

Chapter 6

The G20's Role in Fostering Trade and Investment

Gordon Hanson

There is increasing optimism that the worst of the pandemic may be behind us. Whether the Omicron variants were the last major spikes of the coronavirus disease (COVID-19) or whether there are others still to come, global economic actors are turning away from the immediate demands of the health crisis and towards the challenge of reigniting long-run economic growth. Future growth will, as always, largely depend on expanding the capacity of cities, regions, and nations to sell their goods and services to each other. Yet, global trade faces stiff headwinds. The United States (US)–China trade war has put the world's two largest economies behind obstinate walls of tariffs, rising global geopolitical tensions have complicated efforts to revive multilateral cooperation on trade, and the pandemic has severely disrupted both global supply chains and the movement of people across borders that is essential for international commerce. Members of the G20 must find ways to foster trade and investment in an environment in which the institutions and infrastructure underlying the international trading system are badly strained.

Repairing the global trade engine will require concerted efforts on the part of the G20. Of primary concern, members will need to confront how globalisation has increased economic disparities within their economies. These disparities, which often fall along regional lines, have generated deep pockets of economic hardship, increased resentment towards the institutions of power, and heightened suspicion about the value of open borders. They also represent an intensifying spatial misallocation of resources within countries, which impedes growth. In this chapter, I review the uneven consequences of globalisation for G20 members and discuss approaches that could improve the prospects for trade and investment to deliver greater economic prosperity amongst heretofore excluded and marginalised groups. Having countries focus on fixing domestic distortions is an admittedly unconventional approach to fostering trade and investment. However, the damage done by three decades of globalisation has been intense and mandates commensurately intensive efforts to remediate these harms. Unless those left behind by globalisation – both in advanced and middle-income countries – come to feel that they have more to gain from the global trading system, the politics of openness are likely to remain toxic and an obstacle to cooperation.

There are of course more conventional approaches to fostering trade and investment, which I will mention but not discuss in detail. Top amongst these is restoring the functionality of global trading institutions. As the ability of the World Trade Organization (WTO) to resolve trade disputes has eroded, countries have increasingly turned to bilateral or regional solutions. Admittedly, member

countries, including the US, have frequently acted in bad faith when it comes to supporting the WTO's mission. Be that as it may, in the absence of demonstrable evidence that the WTO works, the organisation may be increasingly sidelined. The G20 could achieve such a demonstration by, amongst other options, supporting WTO efforts to address climate change. Two promising options in this domain are clarifying, first, how border carbon-adjustment taxes could be made compliant with WTO rules, and second, how countries can promote green technology without violating WTO commitments. Unless the WTO is seen as leading on vital issues of the day, it will be seen as an anachronism.

1. Globalisation's Uneven Rewards

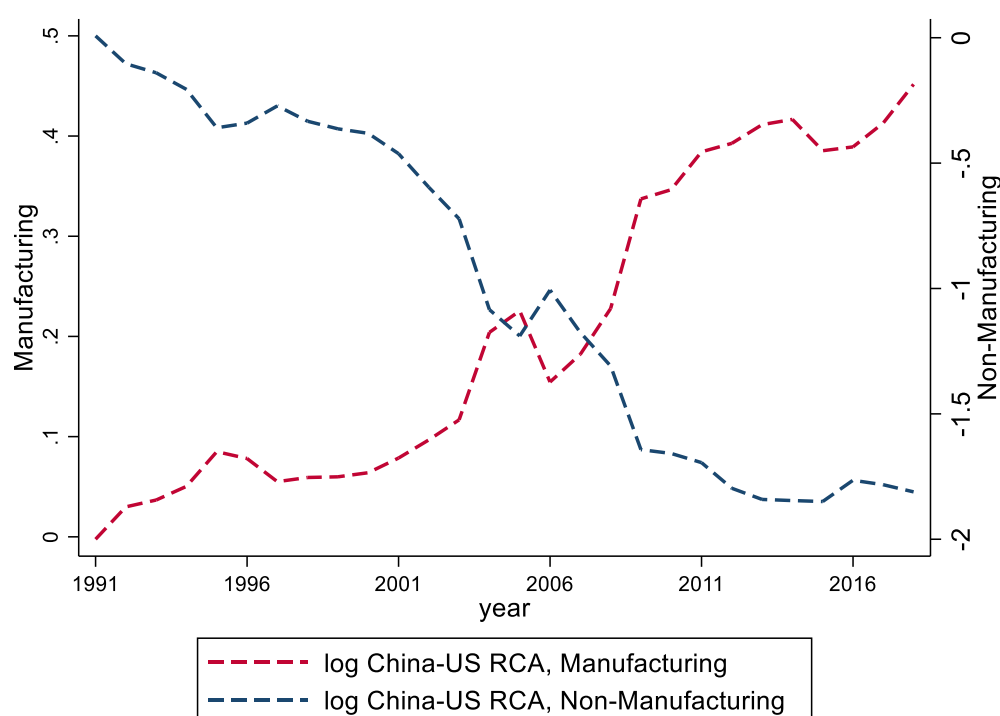
In the heady days of the early 1990s, there was every expectation that expanding global commerce would alleviate global poverty, enhance international security, and lead to convergence in democratic norms. To be sure, the massive increase in international trade and investment fuelled by the fall of communism, trade liberalisation in developing economies, and the formation of the WTO contributed to a substantial improvement in global living standards, especially in China and India. However, in high-income countries, and in many middle-income ones as well, globalisation severely disrupted life in many communities. In rich nations, it was the less educated and those working in traditional manufacturing who were hardest hit; in emerging economies, losers from globalisation included those pushed into working in the informal sector and living in regions poorly connected to global markets.

