

The Intellectual Basis of U.S. Trade Policy Trench Warfare

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The innovation economics approach to trade is the optimal one for boosting U.S. competitiveness, innovation and productivity.

Washington’s trade policy debate is like World War I trench warfare. Both sides (free traders and protectionists) are fully and whole-heartedly committed to their doctrinal views; neither side willing to give an inch for fear of total victory for the other side. Each side is sure that if they just speak even more loudly, then they will eventually prevail on the latest trade policy skirmish. Pure free traders believe in unrestricted trade, even if it is one-sided (e.g., free trade on the United States’ part, but protectionism from competitors), because whatever is lost from ceding a U.S. industry’s production to other countries is more than made up for by the benefits from lower import prices. Protectionists distrust globalization and see it as a race to the bottom, preferring that the United States not only not enter into additional trade agreements, but roll back existing ones.

These disagreements don’t stem just from politics, in the sense of conflicts between interests. They also reflect differences over economic doctrine—differences in deeply held views about how economies and trade work and the ideal form of trade policy. Based on these doctrines, different people stress different goals and values and work under different assumptions about how trade works and what the goal of trade policy should be.

INTRODUCTION

Trade is an economic policy issue. Accordingly, the competing underlying economic doctrines held by analysts, economists, and policymakers play an important role in shaping their positions regarding trade policy. At its core, trade policy is based in economics. And despite what many economists claim, economics is not a science. And, as with economics, intellectual approaches to the issue of trade differ substantially. These approaches reflect differences in economic doctrine among economists, policymakers and others. This paper postulates and describes three competing economic doctrines that shape the trade debate: the predominant neoclassical doctrine (NC), the oppositional neo-Keynesian doctrine

(NK), and the emerging innovation economics doctrine (IE). It then explains how each doctrine leads to different views of optimal trade policy.

While there is no scientifically optimal trade policy—since any policy position reflects different goals, assumptions and values—this paper argues that the innovation economics approach to trade is the optimal one for boosting U.S. competitiveness, innovation and productivity. In this case, the IE approach holds that trade can bring gains, principally through scale economies, competition and learning. However, unlike the neoclassical view which holds that all trade is welfare-enhancing, that nations do not compete with each other, that no industries are more important than others, and that the U.S. trade deficit reflects strength, IEs hold a different position. They believe that trade can be welfare-reducing if foreign mercantilist distortions are significant (as the United States has experienced over the last decade with the dramatic expansion of trade conducted with mercantilist nations, especially China), that the United States does compete with other nations, that high-value-added, innovation-based industries are more important than others and should receive priority in trade policy, and that as currently structured, the U.S. trade deficit represents a threat to U.S. prosperity.

Regardless of the economic—and thus trade—doctrine one holds, understanding this doctrinaire source of differences over trade policy should help policymakers understand core issues and hopefully make more informed decisions.

THE ROLE OF ECONOMIC DOCTRINES

Many economists like to portray their field as a science and themselves as the sole arbiters of economic truth. In fact, economics has much in common with philosophy; and, in fact, different economists hold different economic philosophies. As Joseph Schumpeter, perhaps the patron saint of innovation economics, once stated regarding ideology, “The majority of economists...are ready enough to admit its presence, but like Marx, they find it only in others and never in themselves. They do not admit that it is an inescapable curse and vitiates economics to its core.”¹

When considering most policy issues with an economic component, it is important to realize that much of what appears to be objective theorizing and unbiased analysis is, in fact, deeply shaped by the doctrine of the economist. Economists’ and policymakers’ beliefs about what policy works best, including their beliefs about the appropriate trade policy, are not simply independent constructs applied to new contexts; rather, such beliefs constitute and are a reflection of coherent world views or doctrines. Such doctrines profoundly shape how proponents view the economy, what they consider important, and most importantly, what they believe to be correct vs. misguided public policy. These economic doctrines guide thinking and help individuals make sense of a complex, rapidly evolving economy.

