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TRANS-PACIFIC PARTNERSHIP: An American Perspective

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Overview

Americans, more than at any time in recent history, are focused on jobs and income, especially for the broad middle class. Quite understandably, they are worried about the future. The recession of 2008-2009 was the deepest since the Great Depression of the 1930s, and recovery from it has been the slowest. Unemployment remains at about 8 percent nationally, with the number of long-term unemployed (six months or longer) stuck at a higher level than in previous recoveries. The U.S. job market is becoming noticeably divided between higher-skill, higher-income jobs and lower-skill, lower-income ones. Income inequality has risen sharply.

Americans' standard of living has taken a sharp hit. The Federal Reserve reports that the median net worth of families fell nearly 40 percent in the three years from 2007 to 2010, with two decades of wealth wiped out during that period. Real household income also has fallen sharply since the end of the recession. Incomes have fallen more <u>since</u> the recession than during the recession itself, bringing median real income 8 percent lower than in January 2000, according to Sentier Research analysis of U.S. Census Bureau data.

Corporate profits and productivity have rebounded, however. Corporations are sitting on roughly $1.7 trillion cash that they are reluctant to use for new investment or hiring for a number of reasons, including deep uncertainty about the present state of the world economy and the future direction of U.S. economic policies.

It is against this backdrop that the Trans-Pacific Partnership is being negotiated between the United States and ten other Asia-Pacific countries. The TPP is being promoted by the Obama Administration as a high-standards 21st century agreement that will promote U.S. exports to the rapidly growing Asia-Pacific region and give multinational firms a strong incentive to base their operations – and jobs – in the United States, rather than continue recent trends of outsourcing and offshoring.

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The question is, what impact will the TPP have on business behavior, job creation, and income growth in the United States? Will it reverse, or even slow, decades of job-shifting to lower-cost countries in Asia and elsewhere? Will it begin to restore the middle-skill, middle-income jobs (largely related to manufacturing) that have evaporated with increasing speed since China joined the World Trade Organization in December 2001, with the decline picking up even more momentum during and since the recent recession?

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This author is skeptical. Based on available information, the TPP appears more likely to reinforce recent trends toward offshore investment, production, and job creation than to reverse those trends. At the margin, the TPP also is likely to reinforce the continuing erosion of middle-income jobs and rising income inequality in the United States.

The reasons are complex and stem as much from changes in global business models and domestic impediments to investment and job creation as from incentives offered by countries in Asia and elsewhere to attract U.S. companies to their shores. The growing reliance by U.S. manufacturers on highly mobile non-equity modes of investment, coupled with the prevalence of global supply chains centered heavily in China and wider Asia, means that a regional agreement along the lines of the TPP likely will increase the attractiveness of lower cost centers of production in the Asia-Pacific region, particularly as costs within China rise.

By the same token, the TPP will benefit those multinational firms taking advantage of its benefits to spread their investment and job creation to lower cost countries, such as Malaysia, Mexico, Peru, and Vietnam, which are eager to see higher levels of foreign participation in their economies. The agreement's market-opening provisions, coupled with investment and intellectual property rights protections, disciplines on state-owned enterprises, and other features will make these not-fully-tapped markets even more attractive locations for multinational firms' operations.

The United States, as the world's largest host of foreign direct investment and the world's largest market, clearly offers many attractions for investors. However, despite some highly publicized examples such as Airbus, recent trends show global firms increasingly preferring other markets, particularly China and other emerging economies, for their investments. Moreover, some widely watched comparisons of international competitiveness and business-friendliness rank the United States lower than in previous years, with some important red flags noted about the overall climate for doing business.

The United States is and must remain a part of the global economy. A market-opening agreement that eventually includes Asia's largest economies; addresses anti-competitive practices and market structures that impede genuine market access for foreign firms; and improves protection for investors would offer measureable benefits for U.S. firms active in international trade and investment – with corollary benefits for the U.S. economy and certain elements of the U.S. workforce.

That said, what may be good for global corporations in the case of the TPP may not be good for the future of a strong and diversified U.S. economy. U.S. policy makers urgently need to address domestic impediments to investment and job creation at home in order to maintain the attractiveness of the United States to multinational firms and to boost the competitiveness of small- and medium-sized firms competing in global markets. Moreover, the TPP contains some serious flaws that should be fixed before a final agreement is concluded.

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This paper is divided into four parts. Section I describes the history of the TPP and its role in regional integration. Section II critiques selected provisions of the TPP agreement. Section III examines one of the key claims made by TPP proponents, namely that the agreement will induce global corporations to base more of their operations in the United States and thus create and retain high-quality jobs at home. Section IV makes some overall conclusions about the future of the TPP.

I. TPP AND REGIONAL INTEGRATION

The Trans-Pacific Partnership is the latest initiative involving the United States aimed at improving market access and the overall business climate in participating nations on a bilateral or regional basis. Negotiations have taken on new importance in the face of the moribund Doha Development Agenda negotiations under the auspices of the World Trade Organization.

The TPP is the most ambitious of all U.S. preferential trade agreements to date, covering as it does many issues of importance to U.S. exporters and investors and involving more countries than any other regional agreement. The negotiating text contains more than twenty chapters covering a wide range of substantive issues, including customs facilitation; cross-border services; government procurement; telecommunications; competition policy; rules of origin; investment, labor and environmental protections; intellectual property rights; and provisions aimed at facilitating trade and investment.

