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The Economics of Outsourcing: How Should Policy Respond?

Abstract

Outsourcing is a central element of economic globalization, representing a new form of competition. Responding to outsourcing calls for policies that enhance national competitiveness and establish rules ensuring acceptable forms of competition. Viewing outsourcing through the lens of competition connects with early 20th century American institutional economics. The policy challenge is to construct institutions that ensure stable, robust flows of demand and income, thereby addressing the Keynesian problem while preserving incentives for economic action. This was the approach embedded in the New Deal, which successfully addressed the problems of the Depression era. Global outsourcing poses the challenge anew and calls for creative institutional arrangements to shape the nature of competition.

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I The outsourcing controversy

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

Understanding offshore outsourcing involves two distinct exercises. The first involves understanding the phenomenon, while the second is assessing its likely empirical impact. The focus of the current paper is on the phenomenon. Outsourcing is represented as a central element of globalization, and policymakers need to understand its economic basis if they are to develop effective policy responses.

The paper maintains that outsourcing should be viewed as a qualitatively new phenomenon that is to best understood as a new form of competition. Responding to it calls for the development of policies that enhance national competitiveness and establish new rules governing the nature of global competition. Viewing outsourcing through the lens of competition connects with early 20th century American institutional economics. The policy challenge is to construct institutions that limit retrograde competition while preserving incentives for economic action. At the same time, these institutions must promote stable flows of demand and income, thereby addressing the Keynesian problem of inadequate aggregate demand. This was the analytical foundation of the approach embedded in Franklin Roosevelt's New Deal in the United States, and it gave rise to a wave of economic prosperity after World War II. Global outsourcing represents a new economic challenge that calls for a new set of institutions. Addressing such challenges is always difficult, but the challenge of global outsourcing is compounded by lack of global regulatory institutions and changes in the balance of political power that make it difficult to enact needed reforms.

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

II. The economics of outsourcing

By way of beginning it is worth defining the meaning of some terms widely used in the outsourcing debate. Sourcing represents sources of supply, and these sources can be domestic or global. Outsourcing represents taking an activity that was previously produced within the boundaries of the firm, and having it sourced (supplied) from outside the firm. Offshoring represents moving an activity that is produced within the firm to another country, but the activity continues to be produced within the firm in an international subsidiary. Finally, offshore outsourcing represents taking an activity that was previously produced within firm, and having it both sourced from another country and produced by an outside supplier. Both offshoring and offshore outsourcing can contribute to national job loss. The difference is that in the former case the activity continues to be produced within the firm, whereas in the latter case it is moved outside the firm. Over the last several decades there has been an ongoing outsourcing revolution as firms have redefined their production competencies. Initially, this revolution took the form of domestic outsourcing, and it was widely associated with the phenomenon of sub-contracting. More recently, it has taken the form of offshore or global outsourcing as firms have shifted to relying on foreign suppliers.

Offshoring and global outsourcing are empirically and theoretically contested phenomena. At the empirical level the problem is how to assess their empirical significance. Mankiw and Swagel (2006) adopt a "job count" approach in their assessment of the impact of outsourcing on the American economy, and argue that the number of jobs outsourced is relatively small compared to the total stock of jobs. For instance, they cite a Forrester Research report (McCarthy, May 2004) estimating that 830,000 U.S. jobs would be moved offshore by the end of 2005, while Goldman Sachs calculate that between 15,000 and 30,000 jobs are currently being offshored monthly. They claim that this is small relative to total U.S. employment of almost 135 million, and therefore conclude that the significance of employment offshoring has been blown massively out of proportion.

There are two problems with this naïve job count approach. The first less important problem is that the volume of outsourcing may increase significantly in future as firms become more globally active. This possibility was noted in the Forrester

Research report, particularly as regards services. It has also been emphasized Blinder (2006) who documents the potentially wide array of future jobs that might be offshored.

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

This observation leads into the theoretical controversy surrounding offshore outsourcing. Supporters of outsourcing interpret it as a natural extension of the motivation for trade. Just as the boundary between domestic market and non-market activities may change over time owing to technological innovations, so too the boundary between internationally traded and non-traded goods may change. From this perspective, technological advance has turned goods and services that were previously internationally non-tradeable into goods and services that can now be internationally traded. The international application of the principle of comparative advantage to the production of these newly tradeable goods and services can therefore yield additional gains from trade.