In retrospect, we now appreciate that by the 1990s high-income countries were comprised of disparate sets of regions that engaged with global markets in fundamentally different ways. Large, dynamic cities attracted the most educated workers, were headquarters to major corporations, and housed clusters of innovative firms in digital technology, finance, the life sciences, and other knowledge-intensive sectors. Expanded global trade meant increased demand for the business services (consummating mergers and acquisitions, consulting on management strategy) and technology services (creating software, licensing patents and other intellectual property) that they produced. Incomes and real estate values soared in London, New York, Shanghai, Silicon Valley, and Seoul, as new talent and capital poured in. Many emerging economies began producing goods that embodied the technology created by global knowledge centres, along rapidly expanding global supply chains. Countries with large commodity sectors – including Argentina, Australia, Brazil, Canada, Indonesia, Russia, and South Africa – saw soaring demand for their exportable goods.

The economic position of many smaller and medium-sized cities and towns in high-income countries was altogether different. In the second half of the 20th century, they had become home to large manufacturing factories, fossil fuel-based sectors, and other vestiges of the old industrial economy. Figure 6.1, which describes the evolution of comparative advantage in manufacturing and non-manufacturing for China relative to the US, frames the challenges confronting manufacturing regions in rich countries. As China joined the WTO in 2001 and reformed its economy, its productivity in manufacturing intensified greatly, which caused its comparative advantage in the sector to strengthen correspondingly. For older factory towns in the US Midwest

and Southeast, the United Kingdom's industrial north, and Germany's east, globalisation caused major contractions in the demand for labour via import competition from abroad. Compounding the pain was technological change in the form of automation and the progressive move away from coal and other dirty fuels, both of which dented labour demand for those without a college education. Because traditional industrial regions tended to be highly specialised in their core tradable sectors, the negative shocks that they experienced caused substantial job loss, often within the time span of a decade or less. Factories and mines closed, investment in new businesses largely failed to materialise, and workers, particularly those without a college degree, had difficulty transitioning into new lines of work.

Figure 6.1: Revealed Comparative Advantage in Manufacturing and Non-Manufacturing, China Relative to the United States