Other chapters aim to promote regulatory convergence; address emerging technologies; help small and medium-sized enterprises enter global markets; ensure that state-owned enterprises compete fairly with private companies; and facilitate the development of production and supply chains. A comprehensive tariff package also promises improved access to partner countries' industrial and agricultural markets. The United States has preferential trade agreements with six TPP parties (Australia, Canada, Chile, Mexico, Peru, and Singapore), that already provide good market access in those countries. However, additional benefits will accrue from improvements in such behind-the-border measures as intellectual property rights protection and others.

The TPP builds on an earlier agreement among four countries. At the APEC Leaders' Summit in 2002, Chile, New Zealand, and Singapore agreed to launch negotiations for a Trans-Pacific Strategic Economic Partnership Agreement (TPSEP). Soon joined by Brunei Darussalam, the four founding countries signed the TPSEP agreement in 2005, which entered fully into force in July 2009. Between 2008 and 2010, five more countries joined negotiations: Australia, Malaysia,

Peru, the United States, and Vietnam. These parties agreed to negotiate a newly named and more comprehensive Trans-Pacific Partnership agreement.

In May 2012, Canada and Mexico were invited by the other nine partners to join negotiations. Participation of Japan, Korea, and China – which together account for about 90 percent of East Asian GDP – remains doubtful, at least in the near future. Japanese Prime Minister Abe appears likely to delay any decision until after the upper house election in July 2013. Strong political opposition, including from within his own party and from Japan's influential farm lobby, raises real questions about whether Japan ultimately will decide to participate.

Korea has or is negotiating FTAs with all TPP countries, as well as with China, and so far is keeping its distance from TPP negotiations. However, the fact that the U.S.-Korea FTA contains many of the features being negotiated in the TPP would make Korea's entry into the TPP relatively painless for that country economically (although not necessarily politically). China, which has its own network of Asia-based trade agreements and has pursued a three-party agreement with Japan and Korea (which could be sidelined by rising tensions between these countries), sees the TPP largely as a U.S. initiative to marginalize China.

II. TPP: THE GOOD, THE BAD, AND THE MISSING

The United States is and must remain an active participant in the global economy, especially the fast-growing and highly populated Asia-Pacific region. Establishing a strong, non-discriminatory regional framework has taken on new importance in the wake of failed multilateral negotiations under the auspices of the World Trade Organization.

The TPP also offers a good opportunity for joint American-Australian action. As Asia-Pacific partners for many years, the United States and Australia have cooperated to promote a variety of regional and global agreements on trade and investment, including in the GATT/WTO, APEC, and other fora. The TPP is the latest example of joint action to promote market-based liberalization in trade, investment, services, and other sectors. U.S.-Australia cooperation can be vital in forging market-based principals for state-owned enterprises and other less transparent features of the so-called "Asian" or "China" model.

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Beyond the traditional market-opening provisions for goods and services, potential benefits of the TPP include regulatory compatibility; customs and trade facilitation; efforts to address emerging technologies; and strengthened competition policies in participating countries, to mention just a few.

As it appears to be shaping up, however, the TPP agreement contains some serious flaws and fails to address some important trade-distorting practices that are particularly prevalent in Asia. The negotiating text has not been released to the broader public, but general information about the agreement is available on the U.S. Trade Representative's (and other governments') websites, and leaked texts have appeared in various news reports. Although not all of these reports can be substantiated, information available raises a number of important concerns. Among these are:

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Country coverage: without the participation of China, Japan, Korea, Hong Kong, Taiwan, or Thailand, the TPP will not achieve the degree of Asia-Pacific integration that will maximize economic benefits and minimize the potential for trade diversion or competing regional blocs. Within Latin America, Brazil is not even mentioned as a possible participant.

State-owned enterprises (SOEs) and government preferences: Can the TPP realistically grapple with distortions created by SOEs and discriminatory government benefits offered to favored firms or industries? The WTO and the GATT Subsidies Code before it have attempted to discipline state support of industries, with limited success. The United States may succeed in pressuring a relatively poor, small economy like Vietnam – eager to reap the gains from the TPP in inward foreign investment and preferential access to the large U.S. market – to agree to tight strictures. China, however, whose economy still is heavily dominated by SOEs, would have little incentive to accept strict outside constraints. Moreover, it is very difficult to enforce rules in an area in which company- or industry-specific information is notoriously difficult to obtain.

Government pressure to invest locally: Given widespread anecdotal evidence that the Chinese government, in particular, as well as other governments in Asia and beyond, sometimes condition foreign firms' access to their markets on local investment or joint ventures with domestic partners, the TPP would seem to offer a rare opportunity to tighten existing international rules on such trade- and investment-distorting behavior. There are no signs that this issue is on the agenda, however. Moreover, as is the case with disciplines on SOEs and government preferences, any new standards established in this area would be difficult to enforce, since targeted firms are reluctant to reveal publicly the degree to which their investment decisions are influenced by foreign government pressure.

Complexity: One advantage of regional or multilateral agreements is the reduced complexity that comes with them (i.e., fewer "spaghetti bowls" with numerous and overlapping rules). However, the TPP appears at risk of adding to the complexity of international rules in a number of areas, thus detracting from its potential benefits. One reason for increased complexity is that all regional and bilateral preferential trade agreements (PTAs) among TPP countries will remain in force. The United States favors the negotiation of ***market access schedules*** on a bilateral basis, which would leave each country's existing schedules unchanged. Australia, New Zealand, Singapore, and possibly other countries reportedly favor a global approach, under which one common market access schedule would apply to all TPP countries; existing PTA schedules

would be replaced by new TPP commitments. The current TPP text evidently offers a hybrid solution, with countries choosing which approach to take. A global approach clearly offers greater simplicity and thus greater benefits to trade.