It is not only Ph.D. economists working at the Council of Economic Advisors, on the Joint Economic Committee, or in think tanks who are influenced by doctrine. Virtually everyone involved in economic policy, knowingly or not, adheres to a particular economic doctrine, even if they cannot describe or name it.² Indeed, as John Maynard Keynes once stated, “Practical men, who believe themselves to be quite exempt from any intellectual

influences whatsoever, are usually the slaves of some defunct economist.”³ Or as Milton Mueller has argued more recently, using the term “ideology” in place of doctrine:

The term *ideology* has a negative connotation, sometimes justifiably so. It can mean a dogmatic or religious adherence to a set of precepts and predictions regardless of their pragmatic utility or correspondence to reality. While it is true that ideologies bring those risks, it is also true that any good-faith effort to understand and cope with unprecedented societal developments requires something akin to what I mean by ideology. One’s ideas and analysis must strive to make sense of the world in a way that facilitates both private and collective action. People will, in fact, link their perceptions and ideas into relatively consistent, comprehensible principles that can be communicated and understood by a broader public so as to coordinate their response.⁴

THE THREE COMPETING ECONOMIC DOCTRINES

In order to make sense of the vigorous debates over trade policy, it is important to understand the doctrines’ different underlying positions. Since much of trade policy is about economics, it is imperative to understand that different and competing economic views stem from differences among economic doctrines.⁵ Until quite recently, three economic doctrines competed for intellectual supremacy: conservative neoclassical (sometimes called “supply-side economics”); liberal neoclassical (what used to sometimes be called “Rubinomics,” referring to the policies and views of President Bill Clinton’s Secretary of the Treasury Robert Rubin); and liberal neo-Keynesian. In the last decade, however, a small but growing share of economists have begun arguing that the conventional doctrines are fundamentally limited and a poor guide to understanding the 21st century innovation-based economy, and that a new economic doctrine—what is termed here “innovation economics”—is a better guide to policy.

To be sure, these doctrines are not straightjackets; not everyone is firmly in one camp or the other. Moreover, an individual’s economic views evolve. However, approaching economic policy issues such as trade through the lens of doctrines does help explain many differences in policy positions. As such, understanding the goals and principles undergirding each doctrine will help explain the divergent approaches to trade policy.

Conservative and Liberal Neoclassical Economics

A core principle of both conservative and liberal neoclassical economists is that allocative efficiency should be optimized. Allocative efficiency refers to the allocation of scarce resources in such a way that maximizes the net benefit attained through their use, while also producing the quantity and mix of goods and services that is most beneficial to society. A market economy characterized by allocative efficiency is one in which scarce goods and services are consumed on the basis of the prices consumers are willing to pay and produced on the basis of equality between marginal cost and price. Neoclassical economists believe that economic welfare is almost always maximized if actors in competitive markets set prices that are not distorted by policy. They spend much of their professional lives defending this utopian balance, believing that any violation of allocative efficiency leads to “deadweight loss”—a loss of economic efficiency as people buy too much of a product that

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is priced lower than it costs to produce (due to preferential tax incentives or subsidies, for example), or buy too little of a product priced higher than the cost (from regulations or taxes, for example) at a market-clearing profit.

Of course, no economy, market-based or not, is ever characterized by perfect allocative efficiency. However, neoclassicalists see the economy as a large market of goods and services tending toward an equilibrium that at least approaches allocative efficiency, one that is usually best left to itself. Equilibrium occurs when a market price is established through competition such that the amount of goods or services sought by buyers is equal to the amount of goods or services produced by sellers. The main task of economic policy as neoclassicalists see it is simply to reduce artificial barriers and impediments to market equilibrium, particularly by ensuring that prices are aligned with costs. This, indeed, is one of the reasons why economists reject so much of government action—or at least, in the case of liberal neoclassicalists, accept government action but argue that it hurts efficiency. Moreover, because allocation is based on price-mediated supply and demand factors, NCs believe that economies are usually in one, and only one, equilibrium and that any disequilibrium is welfare-disrupting.

Further, NCs hold that individuals act in response to incentives to rationally maximize their own self-interest, and that individuals' pursuit of their own self-interest generates the public interest. Indeed, according to Adam Smith, the individual who “intends only his own gain” will, in the course of maximizing his needs, be “led by an invisible hand to promote...the public interest.”⁶

Although conservative and liberal neoclassicalists agree on much, they differ in some important ways. In general, conservative neoclassicalists are less concerned with fairness, generally view markets as not prone to failure, and are less willing to assign intervening roles to government. They believe that many government expenditures, including both direct spending and tax expenditures, have a host of pernicious effects—particularly because they distort allocative efficiency and reduce incentives for market actors.⁷ Liberal neoclassicalists are generally more concerned with fairness, see market failures as somewhat more common (although not as common as Keynesians and innovation economists see them), and are more willing to have the government intervene in the economy, especially to promote fairer outcomes, even though they think government intervention usually harms efficiency.