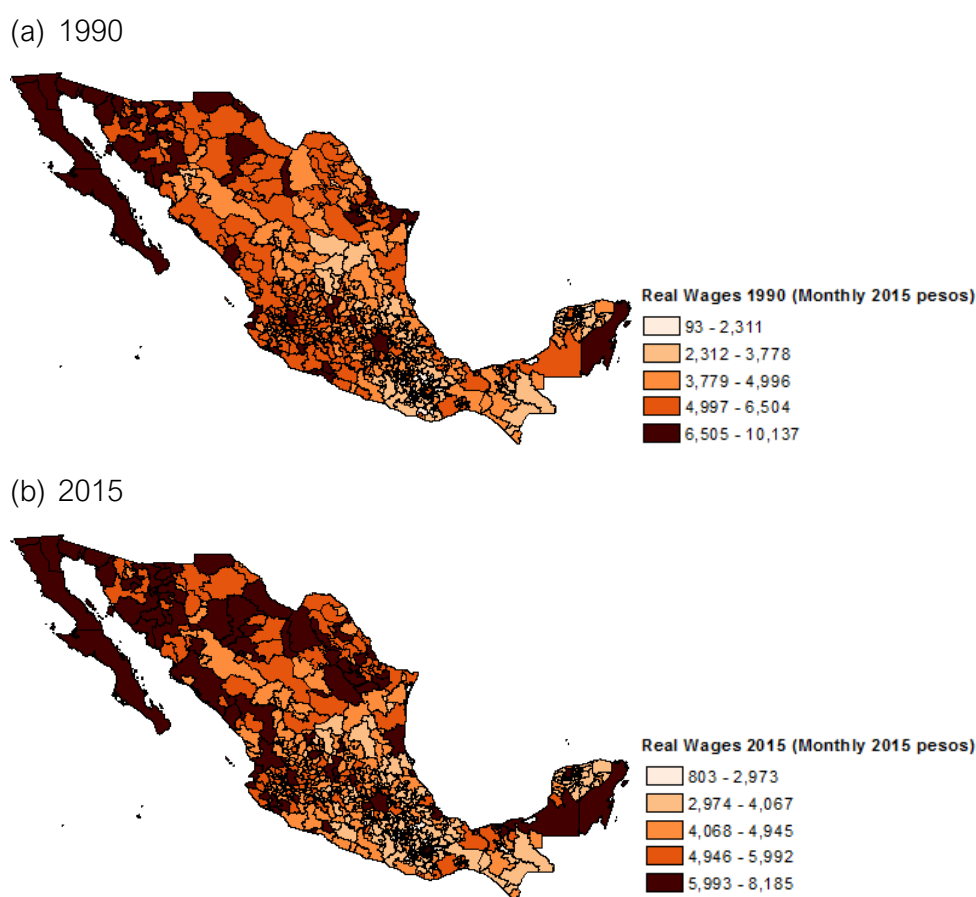
RCA = revealed comparative advantage, US = United States.

Source: Autor, Dorn, and Hanson (2021).

Perhaps the most surprising feature of how former industrial regions adjusted to changing economic conditions related to the geographic mobility of labour. By and large, local labour markets subject to concentrated job loss did not see much net outmigration of non-college-educated labour. The result was an entrenchment of economic distress. Joblessness of working-age adults remained elevated for decades after the onset of the disruptions, which in some regions contributed to the dissolution of families, drug and alcohol abuse, greater child poverty, and the fraying of the fabric of communities. Although the exact nature of regional decline varied across national contexts, a common feature was diminished economic prospects for non-college-educated workers. Distress ultimately stoked resentment. It is in these left-behind regions that support for nationalist-populist political movements has flourished, as seen in political developments in France, Germany, the United Kingdom, and the US.

In parallel fashion, many emerging economies have developed their own regional economic divides, which likewise have been exacerbated by globalisation and other sources of economic disruption. In Mexico, for instance, the North American Free Trade Agreement (NAFTA) helped industry expand in the country's better-educated and better-connected northern cities, while the country's poorer and more remote south endured decades of stagnation. Figure 6.2 shows real wages by municipality in Mexico in 1990, before NAFTA was enacted, and 2015, once globalisation had reached its apex. Readily apparent is that the regions that enjoyed the greatest wage growth were clustered in the country's north, close to the US border, and in the foreign tourist zones of the country's Baja California and Yucatan peninsulas. In much of southern Mexico, which has weak access to global markets, limited education, and poor infrastructure, real wages declined on average across many municipalities.

Figure 6.2: Real Wages by Municipality in Mexico, 1990 and 2015



Source: Chiquiar and Tobal (2019).

More generally, in much of the emerging world, the absence of economic opportunity tends to manifest not in high rates of joblessness but in high rates of informality, with its attendant adverse consequences for current productivity and future earnings growth. Regionalised patterns of gains and losses from globalisation are also apparent in Brazil, South Africa, and Turkey. Even China has not escaped this predicament. Today, many of its inland regions depend heavily on remittances from workers who have migrated to richer coastal cities, while its heavily industrial

northeast concerningly resembles regions in other countries that later endured protracted decline.