Another area of potentially increased complexity is ***rules of origin*,** i.e. rules that determine the country of origin of a product. With each new PTA, industries push negotiators to develop ever-more refined rules of origin that favor their own competitive position and add to the spaghetti bowl effect. The TPP is unlikely to prove any different in this regard. Negotiators should aim as much as possible to use existing rules of origin or, even better, to create a single rule of origin in covered sectors for all TPP members.

Dispute settlement provisions also could add to the complexity of international rules: Will the TPP create a dispute settlement system modeled on the WTO and other preferential trade agreements, such as NAFTA? If so, will such a parallel system create a risk of forum shopping by aggrieved parties, especially given the inevitable differences between provisions of the various agreements?

Private versus public interest: Multinational firms are the major source of U.S. exports and foreign direct investment, so it is only natural that they will have a large voice in shaping the TPP and other trade agreements. However, negotiators and policy makers need to guard against "capture" by firms whose private interests may not always dovetail with broader U.S. public interests. U.S. negotiators risk overreaching in their efforts to satisfy specific industry desires, not only by driving potentially insurmountable wedges between countries but also by generating broad public backlash once negotiating texts are made public. For example, press reports indicate that a majority of TPP countries have balked at U.S. proposals on intellectual property rights (see below). Australia (and possibly other countries) also objects to inclusion of investor-state dispute settlement provisions.

As for public backlash, negotiators should recall the fates of the Anti-Counterfeiting Trade Agreement (ACTA), Stop Online Piracy Act (SOPA), and Protect IP Act (PIPA). These measures were aimed at reining in counterfeiting and online piracy, but they provoked strong public and industry protests that led to ACTA's rejection by the EU Parliament and SOPA's and PIPA's failure in the U.S. Congress. In each case, interested industries pushed for provisions that critics alleged would stymie Internet-based activities.

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Emerging technologies. Little information is available about these provisions. However, do they seek to achieve via trade negotiations some of the same controversial protections sought via failed domestic legislation (e.g., ACTA, SOPA, and PIPA)? Who is watching out for consumer and user interests in such areas as privacy and access to the Internet?

Intellectual Property Rights (IPR) provisions: This area reportedly has been a stumbling block in negotiations, with the United States pitted against many, if not most, TPP countries, many of which favor current rules in the WTO Trade-Related Intellectual Property Rights (TRIPS) agreement. The TPP text appears to go beyond the TRIPS agreement in some important ways. A leaked version of a 2010 text requires that participating countries ratify or accede to all major international IPR conventions or treaties (eleven listed in the text) by the date the TPP enters into force. Achieving that goal would be a heroic feat even in the most advanced democracies.

Most controversial are provisions offering U.S.-model protections for copyrights and patents. In the area of copyrights, so-called "Mickey Mouse" provisions establish 70- to 120-year protection for most products; tight "fair use" restrictions; criminal penalties for violations; and a requirement that losers pay court and attorney fees. Patent provisions for pharmaceuticals impose tight limits on marketing and use of generic drugs. While the U.S. leadership position on invention and innovation must be protected, a reasonable compromise should be possible without using a "cookie-cutter" approach that imposes U.S. standards, some of which border on being anti-competitive, on all countries.

Facilitating development of production and supply chains. This feature of the TPP presumably entails negotiating the removal of barriers to firms' ability to invest in, and source inputs from, the countries of their choice. These provisions undoubtedly are a U.S. objective. Not only do U.S.-based firms account for the largest share of production and supply chains established within other TPP countries; but it is not clear what, if any, U.S. barriers would be on the chopping block. While the removal of barriers to investment and sourcing of inputs can contribute to the overall efficiency and profitability of firms taking advantage of same, these provisions reinforce the conclusions outlined in Section III – namely, that the TPP will be more likely to increase the attractiveness of lower cost Asia-Pacific countries as spokes in China-centric supply chains, rather than to induce firms to locate more production – and jobs – in the United States.

Investor/state dispute settlement. This feature of NAFTA has been one of its most controversial. Critics claim that foreign investors have rights not available to domestic firms and that this provision threatens governments' ability to regulate, especially in areas of public health, safety, and the environment. Despite the exaggerated nature of some critics' concerns, there arguably is no reason why foreign investors should have access to extraterritorial dispute settlement in countries with high standards of legal protection and strong, fair judicial systems. Most multinational firms protect themselves through insurance or investor-state contracts, particularly in countries whose judicial systems pose some concern. Australia and possibly other countries oppose inclusion of this provision in the TPP (even though Australia has included similar provisions in some of its bilateral trade agreements).

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Although U.S. industry strongly favors this provision, alternative approaches would seem feasible and arguably more desirable as a template for future agreements. One possibility could be modeled on the OECD's approach to determining whether or not low tax jurisdictions qualify

as problematic tax havens. Under such an approach, negotiators could establish clear criteria that a TPP country must meet in order to qualify as a "high standards" country for purposes of dispute settlement. Such criteria could include: legal protections available to investors; independence of the judiciary; appeals process; and other relevant measures. (The simpler and more straightforward, the better. Avoid having investment attorneys or arbitrators write these criteria.) Domestic dispute settlement procedures would be used to resolve disputes involving foreign investors in high standards countries, just as in the case of disputes involving home country investors.