This conclusion regarding outsourcing and gains from trade has recently been challenged by Gomory and Baumol (2000) and Samuelson (2004). These authors use pure trade theory to examine the question of international catch-up, and they conclude that a country can lose if the catch-up takes place in the export industry of the advanced country. In this case the advanced country suffers an adverse terms of trade effect because the global supply of its exported product increases.

Though logically watertight, one problem with the Gomory-Baumol-Samuelson critique is that it focuses on export-sector related developments, whereas most of the concern about outsourcing seems to relate to potential developments in the service sector. Additionally, their critique of outsourcing is static in nature, focusing on changes in equilibrium patterns. An alternative institutionalist approach is to view outsourcing through the lens of competition. Such an interpretation sees it as changing the competitive process governing trade, giving rise to a new competitive regime in which both structure of bargaining power and the margins of competition (those areas where companies and countries compete) are changed.

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

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

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

Stage one of the U.S. retail revolution started 40 years ago with the emergence of large-volume discount stores like Wal-Mart, which was created in 1962. Initially, the business model was based on national sourcing, with the big-box stores buying from the cheapest national manufacturer. Such stores pitted producers against each other nationally, so that companies in New York were forced to compete with those in California. This new national rivalry provided lower prices, and it was largely beneficial because all suppliers were located in the United States and operated under broadly similar laws. However, even then there were negative effects, as the new competition encouraged manufacturing to move south to nonunion “right-to-work” states where organizing

[1] The seminal article on the emergence of this sourcing model is Gereffi (1994). The use of this sourcing model by the retail sector is documented by Hamilton (2005).

workers was more difficult and labor costs were lower.

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

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

Outsourcing can be viewed as an application of the retail sector's global sourcing model to manufacturing. In effect, manufacturers are now also looking to source globally, and they too are asking their suppliers to meet the "China price." The development of global sourcing is exemplified by the American auto component giants, Visteon and Delphi. Initially spun off from their respective parent companies, Ford and General

Motors, Visteon and Delphi engaged in national competition. In 2005, Ford and General Motors both announced that they were shifting to a global sourcing model and that their spin-offs would in future have to meet the China price if they wished to keep business. Given their higher union wages and benefits, both Visteon and Delphi have been shedding jobs and shifting production offshore, including to China. However, both have found it increasingly difficult to compete, and Delphi filed for Chapter 11 bankruptcy in October 2005.

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

The maturation of globalization can be viewed as combining the developments of the last several decades into a highly synergistic system. There are four elements to this mature system. The first element is the global sourcing model discussed above, which was initially developed in the retail sector and is now being applied everywhere. The second element is the mobility of capital, technology, and methods of production. This mobility is rooted in the MNC experience with foreign production platforms, and it also links with technological innovations that have facilitated the transfer of technology and the international coordination of business activity. The third element is international economic policies that have dismantled trade barriers and promoted international economic integration, thereby bringing down the cost of moving goods across borders. Technology, in the form of lowered costs of transportation, has had a similar impact by also lowering costs of moving goods over long distances. The fourth element of mature globalization is the addition of two billion workers to the global labor market, given the end of economic isolationism in India, China, and the former Soviet bloc countries.[2]

Whereas the initial era of globalization (1945 – 1980) was one of classical free trade involving the movement of goods across international boundaries, the new era (since 1980) also includes mobile capital and technology. Consequently, all countries have access to similar methods of production, so cost arbitrage (especially wage arbitrage) becomes a critical driver of the system.

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

III Institutionalism versus Neo-classical trade theory

Such an equalization process shares some common features with the Stolper – Samuelson (1941) theorem of neo-classical trade theory. According to that theorem,

[2] Freeman (2004) has emphasized the significance of the addition of 1.5 billion workers to the global labor market. The end of economic isolationism in China, India, and the former Soviet bloc added three billion persons to the global economy, of which approximately half are economically active. However, Freeman believes that globalization is being driven by classical comparative advantage, so the wage effects of increased global labor supplies can potentially be offset by the production gains that come from reallocating global production in accordance with the principle of comparative advantage.

when a rich capital-abundant country engages in free trade with a poor labor-abundant country, wages in the rich country fall. The Stolper-Samuelson effect emphasizes the income distribution impacts of trade, and it is modeled in a world in which countries share the same technology, perfect competition rules, there is full employment, and international production is determined according to the principle of comparative advantage.