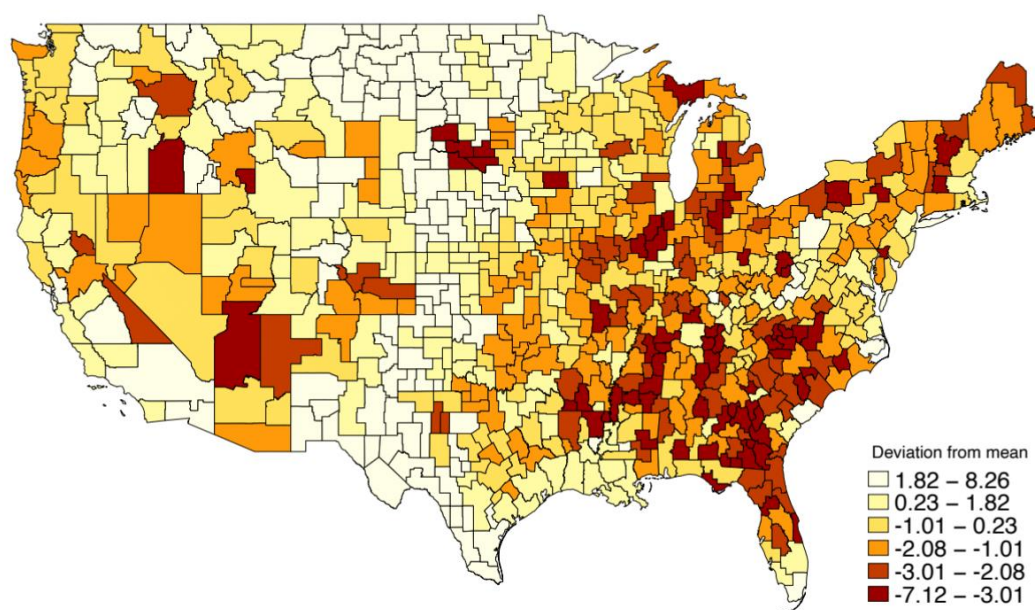
The last 3 decades of globalisation have left many economies riven by regional economic disparities that call attention not just because of the hardship and animosity they engender but because they represent a spatial misallocation of resources. Workers from depressed, low-wage areas are not leaving in sufficient numbers to compress large differences in earnings and living standards across regions within countries. Helping to close regional economic divides would therefore do more than address concerns about equity. It could improve national and global economic efficiency as well.

2. Framing the Challenge

The absence of sufficient labour flows within countries from distressed regions with low wages and low employment rates (or high informality) to thriving regions with high-wage jobs and high employment rates (or low informality) is suggestive of market distortions that obstruct the reallocation of resources across sectors and space. Such distortions justify government intervention, depending on their origin and severity. By contributing to a misallocation of resources across regions within countries, these distortions further disrupt the flow of goods, services, capital, and labour amongst G20 members. Removing them could enable countries to improve living standards in distressed regions, while at the same time making trade patterns more strongly grounded in intrinsic regional comparative advantage. An essential task for G20 nations is therefore to assess the health of their internal labour markets in order to identify instances of a misallocation of resources, the causes of these misallocations, and the types of government actions that could help alleviate them.

In Figure 6.3, we see an example of the regional economic challenges confronting high-income nations in the case of the US. The figure maps the change in the employment–population ratio – total employment of individuals 18–64 years of age divided by the population of individuals 18–64 years of age – for US regional economies (defined as commuting zones) between 2000 and 2019. The employment–population ratio summarises the economic health of a local economy. This ratio rises when real wages rise, as more individuals are drawn into paid work, and declines as real wages fall, as more individuals elect to exit the labour force. Concentrated, long-run declines in the employment–population ratio are therefore evidence of the disappearance of attractive opportunities for work. What is striking about Figure 6.3 is that the US is widely considered to have the most flexible labour markets amongst high-income countries. Even in purportedly dynamic market contexts, localised economic stagnation can become entrenched.

Figure 6.3: Change in the US Employment–Population Ratio, 2000–2019



US = United States.