For those countries whose judicial/legal systems are a concern, special codicils could be negotiated to give investors alternative means of resolving disputes, ideally drawing on existing venues for arbitration and dispute settlement (e.g., the World Bank's International Centre for the Settlement of Investment Disputes, ICSID; or the United Nations Commission on International Trade Law, UNCITRAL). This approach admittedly involves a delicate matter of identifying "good" and "bad" (or inadequate) judicial/dispute resolution systems; but given the wide diversity of TPP participation now and the prospect of more countries with different legal traditions joining, this selective approach might be better than offering blanket assurances of third party dispute settlement even for investors in high standards countries. It also might offer an incentive for lower standards countries to improve their legal and judicial systems in the interests of attracting foreign investment and gaining authority over dispute settlement.

Currency manipulation: The TPP does not address a major source of distortion in international trade, namely currency manipulation to gain competitive advantage. Although the WTO's GATT Article XV:4 prohibits contracting parties from using exchange arrangements to frustrate the provisions of the agreement, this stricture has proved to be toothless. The issue of currency manipulation clearly is fraught with difficulty and is not easily resolved. However, because Asian countries are among those with excessively large international reserves that indicate undervalued exchange rates (now or in the past), the TPP would seem to be an ideal venue to begin seeking some sort of international agreement on acceptable norms. The IMF and finance ministries of TPP negotiating partners would have to be involved in this discussion.

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One possible approach could be modeled on provisions in many U.S. trade agreements concerning labor and environment. As a first step in addressing this chronic problem, TPP countries could commit not to use exchange rates as a means of gaining competitive advantage in global markets or to favor domestic producers over foreign competitors in domestic markets. Consultation and information-sharing provisions could be added (e.g., information on a country's policies for intervention and details on its foreign currency holdings). While largely hortatory, such a provision at least would offer some grounds for challenging practices that appear to violate the commitment.

Even if this modest first step could be achieved, enforcement would be the most difficult challenge – not only establishing criteria to determine whether and to what extent a government is manipulating its currency to gain competitive advantage, but also providing meaningful measures of redress. The IMF has failed on this important aspect of its mandate. Perhaps a smaller group of somewhat like-minded countries could forge a new path.

III. U.S. OBJECTIVES: CAN THE TPP DELIVER?

An assessment of the TPP could stop with the analysis presented above. However, it also is worth examining one of the key premises of the TPP offered by its proponents.

Changes in business models and shifting centers of global economic growth and market demand raise serious doubts as to whether the TPP will deliver on its promise to restore high-quality American jobs, especially in the shrinking middle-skill, middle-income range.

In announcing the United States' intention to take part in TPP negotiations, the U.S. Trade Representative's office stated that "we are seeking to boost U.S. economic growth and support the creation and retention of high-quality jobs at home by increasing American exports to a region that includes some of the world's most robust economies and that represents more than 40 percent of global trade." In testimony before the House Ways and Means Committee on December 14, 2011, Deputy U.S. Trade Representative Demetrios Marantis stated that by promoting linkages with Asia-Pacific supply chains, the TPP will "encourage companies to retain their operations – and jobs – in the United States and not have to relocate to ensure they can stay competitive."

Leaving aside the fact that the largest Asia-Pacific economies are not taking part in TPP negotiations, the question remains whether the agreement will achieve the stated goals. Changes in business models and shifting centers of global economic growth and market demand raise serious doubts as to whether the TPP will deliver on its promise to restore high-quality American jobs, especially in the shrinking middle-skill, middle-income range.

Moreover, China is the elephant in the room when it comes to Asia and the future of regional integration, investment, and job creation. China's entry into the WTO in December 2001 was a game-changer for the global economy. The world's largest low-cost workforce suddenly was coupled with new protections for exporters and investors stemming from China's WTO commitments on tariff rates, customs procedures, investment, intellectual property rights, and a host of other areas. Access to the large U.S. market also was locked in through China's WTO membership and associated changes in U.S. law.

A steady postwar erosion of U.S. jobs in the high-productivity manufacturing sector turned into a flood after 2001, as U.S. firms relocated production to China. In addition to improved market access and low-cost labor, these firms also were lured by generous investment incentives and subsidized inputs offered by the central or provincial governments. The flip side of this picture was a sharp increase in U.S. imports of intermediate and finished goods from China and other emerging market exporters, and a dramatic rise in the profits of multinational firms.

Over the past decade, China has positioned itself as the hub of a growing number of global supply chains, as multinational firms centered their operations in Asia to take advantage of the region's rapidly growing consumer base and also its generally low production costs, especially labor. Moreover, according to a recent study from the Peterson Institute for International Economics, the renmimbi has replaced the dollar as the anchor currency for a majority of East Asian countries, locking multinational firms – and their exports from Asia – in the embrace of an undervalued renmimbi bloc.

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Developments in China in the coming years, as much or more than any other factor, will have a significant impact on future trends in trade, investment, production, and job creation in the Asia-Pacific region and beyond. If China can make a successful transition to a sustainable growth model based strongly on domestic demand and can avoid serious political instability, the country is likely to remain a major force in global demand and an attractive site for global production and supply chains.

Global Supply Chains and Non-Equity Modes of Investment

Each decade since World War II has witnessed developments that have changed the face of international trade and investment. The negotiated reduction in high postwar barriers to trade and investment; the miniaturization of electronics; improvements and cost reductions in transportation and communication; Internet-driven services, such as logistics, financial, research, and development; and a range of similar innovations have led to unprecedented levels of cross-border investment, joint ventures, and other attributes of a globalized world with high levels of international trade and investment. The increasingly multinational character of production has long since blurred traditional notions of national identity in the realm of international trade and investment.