Globalization adds greater realism to the assumption of shared technology, and it therefore strengthens the relevance of Stolper-Samuelson. Globalization has also been associated with a fall in the cost of transportation – which is a form of sand in the wheels of trade – and this too strengthens the Stolper-Samuelson effect. Lastly, by making capital mobile between countries, globalization tilts the Stolper - Samuelson effect (which is derived under the assumption of capital immobility) toward full-blown neo-classical factor price equalization. This is tantamount to putting the Stolper—Samuelson effect into hyperdrive.

The above wage and income distribution features of neo-classical trade theory are consistent with institutionalist logic. However, there are also significant differences between the two perspectives, and these differences mean that the neo-classical Stolper – Samuelson and factor price equalization results only partially capture institutionalist concerns. First, whereas neo-classical trade theory assumes full employment, an institutionalist perspective allows for less than full employment. Consequently, offshoring can have unemployment effects that impact both prices (including wages) and quantities. Second, an institutionalist perspective denies that global production is necessarily organized around the principle of comparative advantage. Instead, global production is organized on the basis of competitive advantage. This may coincide with comparative advantage, but there is no automatic presumption that it will. This raises questions about automatically assuming that offshoring automatically raises global productivity since highly productive facilities can be closed and replaced by less productive foreign facilities because of nominal cost differences. Third, the neo-classical Stolper – Samuelson and factor price equalization results are derived in the context of perfect competition, whereby economic power is completely absent. From an institutionalist perspective power is always present, and globalization has changed power relations by giving firms greater exit options. This shift has increased firms' power versus both labor and governments, with the shift in power being brought about by new institutional patterns of competition based on new business models, technologies, and changed economic policies. Finally, institutionalists view economic activity as always taking place in the context of laws, regulations, and business customs. These facets of business life are absent in the neo-classical model with perfect competition, and that model therefore misses how global outsourcing allows firms to arbitrage the regulatory and business environment. In effect, globalization creates new margins of competition.

IV Macroeconomic consequences of changing global competition

The changed microeconomic competitive conditions associated with globalization have significant macroeconomic implications. A first implication concerns income inequality, which has increased in almost all countries (Milanovic, 2005). Within the U.S. this increase has occurred in two stages. During 1980s and 1990s the wage – profit share was largely unchanged but family income inequality increased, suggesting changes in the distribution of wages favorable to upper-income managerial workers. This has been followed since 2000 by a significant increase in the profit share.[3]

A second implication concerns the structure of global demand. The new global sourcing model encourages companies to shift production offshore and export back to their home base. In developing countries there is an incentive to keep wages down de spite productivity growth in order to retain international competitiveness, as exemplified in Mexico where real wages have stagnated over the past twenty years. These pressures retard domestic demand and the emergence of a large middle class. Consequently, developing countries are compelled to rely on export-led manufacturing growth whereby they sell to developed countries rather than developing domestic consumption markets.

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

Though the new competitive global microeconomic structure has contributed to low consumer prices that have benefited Northern consumers, it has also been adversely transforming the structure of income and aggregate demand generation. In the U.S. there

[3] The increase in global income inequality, within and between countries, is documented by Milanovic (2005). The increase in U.S. family income inequality is documented by Mishel et al. (2006). Krugman (1995) attributes 10 percent of the increase in U.S wage inequality in the 1970s and 1980s to trade. Cline (1997) attributes 37 percent of the increase to trade. Palley (1999a) examines overall income inequality using the U.S. family income gini coefficient, and reports that 24 percent of the increase in inequality between 1980 and 1997 is directly attributable to increased openness, and this rises to 34% if the negative effect of trade on union density is taken into account. Kletzer (2001) has documented the direct wage losses of those actually losing jobs owing to trade.

has been a gradual hollowing out of the middle class.[4] In the global South, a surplus labor condition combined with South – South competition for Northern export markets has retarded Southern wage growth that could provide the future foundation for global aggregate demand. With global supply growing as a result of export-led manufacturing growth, this configuration carries the risk of global deflationary pressures.[5]

Thus far, these adverse macroeconomic developments have been kept at bay by rolling stock market and housing price bubbles, and by increased access to credit for consumers. In the U.S. particularly, these developments have enabled households to maintain consumption spending, thereby maintaining global aggregate demand. However, ever-rising debt-to-income ratios are not sustainable as this produces rising debt service burdens. Similarly, asset price inflation significantly in excess of the general rate of inflation is also not sustainable as this produces excessive asset valuations. This suggests that these trends must slow or even reverse, and when that happens the global economy could suffer a severe recession owing to accumulated financial imbalances and inadequate aggregate demand. Moreover, recovery from such a recession could prove difficult because of large debt over-hangs and permanently atrophied structures of income and demand generation.