Source: Autor, Dorn, and Hanson (2021).

For emerging economies, there is familiarity to the exercise of how to improve the spatial allocation of resources. As their populations were urbanising in earlier decades, the resource misallocation was obvious: too many people lived in poor rural areas and too few lived in industrialising and service-oriented cities. The solution then was rural–urban migration, which occurred at varying speeds across places. Looking back, it would be a mistake to see market forces as solely responsible for righting that earlier rural–urban disequilibrium. It is true that workers moved to cities largely at their own behest, as new businesses in urban areas set up shop. But governments also played an important role in facilitating resource flows. They built needed infrastructure – such as roads, ports, power plants, water systems, schools, and hospitals – and fortified market structures by deepening capital markets, strengthening legal institutions, and modernising communication systems. These interventions, roundly cheered by market actors at the time, made urbanisation possible.

Today, the challenge is messier. In most G20 countries, with India being an important exception, urbanisation is complete or nearly so. The problem is that too many workers appear stuck in regions or sectors in which productivity is low and opportunities for advancement are meagre. Alleviating these misallocations often entails moving resources between urban areas, which can be costly to engineer. Governments must think inventively about how to help correct existing distortions. A welcome by-product of this effort would be greater trade and investment amongst G20 economies.

3. Making Globalisation Work for the Many and Not Just the Few

How can countries expand trade and investment while improving the quality of jobs available to workers, especially those who are not highly educated? To envision how the G20 could achieve progress on this crucial challenge, I discuss evident distortions in housing, labour, and capital markets that appear to impede economies from discovering or fully realising their comparative advantage and imagine how alleviating these distortions could create more widespread prosperity. Because not every distortion is present in every G20 economy, not every intervention would be suited for all national contexts. Yet, there is sufficient commonality in the economic challenges members confront to warrant a collective examination of policy options.

In undertaking this examination, it is worth keeping two regularities in mind. One is that once a country has achieved high levels of urbanisation and settled its sparsely populated regions, it can be difficult to get people to move. Sluggish labour mobility means that any added distortions to mobility can have outsized effects. It also means that it may be harder to bring people to jobs – via people-based policies that ignore geography – than it is to bring jobs to people – via place-placed policies that condition on geography. A second regularity is that after periods of economic disruption, uncertainty about comparative advantage may be rife. Just as regions can rapidly industrialise, they can rapidly deindustrialise. Figuring out which tradable activities to pursue next can be daunting. Allowing for experimentation and cultivating economic ecosystems that provide fertile ground for a broad set of activities may therefore have higher social returns than making bets on specific companies or industries.

3.1. Fixing Housing

Perhaps the most common factor that prevents low-wage workers in depressed regions from taking advantage of opportunities in dynamic cities is the lack of affordable housing in these cities. In many countries, housing regulations or other distortions artificially restrict housing supply. In high-income contexts, such restrictions include limits on building height and the number of dwellings that can be constructed on a plot of land (which reduce the density of housing), and onerous processes for obtaining approval to undertake construction (which slows down housing development); in middle-income nations, they include the absence of land titles in many informal settlements (which complicates selling land), burdensome processes for aggregating small land parcels into larger plots (which complicates increasing housing density as cities grow), and rent-seeking by those who oversee the approval of construction projects (which lowers the return on housing investment).

Restrictions on housing supply may mean that when, say, biotech firms in Boston or medical device factories in Tijuana expand their operations and increase employment, the resulting growth in housing demand does more to drive up the price of housing than it does to expand the quantity of housing. Consequently, some individuals, and those with lower incomes in particular, may be pushed out of a city or dissuaded from moving in. Low-wage workers, who could potentially take up jobs in non-traded activities that indirectly support export industries or traded activities that directly support them, may be excluded from opportunities in dynamic cities. The consequence is less economic growth in places like Boston and Tijuana and more inequality in outcomes across regions within countries. Making housing easier to build would let growing regions capitalise on

their comparative advantage and enable low-wage workers to benefit more fully from the resulting expansion.