The past decade has seen a broadening and deepening of these trends. Two phenomena in particular have resulted in increasingly sophisticated production and investment patterns by multinational corporations: the proliferation of global supply chains and of non-equity modes of investment in a wide range of goods and services sectors.

Highly integrated global supply chains (and their regional counterparts) thrive by parceling out production and services to the most efficient suppliers, regardless of country. These networks (also known as global value chains) account for a significant and rising share of global production and trade. According to the OECD, intermediate inputs produced through offshoring and outsourcing represent 56 percent of world trade in goods and 73 percent of global services trade.

Another trend changing the face of international trade and investment is the growing reliance by global companies on non-equity modes of investment, such as contract manufacturing, services outsourcing, franchising, licensing, and management contracts. Apple Inc. is the most widely cited example, with components of its iPad and iPhone originating in multiple countries and only

a small fraction of total value-added occurring in China during final assembly. UNCTAD's 2011 World Investment Report makes it clear just how widespread this phenomenon is, not only in electronics but also in a wide range of other sectors, including auto parts, pharmaceuticals, semiconductors, garments, footwear, toys, IT services, business processing operations, and retail/hotel/restaurant franchising and management contracts.

Non-equity modes of investment (NEMs) have accelerated rapidly over the past decade and now exceed the growth of foreign direct investment by multinational firms. According to UNCTAD, cross-border NEMs accounted for an estimated $2 trillion in sales in 2010 (a conservative estimate, given gaps in available data) and are growing faster than most of the industries in which they operate. Consumer electronics producers outsource on average about 80 percent of production by cost of goods sold, and auto parts producers outsource roughly 50 percent. More labor-intensive industries, such as toys and sporting goods, outsource about 90 percent of production.

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These trends are likely to continue and even strengthen, given the increased importance of market demand in the Asia-Pacific region and strong market and shareholder pressure on firms to maximize efficiency. According to data analyzed by FactSet and cited by Gillian Tett in the *Financial Times* (August 12, 2012), many U.S. Fortune 500 companies derive more than half their revenue from sales outside the United States, with some, such as Texas Instruments, reportedly earning nearly 90 percent of their revenues in overseas markets.

The importance of emerging markets in global demand dovetails with the competitive advantages offered by NEMs. NEMs allow companies to streamline their operations and focus on core competencies, thereby reducing capital and operating costs, an increasingly important consideration for shareholders and investors. NEMs also increase firms' ability to respond to changes in demand or other market conditions by rapidly ratcheting production levels up or down or even by relocating, especially to lower cost production centers.

In electronics, a small number of contract manufacturers, mostly based in East Asia, produce for all major global firms and account for the lion's share of NEM contracts and employees. Some of the largest, including Hon Hai Precision (better known as Foxconn) of Taiwan and Flextronics of Singapore, are major global firms themselves and are actively expanding into lower cost production platforms outside of China and developing Asia, including in Latin America and to a lesser degree Africa. These and other firms, according to UNCTAD, already have shifted production from China's increasingly costly coastal regions to China's interior provinces and to Vietnam, Malaysia, and Indonesia. UNCTAD estimates that about eighty percent of NEM employment is in developing or transition economies, including China.

For firms seeking to expand their networks of global supply chains and non-equity modes of investment, the TPP will enhance the attractiveness of participating countries, especially those with lower costs of labor and other factors of production. Preferential access to markets (especially the large U.S. market); strengthened protections for investment and intellectual property rights; improved competition laws; reduced red tape and regulatory conformity; disciplines on state-owned enterprise behavior and government preferences; and a host of other provisions will make these lower cost TPP countries more attractive as locations for production.

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Coupled with these market trends are the often-generous incentives given by host governments in Asia and elsewhere to firms willing to locate production facilities in their territory. Tax holidays; subsidized access to capital, land, and water; government-funded training facilities for workers; and a host of other benefits can tip the balance of a firm's decision to locate production in one country or another. Of course, the overall investment climate, including infrastructure and workforce preparedness, ultimately is more important than incentives. But other things being equal, countries like the United States, which are unable or unwilling to offer similar concessions, often end up on the losing end of firms' location decisions. (To be sure, many U.S. states offer investment incentives, but cash-strapped governments in democracies face limitations that governments in state-centric countries do not.)

Shifts in the U.S. Labor Market and Rising Income Inequality

Globalization has brought undeniable benefits to millions of people throughout the world. Although space limitations prevent a full listing of those benefits, it is clear that increased linkages among countries driven by technology, trade, and investment have raised incomes, lowered prices, and reduced poverty levels in advanced and emerging economies alike. However, it also is widely recognized that the benefits of globalization are not shared equally.

Based on new World Bank data, former World Bank economist Branko Milanovic concludes in a recent article that the biggest losers of globalization, or at least those who gained little or nothing, include the citizens of advanced economies whose real incomes stagnated between 1988 and 2008. His conclusions dovetail with other studies by the OECD, IMF, and independent scholars about structural changes taking place in the U.S. and global economies that raise serious questions about whether a sufficiently strong foundation is being laid today for future U.S. productivity gains, economic growth, and full employment. (From this point, discussion will focus on the U.S. economy, even though some of the same structural changes can be seen in other advanced economies.)

