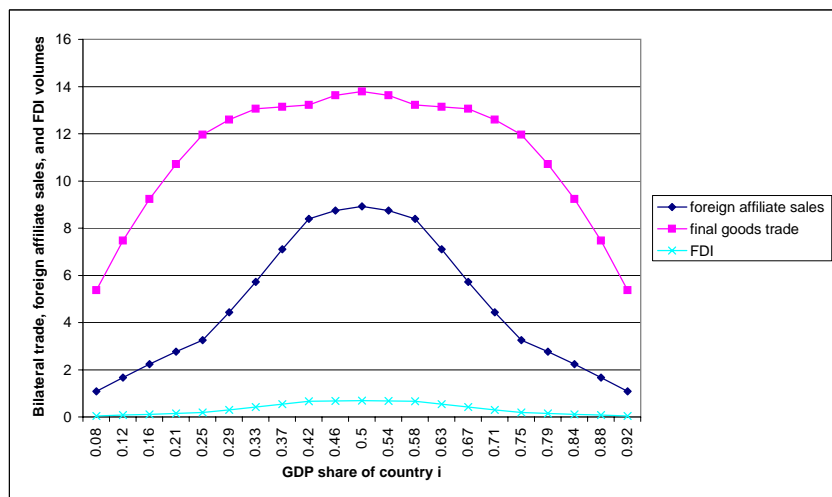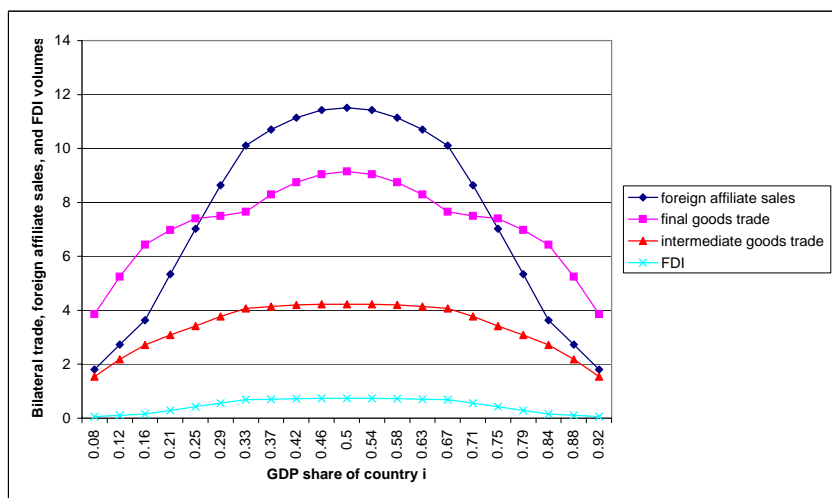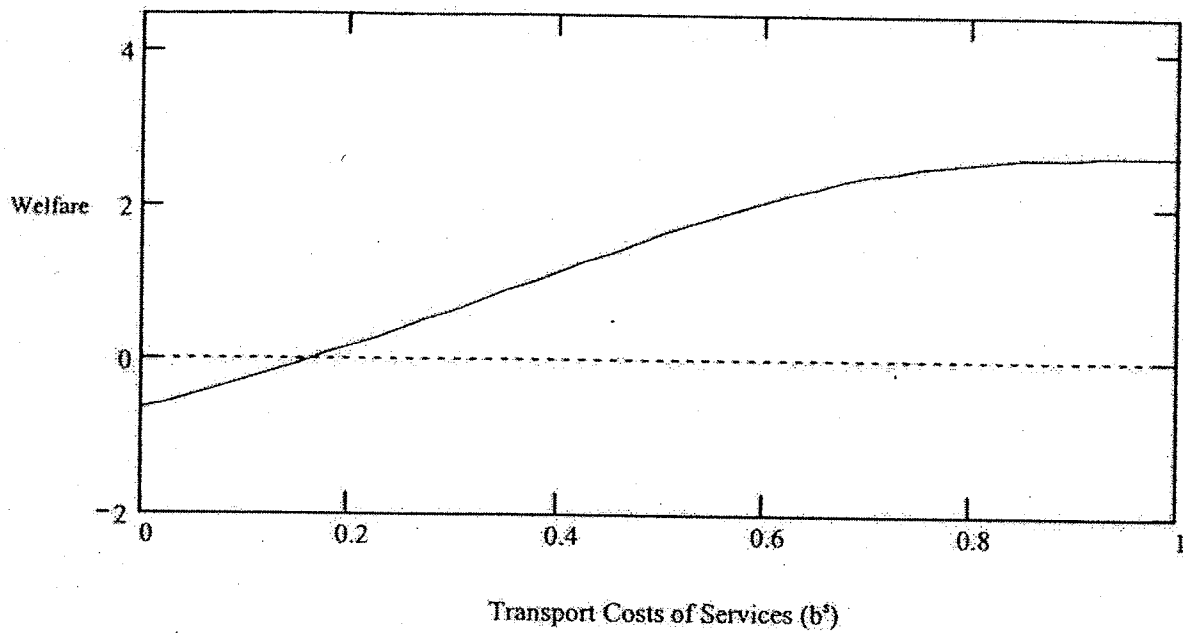

Figure 2c: Volume of Final and Intermediate Goods Trade, Foreign Affiliate Sales and FDI (i and j Small)

Figure 3. Percent Change in Utility from a Regional FTA in Goods and Services Versus a Multilateral FTA in Goods

Transport Costs of Services (b^s)

Assume $b^g=0.1$, $t^g=0.3$ initially, and $t^s=0.6$ initially.