3.2. Building Human Capital

An important consequence of globalisation is continual turnover in the industries that comprise the export base of a region or country. In a dynamic global economy, the places that excel in specific sectors are constantly changing. As some regions acquire comparative advantage in an industry, other regions may see their comparative advantage in the industry diminish. The resulting turnover in industries that are present in a region requires workers to upgrade their skills, often several times over their careers. Acquiring new skills is likely to be especially important in regions that have suffered a major contraction in their core export industries. Research documents that these events, which typically involve the shutdown of multiple factories and the mass layoff of personnel in a compressed time span, have scarring effects on workers in the form of extended periods of joblessness and lower lifetime earnings.

The scarring effects of job loss run counter to the predictions of standard economic models. According to standard theory, the higher that unemployment is in a region, the lower the wages and the more attractive the region is to firms in tradable industries that wish to expand their operations. Yet, this mechanism tends to be disappointingly absent in regions that have seen their main export industries disappear. Rather than attracting firms to a region, high rates of joblessness (or informality) may deter potential investors, who may have concerns over the degrading of worker skills or be put off by the absence of desired input suppliers in the local economy. For their part, workers may be unsure about which type of training to pursue or in the aftermath of losing a job may lack the financial wherewithal to complete training. The consequence of local inaction by firms and workers is deindustrialisation. Just as positive spillovers between firms can create a virtuous cycle of agglomeration when a region is growing, they can create a destructive cycle of de-agglomeration when a region is contracting.

Promising recent evidence has indicated that active labour market programmes can be successful in improving outcomes for the long-run unemployed, as well as for disadvantaged youth (Katz et al., 2021). Traditional forms of subsidised worker training – in which workers are left to choose programmes on their own, are only offered options selected by government bureaucracies, or are trained for jobs in the public sector – often have poor results (i.e., their costs far exceed any gain in worker earnings). Newer approaches impart skills desired by local employers (where programmes certify participants for occupations that are in demand by sectors expanding nationally) and offer additional employment services (related to finding jobs, retaining jobs, and advancing on the job). Rigorous evaluation of active labour market and sectoral training programmes in the European Union and the US indicate that they substantially increase participants' likelihood of becoming employed and earnings once on the job (relative to no training) and tend to generate sufficient additional earnings to exceed programme costs within 5 years or so. Although there has not been research on the feasibility of conducting sectoral training in distressed regions on a large scale, the success of Denmark's 'flexicurity' framework, which includes an active training component for unemployed workers, is promising evidence in this direction. Governments should be exploring how to deploy new approaches to worker training to help distressed labour markets.

3.3. Encouraging Investment

Economies succeed in raising living standards when new businesses or existing firms invest in a manner that raises the productivity of their workers. Encouraging these investments – which expand factories, improve production processes, and introduce new products – is of major interest to policymakers. Because large companies, and multinational enterprises in specific, tend to pay their workers high wages and be successful in breaking into new export markets (relative to other firms), regional and national governments are eager to attract them to their jurisdictions. One consequence of this eagerness is competition amongst jurisdictions in recruiting companies by offering tax breaks, subsidies, and other fiscal inducements. Over the last 3 decades, such tax and subsidy competition has intensified greatly.

A growing body of research indicates that tax competition to recruit individual businesses is often unproductive. The region that ‘wins’ the competition to attract a major company to its locale does tend to see expanded employment in that company’s main industry. However, the winning region generally sees no gain in its aggregate employment, relative to other regions that were under consideration by the targeted firm. Tax competition thus appears to be zero sum – one jurisdiction’s gain is another’s loss – while on net transferring income from taxpayers to business owners. Moreover, the ‘winning’ regions tend to be places that were already primed for success. Governments are thus devoting recruiting resources to luring companies to the most desirable sites for production, at the expense of assisting struggling communities.

Because most of the funds that governments spend on promoting local economic development go to tax breaks and other subsidies, there is potential for public entities to channel resources to distressed regions simply by repurposing these funds, without adding strain to public budgets. Resources currently devoted to tax competition, for instance, may be more productively spent on active labour market programmes in regions with low employment rates or high informality. Other promising uses of these funds include technical assistance (e.g., advice on finding new markets, adopting new technology, or improving logistics or management techniques) to businesses already located in distressed markets and helping these markets repurpose abandoned factories and similar structures for alternative uses.