IV How should policy respond? Rediscovering Keynesian and Institutionalist economics

The current model of globalization brings low consumer prices as advertised.

[4] The hollowing of the middle class is documented by Mishel et al. (2006) who show how family income inequality has increased (p.54-65) and the relatively more rapid expansion of low-paying jobs (p.166-69). They explain these trends as a result of trade and union decline, and express skepticism that they are due to a shift in demand toward high-skilled workers (p.169-200), which is the conventional neo-classical explanation (Levy and Murnane, 2004).

[5] The global deflationary risks of export-led development are explored in Palley (2003) and Blecker and Razmi (2005).

However, it delivers low prices at the high cost of undermining the structure of income and demand generation. Today’s economic conditions have hints of the 1920s, a decade marked by a credit-driven boom in U.S. and relative stagnation in the rest of the world. Meanwhile, income and wealth inequality in the U.S. have returned to levels that prevailed in the 1920s (Wolff, 2001). This raises the possibility of a new era of global economic stagnation, that in a worst case scenario could replay problems similar to those that afflicted the global economy in the 1930s.

The problems of the Depression era were solved after World War II by application of new economic ideas developed in the 1930s. These ideas have continuing relevance in the era of globalization. Unfortunately, the economic success that ensued in the thirty years after World War II contributed to a belief that the economic problem had been permanently solved and that the policies and institutions adopted after the Depression were no longer needed. The result has been a gradual expunging of the thinking forged in the Depression, and economic theory has slowly drifted back to the economics of the pre-Depression era. Carried by this tide, economic policy makers have been persuaded to create a modern variant of the pre-Depression era economy under the rubric of globalization.

One lasting contribution of the 1930s is associated with the British economist John Maynard Keynes, who identified the importance of aggregate demand for determining the level of employment and output. In the Keynesian model, unemployment can result from reduced household and business spending. At best, free markets are slow to remedy such conditions, and at worst they can get trapped with permanent high unemployment.

Keynes recognized that the price system does not automatically generate sufficient demand, and what works in individual markets does not automatically work for the economy as whole. In individual markets, lower prices make a good relatively cheaper thereby providing an incentive to switch spending from elsewhere. However, this does not work for the economy as a whole because all prices are falling. Indeed, the process can even work in reverse because falling prices increase debt service burdens of businesses and households that are debtors, thereby potentially lowering total demand and bankrupting the banking system. Consequently, there is a reason for policy to step in and stabilize demand through monetary (interest rate) and fiscal (government budget) policy.[6]

A second vital intellectual contribution came from American institutionalist economists, the leading lights of which were John Commons, Thorsten Veblen, and Wesley Mitchell. Institutionalists emphasized the importance of the nature of competition and the problem of destructive rivalry—what Commons (1909, 68-69) termed the "competitive menace." This idea resonates with today's notion of the "race to the bottom." What appears to maximize well-being from an individual perspective can be suboptimal once the competitive interplay of actions is taken into account.[7]

Institutionalist thinking constructs the policy problem in terms of "regimes of competition," with some regimes promoting societal welfare better than others. In the 1930s, President Franklin Roosevelt's New Deal policies embodied much institutionalist thinking. In combination with the adoption of a Keynesian macroeconomic stabilization policy, the New Deal eventually solved the crisis of the Depression era and made way for

[6] Tobin (1975, 1980) and Palley (1999b) have examined why generalized price deflation can be unstable.

the prosperity that followed World War II. The innovations of the period included new labor laws establishing the right to organize, the minimum wage, the 40-hour workweek, and the right to overtime pay. In the financial realm, creative reforms included the establishment of the Securities and Exchange Commission to oversee financial markets. Today's challenge is to come up with a similarly innovative set of arrangements that addresses globalization and outsourcing.