According to the OECD, the United States ranks fourth in the OECD for income inequality (after Chile, Mexico, and Turkey). This disparity is due primarily to the widening wage gap between the richest and poorest 10% of full-time workers. The OECD notes that the wealthiest workers collected the bulk of the past three decades' income gains, due largely to rising incomes of

corporate executives and finance professionals. Other studies have shown that income inequality in the United States also is driven by the increasing flow of returns to shareholders.

In its September 2011 *World Economic Outlook*, the IMF devoted a section to labor markets in advanced economies. As the authors note, an economy typically increases national income by shifting labor from lower to higher productivity sectors. Historically, jobs created in these higher productivity sectors have absorbed workers moving out of lower productivity sectors, such as agriculture. However, recent trends in the United States and other mature economies raise serious questions about whether past patterns will hold true in the future.

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Within the United States, the labor market has become increasingly bifurcated, with employment shifting to higher-skill, higher income jobs and lower-skill, lower income jobs, especially in low productivity services sectors. Middle-skill, middle income jobs, predominantly in the high-productivity manufacturing sector, have declined sharply (and did so especially rapidly after China joined the WTO in 2001). The recent recession reinforced these trends, with labor shifting out of manufacturing and into services even faster than before.

Economists have debated for years the impact of technological change and trade on labor markets. Robert Lawrence and other economists have highlighted technology as a more important factor than trade in driving change in labor markets. Clearly, advances in technology favor workers with higher skills, who then benefit from higher wages. However, factors other than technology also appear to be at work, the IMF notes, since the rapid decline in manufacturing employment (in all but the high end of the value-added chain) took place *after* the major innovations in communications and information technology had been absorbed by firms in the 1990s. More recent work by Nobel-prize-winner Michael Spence and other economists cited by the IMF pinpoints trade, especially offshoring and increased imports from emerging markets, as the main driver of changes in the U.S. labor market over the past decade or so.

Increasing shares of the U.S. workforce are subject to competition from abroad through outsourcing and imports, which is causing a shift in employment from the tradable sector to the non-tradable sector, such as government and health care. Such competition also puts downward pressure on U.S. wages and real incomes. Moreover, even in the high ends of manufacturing, computer design, engineering, and other sectors, developing countries have moved up the value-added chain and increasingly produce the more sophisticated components and services in which the United States and other advanced economies traditionally have led. This trend is irreversible and, as Spence observes, means that for the first time, growth and employment in the United States are beginning to diverge.

[M]ore recent work … pinpoints trade, especially offshoring and increased imports from emerging markets, as the main driver of changes in the U.S. labor market over the past decade or so.

These trends have implications for future U.S. growth and productivity gains. As the IMF notes, annual productivity growth in the services sectors experiencing rapidly rising employment between 2000 and 2007 (e.g., construction; and community, social and personal services, which includes health care) was negative or only slightly positive. In contrast, productivity growth in manufacturing was positive over the same period, rising more than 6 percent on average each year. (Although the authors do not note this fact, U.S. employment also has risen in government, a sector not noted for its contributions to productivity growth.)

The IMF authors conclude that the offshoring of high productivity sectors with higher growth potential could dampen growth prospects in the United States in the longer term. Moreover, they note that recent patterns of specialization could persist for some time, as those countries on the receiving end of offshore production (predominantly in Asia) increase their own comparative advantage in these high productivity, high growth sectors through learning by doing. Certainly those countries recognize the benefits, as evidenced by the generous financial and non-financial incentives they offer to firms willing to locate high-productivity activities in their territory.

[I]t is not much of a stretch to suggest that the United States risks losing an important element of its comparative advantage – human capital, a key source of invention and innovation ….

Evidence also increasingly suggests that creative and high-productivity services closely associated with manufacturing, such as research, development, design, and engineering – areas of strong U.S. comparative advantage – benefit from close proximity to manufacturing. A growing number of firms, from GE to Microsoft, have opened such facilities in China or neighboring countries to be closer to production and markets. These firms often are lured by generous incentives or are pressured by host governments to locate high value-added activities in their home markets as a condition of gaining access.

The President's Council of Advisors on Science and Technology in a July 2012 report on advanced manufacturing sounded the alarm on recent trends. The Council noted that "the United States has been losing significant elements of the research and development (R&D) activity linked to manufacturing to other nations, as well as its ability to compete in the manufacturing of many products that were invented and innovated here – from laptop computers to flat panel displays to lithium ion batteries."

The United States not only is losing the edge in some significant areas of manufacturing-related R&D and the ability to produce goods in some important high technology areas. But it is not much of a stretch to suggest that the United States risks losing an important element of its comparative advantage – human capital, a key source of invention and innovation – through the loss of high productivity manufacturing and services sectors via offshoring and the increasingly long-term nature of unemployment, even for skilled employees. It is disturbing to note that even in the nation's capital, operators of the city's subway system cannot find enough skilled employees to maintain escalators in a safe and working condition. These trends are troubling for the world's leading economy and lone superpower.

Too Pessimistic?

For all the evidence presented above, signs pointing in the opposite direction also can be cited showing that the United States remains an attractive location for investment and production. Indeed, the United States is the world's second largest manufacturer, recently overtaken by China. The United States also is the world's second-largest exporter, after China. In an August 2011 study, *Made in America, Again: Why Manufacturing Will Return to the U.S.*, the Boston Consulting Group notes that rising costs in China, coupled with high transportation costs, makes U.S.-based production increasingly attractive. This is particularly true, they argue, for intermediate products, such as auto parts, that are aimed at the final U.S. market.