Today, nearly every regional or national government has an economic development agency whose responsibilities include recruiting new business through subsidies of one kind or another. Governments are deep into an arms race in business recruitment. In an arms race, no individual government has an incentive to disarm. Doing so unilaterally would potentially leave their markets with less investment. The solution is for governments to agree collectively to restrict tax competition. The recent multilateral agreement to establish a minimum corporate tax of 15% is a promising sign that cooperation is possible. The G20 should take the additional step of suppressing the granting of temporary tax breaks in the recruitment of large companies.

4. Final Discussion

Policymaking after the pandemic presents G20 members with an opportunity for a reset. A policy reset seems to be very much in demand. In many countries, the public has grown increasingly sceptical about globalisation. With clear justification, the global economy is perceived as being tilted in favour of economic elites. Less educated workers, informal sector businesses, and regions disconnected from the global knowledge economy often receive few tangible benefits from global commerce. If governments blithely propose a return to pre-pandemic approaches to trade and investment, they are likely to invite scorn and strengthen the political standing of those who propose closing borders. To retain credibility and support, policymakers need to articulate a policy framework that shows how globalisation can benefit the many and not just the few.

In contemplating a reset, policymakers should keep three principles in mind. One is that individual job loss is painful and that regionally concentrated job loss can be devastating. Policy should focus on helping displaced workers get back on the job quickly. If policy is tuned only to national business cycles, and not responsive to regional variation in economic conditions, it may allow regional job loss to morph into persistent regional distress, recovery from which is challenging and costly. A second principle is that in a deeply connected world in which industries easily relocate across regional and national markets, policy needs to be attuned to change. Structures need to be in place to help workers move across sectors and firms to learn new ways of business. Because of spillovers in learning, government support for worker training and business development is often justified. However, indiscriminate support for these activities is not. On worker training, evidence shows wide variation in impacts across programmes. Some do little for workers and simply waste public money. Others, especially those that consciously target skills in demand by local business, can be highly effective. There is wide scope for governments to improve the nimbleness of their economies, but only if policy design follows evidence on how to achieve success.

A third principle relates to cooperation amongst governments. The mobility of companies across jurisdictions creates a hard-to-resist urge for politicians to go hunting for trophy firms. Even if countries succeed in establishing a global minimum corporate tax rate, there will still be ample room for governments to induce business to locate in their economies via temporary rewards of one kind or another. Estimates for the US indicate that the scale of funding needed to raise employment rates and improve outcomes in distressed regional economies is considerably less than funds currently spent on subsidies to recruit businesses. Deepening cooperation to avoid tax and subsidy competition offers a triple win: transfers that increase inequality are eliminated, the social return on public spending is increased, and the spatial misallocation of resources is attenuated. In the absence of cooperation, governments are likely to continue to overcommit resources to companies from outside their jurisdictions that set up operations in regions that are already amongst globalisation's winners. That is not a recipe for building popular support for international trade and investment.

Targeting policy to those left behind by globalisation is important also for the challenge of addressing climate change. Transitioning away from fossil fuels will disrupt economic life in communities worldwide. Just as the WTO needs to take a leading role in helping countries use

trade and investment to shift the global economy towards green energy, member countries need to show how this transition can be managed equitably. G20 countries are the logical lead actors to demonstrate how this transition should proceed. If global trading institutions are laggards in helping chart constructive paths for the energy transition, just as they were in addressing the economic and environmental damage caused by globalisation, then we can confidently expect these institutions to drift into irrelevance. The nationalist voices calling for a retreat from globalisation, while also downplaying the urgency of confronting climate change, are legion. It is imperative that G20 members mirror how countries can responsibly participate in global trade investment while both improving livelihoods for those in the bottom half of their earnings distributions and not imperilling the planet.

References

- Autor, D., D. Dorn, and G.H. Hanson (2021), 'On the Persistence of the China Shock', *NBER Working Paper Series*, No. 29401. Cambridge, MA: National Bureau of Economic Research.
- Chiquiar, D. and M. Tobal (2019), 'Global Value Chains in Mexico: A Historical Perspective', *Banco de México Working Papers*, No. 2019-06. Mexico City: Banco de México.
- Katz, L.F., J. Roth, R. Hendra, and K. Schaberg (2021), 'Why Do Sectoral Employment Programs Work? Lessons from Work Advance', *National Bureau of Economic Research Working Paper Series*, No. 28248. Cambridge, MA: National Bureau of Economic Research.