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

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

Another area requiring new institutional arrangements is exchange rates. Here, the

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[7] Atkinson (1997) has also emphasized the relevance of American institutionalist economic thinking for understanding globalization.

need is to prevent countries from using undervalued exchange rates as a means of competing. Engaging in competitive devaluation is a form of beggar-thy-neighbor economics wherein countries rely on demand in foreign markets rather than building domestic markets. Undervalued exchange rates are an unfair subsidy that distorts the pattern of trade. They also risk causing global deflation because they promote increased supply of exports without increasing global demand.

With regard to national competitiveness, countries need to invest in education that raises worker productivity. There is also a need for job loss assistance and active labor market policies that help displaced workers cope with income losses and obtain training that prepares them for productive future employment. In this regard, a system of wage insurance that insures workers against wage losses from job displacement, such as that proposed by Kletzer and Rosen (2005), can help. More generally, a full-blown "flexicurity" social safety net such as that operated in the Nordic countries is desirable. Such a system protects workers against economic losses associated with economic change, thereby making them open to accepting and living with change (The Economist, 2006).

In the United States there is a special need to attend to the problem of health insurance, which is currently a job cost, since premiums are tied to employment. This crisis is exemplified by General Motors, where the cost of each car made in its U.S. plants includes $1,500 of worker health insurance. Health insurance coverage needs to be detached from jobs, and this suggests a national health plan financed out of general tax revenues.

All of these proposals point to the need for enhanced government provision of insurance and social safety nets. However, as documented by Rodrik (1997), the regulatory and tax arbitrage that is promoted by globalization and global outsourcing undercut government's ability to provide such services. Thus, Rodrik (1997, p.57 – 67) reports that country economic openness negatively impacts government social spending, negatively impacts tax rates on capital incomes, and positively impacts tax rates on labor incomes. These findings support claims of how globalization has tilted the balance of power in favor of capital, and they also implicitly confirm the need for international cooperation to combat tax competition.

IV. Conclusion: the politics of policy response

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

Historically, political economy has been constructed around the divide between capital and labor, with firms and workers at odds over the division of the economic pie. Within this construct, labor is usually represented as a monolithic interest, yet the reality is that labor has always suffered from internal divisions—by race, by occupational status, and along many other fault lines. Neo-liberal globalization has in many ways sharpened these divisions to labor's disadvantage and capital's benefit.

One of these fault lines divides workers from themselves. Since workers are also consumers, they face a divide between the desire for higher wages and the desire for lower prices. Historically, this identity split has been exploited to divide union from nonunion workers, with anti-labor advocates accusing union workers of causing higher prices. Globalization amplifies the divide between people's interests as workers and their interests as consumers through its promise of ever-lower prices. Low prices do indeed yield benefits, but against this must be balanced globalization's impact on wages, work conditions, and the balance of political power.

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

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

Balanced against this, globalization also impacts capital, creating a new split between bigger internationalized firms and smaller firms that remain nationally centered. Larger multi-national corporations that have gone global benefit from cheap imports produced in their foreign factories. Conversely, smaller businesses that remain nationally centered in terms of sales, production and input sourcing are threatened by imports. In the U.S., this division has been brought into sharp focus with the debate over the trade deficit and the overvalued dollar. In previous decades, U.S. manufacturing as whole opposed running trade deficits and maintaining an overvalued dollar because of the adverse impact of increased imports. This time round U.S. manufacturing has been divided with multinational corporations supporting an over-valued dollar and smaller domestic manufacturers opposing it. A similar division within the ranks of business and capital likely exists in Europe.

This division opens the possibility of a new alliance between labor and those manufacturers and businesses that remain nationally based. However, such an alliance will always be problematic because of perennial underlying tensions between business and labor over the wage – profit division. Moreover, business may try to address its own internal division by promoting a domestic “competitiveness” agenda aimed at weakening regulation, reducing corporate legal liability, and lowering employee wages and benefits such as paid vacation time —an agenda designed to appeal to both nationally and internationally centered business, but at the expense of workers.

Solidarity has always been key to political and economic advance by working people, and it is key to mastering the politics of globalization. Developing a coherent story about the economics of neo-liberal globalization around which working people can coalesce is a key ingredient for solidarity. That is why economics is so politically important. Economists tell stories about what is going on in the economy, and there is need for an alternative story to that provided by neo-liberal economics. An institutionalist – Keynesian perspective provides that alternative.

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

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