Some "reshoring" already has occurred. General Electric has moved production of refrigerators from Mexico to Kentucky, water heaters from China, and plans to relocate production of washing machines from Asia. NCR relocated the production of ATMs to Georgia, the Coleman Company is shifting production of a plastic cooler from China to Kansas, and Sleek Audio now produces high-end headphones in Florida rather than China. Even Apple, which has invested billions of dollars in Asian supply chains, plans to make some Mac computers in the United States beginning in 2013. Foreign investment also continues to flow to the United States. Airbus is the latest and most highly visible example of a firm planning to locate production facilities in the United States.

However, even these positive signs are tempered by indicators suggesting the United States is losing some of its luster as a place for investing and doing business. The United States has slipped in the World Bank's Ease of Doing Business rankings and in the World Economic Forum's Global Competitiveness ratings, even as China has risen. When announcing GE's plan to relocate some production to the United States, CEO Jeffrey Immelt was quoted as saying that this move is "as risky a decision as we have ever made." Apple's chief, Tim Cook, noted that many skills associated with manufacturing have left the United States and that Apple's U.S.-based production would remain small. Moreover, while the United States remains a leader in many new and innovative industry sectors, most of them do not create the same number of jobs as previous generations of firms, at least not jobs in the United States.

Apple, the world's most highly valued firm, employs roughly 43,000 people in the United States compared to General Motors' U.S.-based employment of over 400,000 at the peak of its production in the 1950s. Apple also reportedly employs about 20,000 people overseas, along with nearly one million contract workers (most of them employed by Taiwan's Foxconn). Google's cloud computing center in North Carolina's largely defunct furniture-manufacturing region reportedly employs only about 60 computer technicians and other high-skill workers. Even the recently high-employment services sectors, such as construction, health care, and government, are unlikely to generate the same number of jobs as they have over the past decade.

Unless the United States can continue to attract high levels of productive investment at home, the country's ability to generate solid rates of economic growth with full employment, rising incomes, and reduced levels of income inequality will be weakened.

To be sure, these employment trends reflect America's high productivity levels, the highest among industrialized countries. But they also reflect shifts in business models and structural changes in the global economy that have increased the attractiveness of lower income countries as a location for investment and production and also shifted employment opportunities in America. Unless the United States can continue to attract high levels of productive investment at home, the country's ability to generate solid rates of economic growth with full employment, rising incomes, and reduced levels of income inequality will be weakened.

Back to TPP and the Future

What does all this have to do with the Trans-Pacific Partnership negotiations? Simply this. For many years – indeed, in all the years of American trade policy leadership since World War II – American negotiators and policy makers have pursued increased liberalization of markets and the establishment of global rules and norms on the assumption that past trends of economic growth and job creation would continue largely unchanged. Based on the performance of the U.S. economy and labor markets for most of the postwar period, those assumptions proved to be quite reasonable, even as U.S. negotiating objectives evolved to reflect changes in the composition of the U.S. economy and in U.S. interests.

> The financial crisis and its aftermath have lent even more urgency to America's need to rebalance its economy toward increased saving and productive investment and away from excessive consumption and over-investment in housing.

However, the recent financial crisis highlighted, and in some cases magnified, structural changes in the U.S. economy and labor markets that were underway even before the crisis, as outlined above. The financial crisis and its aftermath have lent even more urgency to America's need to rebalance its economy toward increased saving and productive investment and away from excessive consumption and over-investment in housing. Domestic rebalancing also is necessary to reduce America's unsustainable reliance on foreign borrowing and its large and persistent current account deficits.

With American households now reducing their high debt levels and governments at all levels facing cutbacks, domestic demand will be weak for some time. Rebalancing the U.S. economy and raising levels of productive investment ultimately will require an increase in exports (as difficult as that appears today, given ongoing crisis in Europe and slowing growth in China and other emerging economies). Increased exports and export-related investment also will draw more workers back into the higher productivity tradable goods and services sectors. The Obama Administration clearly recognizes the importance of strengthening America's export base, as evidenced by the president's export-doubling initiative.

However, by improving the overall investment climate and facilitating the establishment of production and supply chains in TPP countries, the TPP will increase the attractiveness of lower cost Asia-Pacific countries as spokes in China-centric supply chains. The agreement, therefore, is likely to *reinforce* moves toward off-shoring and outsourcing by U.S.-based multinational firms and not, as proponents argue, induce these firms to strengthen their U.S. production and job base.

Thus, the TPP likely will do little, if anything, to reverse the downward trend in high-productivity investment and job creation in the United States. Moreover, by bolstering corporate profitability and returns to shareholders and executives, the TPP also may worsen income inequality in America at the margin.

This picture is not all black and white. As noted above, the United States is, and must remain, a player in the global economy. U.S. multinational firms compete on the front lines for market share and talented employees. Their success brings measurable benefits to the U.S. economy. However, as a growing body of scholarly work suggests, what is good for U.S. multinational firms may not be good for a strong, diversified U.S. economy, with solid prospects for growth, full employment, and upward mobility for millions of Americans. Restoring high-quality American jobs, especially in the shrinking middle-skill, middle-income range, will require action on other, structural impediments to investment and job creation in the United States.

While it is beyond the scope of this paper to list all of the structural challenges facing the United States, some urgent needs include:

- Setting the United States on a predictable glide path to lower fiscal deficits and debt.

- Making much-needed investment in infrastructure, such as roads, ports, and telecommunications systems;

- Improving education in STEM disciplines (science, technology, engineering, and math) and gearing worker training more toward the needs of manufacturers and other employers.

- Renewing efforts to streamline and improve regulations, including the addition of robust cost-benefit analysis and sunset or review provisions in all regulations with a significant impact on business.

- Simplifying the complex and business-unfriendly tax system, including a reduced corporate tax rate coupled with elimination of loopholes and carve-outs that reduce revenue, distort investment decisions, and discourage firms from repatriating profits to the United States.

  (Banning members of House and Senate tax-writing committees from accepting contributions from firms with business before them – essentially *all* firms – is hopelessly out of the question. However, such a ban would ensure more than anything else that special-interest loopholes and preferences would not creep back into the tax code.)

- Reforming immigration laws to allow skilled foreigners, including those graduating from U.S. universities, to enter and remain in the United States

Restoring high-quality American jobs, especially in the shrinking middle-skill, middle-income range, will require action on other, structural impediments to investment and job creation in the United States.

- Launching an "Invest in America" program. The United States is unlikely to match foreign government investment incentives (nor should we, particularly in the current fiscal climate), but there is no reason why the president and U.S. government agencies cannot be more active in encouraging U.S. and foreign CEOs and their firms to increase U.S.-based investment and production. Coordinating and streamlining the many bureaucratic hurdles businesses face when investing would be an important component of such an effort.

- Finally, U.S. trade policy should seek to build more on U.S. strengths and pursue liberalization in countries offering the greatest potential gains to U.S. firms and exporters. Too many "trade-and" agreements still are driven by geopolitical considerations, rather than by consideration of how they will enhance U.S. competitiveness, growth, and job creation in the future. Even the TPP, which focuses on the important Asia-Pacific region, fails to include the region's largest economies.

One thing is clear, however. While the United States faces significant hurdles in its effort to remain competitive and to lay foundations for strong economic growth and job creation in the future, the time to begin addressing them is now. Failure to address these challenges in a timely manner could lead to further erosion in public and political support for trade and investment liberalization in the future.

IV. CONCLUSIONS

With the collapse of the WTO's Doha negotiations and the proliferation of trade agreements, especially in Asia, it understandably is tempting for the United States to seek to negotiate more bilateral and regional agreements of its own. Indeed, many of the TPP's Asian partners actively encouraged U.S. involvement in these negotiations, in part to balance China's growing clout in the region. And the United States was motivated to join the TPP negotiations in part to establish a template for regional liberalization that stands in contrast to the more limited and state-driven model represented by Asia-only or China-centric agreements.

> As a world leader, however, the United States should seek to ensure that any regional agreement it champions establishes an open, transparent regime that truly facilitates the movement of goods and services ….

As a world leader, however, the United States should seek to ensure that any regional agreement it champions establishes an open, transparent regime that truly facilitates the movement of goods and services, rather than overlays a dizzyingly complex set of rules and standards on top of an existing network of bilateral free trade agreements. From rules of origin and market access schedules to dispute settlement provisions, the TPP sets the stage for greater complexity and potential conflict among provisions, rather than for greater simplicity, clarity, and ease of administration. Not only do multiple layers of rules complicate life for customs officers, but they also make it difficult for businesses to know precisely what requirements will apply to goods and their inputs as they cross borders.

Moreover, an admirable template for the future should be one that sets the stage for the widest possible participation, not only in the region but also beyond. As it is, too many countries see the United States pushing highly legalistic and overly prescriptive provisions that represent an attempt to impose U.S. industries' and interest groups' wish lists onto U.S. trading partners. For example, powerful industry interests that have succeeded in limiting competition at home (e.g., in software, pharmaceuticals, and entertainment) are pushing patent and copyright language in the TPP that is the mirror-image of U.S. legal protections they have won from a compliant Congress. Labor unions and environmental groups similarly are pushing for tough provisions that would establish U.S.-level protections and set the stage for increased arbitration.

Many of these businesses and interest groups have legitimate concerns with foreign government practices. And there always will be some benefits flowing from an agreement that strengthens the rule of law and improves the overall business and investment climate in participating countries. However, at some point, negotiations can become so heavily laden with special-interest wish lists that they collapse from their own weight. Time will tell whether or not the TPP ultimately suffers the same fate as the Doha negotiations, which suffered in part from this problem, among others.

As for concerns about the likely impact of the TPP on jobs in America, some serious questions need to be asked about some of the agreement's provisions. For example, U.S. firms have proven quite capable of establishing production and supply chains that meet their needs, especially when coupled with soaring use of contract manufacturing and other forms of non-equity modes of investment, without the benefit of U.S. Government assistance. If the analysis presented in Section III is correct, then one wonders why U.S. trade negotiators need to facilitate the establishment of global supply chains, possibly at the expense of jobs at home in the middle-skill, middle-income brackets. At the very least, negotiators should have a better understanding of the likely impact of these and other provisions before pushing them.

The reelection of President Obama offers an opportune time for the president to order a review of the TPP as part of an overall assessment of the administration's trade policy. The flaws in the current draft of the TPP agreement are too numerous to allow for minor tweaking but not so serious that they cannot be fixed. By making a forthright effort to streamline and simplify the agreement, and by assuring that broader public interests are being well served, negotiators may be surprised to find their negotiating partners prepared to respond positively and with renewed enthusiasm.

The reelection of President Obama offers an opportune time for the president to order a review of the TPP as part of an overall assessment of the administration's trade policy.

It's worth a try.

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