Both factions are capital fundamentalists, believing that it is the supply of capital that drives economic growth. But these factions also differ with regard to their view of government's role regarding spending and investment. Supply-siders (i.e., conservative neoclassicalists) view lower taxes as the key to growth since it spurs private capital accumulation. In contrast, liberal neoclassicalists seek to spur capital accumulation by reducing government budget deficits, even if this means raising taxes.

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Neo-Keynesian Economics

The second major doctrine is neo-Keynesian economics. Neo-Keynesians hold that demand for goods and services from business investment, government spending, and consumer spending drives growth. Because of their focus on aggregate demand, many neo-Keynesian economic policy prescriptions revolve around increased government spending to keep the economy at full employment.

Neo-Keynesians also place a high policy priority on an equitable distribution of income and wealth which they view as essential to sustaining robust consumption, which in turn leads to greater economic growth. Neo-Keynesians see most economic issues as boiling down to a question of who benefits: working people and consumers, or wealthy individuals and corporations. Thus, they devote significantly less attention to long-term growth.⁸ Moreover, they see little that government can do to directly spur more growth (and conversely, little government can do to harm growth), other than ensure high levels of aggregate demand. Therefore, high taxes on business and regulation do not so much distort allocation efficiency, as they provide framework conditions for economic benefits flowing to most people.

Innovation Economics

Over the past two decades, a new economic doctrine has emerged through the work of a wide range of scholars. Unlike the two prevailing economic doctrines—neoclassical and neo-Keynesian—innovation economics postulates that innovation (the development and adoption of new products, processes, and business models) drives growth. While referred to by a variety of terms (e.g., structuralist-evolutionary, neo-Schumpeterian, or evolutionary economics), the term used here is innovation economics.⁹ IEs make an explicit effort to understand and model those forces and factors conducive to innovative activity. They see innovative advances as resulting from intentional activities by economic actors, including government. Thus, such advances are not exogenous to the process of exchange in price-mediated markets, as NCs hold. If there is a “bible” for innovation economics, it is perhaps Joseph Schumpeter’s classic 1942 book *Capitalism, Socialism and Democracy*, in which Schumpeter explains:

The essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process ... the fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates.¹⁰

Innovation economics holds that the major economic policy priority is long-term growth and that the major drivers of growth are productive efficiency (the ability of organizations and society at large to reorganize production in ways that maximize outputs with minimal inputs, including labor inputs), and adaptive efficiency (the ability of economies and institutions to change over time in response to successive new situations, in part through technological innovation). If the focus in neoclassical economics is the study of how

societies use scarce resources to produce valuable commodities and distribute them among different people, the focus in innovation economics is the study of how societies create new forms of production, products, and business models to expand wealth and quality of life.

In contrast to neoclassical economics, which focuses on getting the price signals right to maximize the efficient allocation of scarce resources, innovation economics focuses on spurring economic actors—from the individual, to the organization or firm, and to broader levels, such as industries, cities, and even entire nations—to take actions to become more productive and innovative. From the standpoint of innovation economists, if policies to encourage innovation “distort” price signals and result in “deadweight” loss to the economy, so be it, because these losses from allocative inefficiency are almost always minor compared to the significant gains from increased productive and adaptive efficiency.¹¹

Innovation economics also holds that although there is equilibrium in some markets at some times, in a growing share of markets in the knowledge-based economy, equilibrium is a fleeting moment. Markets are constantly roiled by entrepreneurial entry, disruptive technologies, political and social upheavals, changes in trade patterns, and more, never settling down into equilibrium. The lack of equilibrium is especially common to industries characterized by higher levels of change and innovation, including information industries. Moreover, innovation economists believe that market disequilibrium is responsible not for economic inefficiency, but for growth and progress itself.

Innovation economics also holds that individuals and firms are not rational maximizers. Rationality has generally been understood to involve consistency across decision-making based on measurable calculations. Risk can be managed through rational decision-making. Innovative activity, particularly if it involves a high degree of novelty, typically involves uncertainty, where outcomes and their associated probabilities are unknown. This is distinct from risk, where outcomes are known with a calculable probability. As a result of such uncertainty, innovative efforts will meet with many failures, as well as some great successes. When the economy is characterized by uncertainty, price signals alone are not the best guide to decision-making.

TRADE POLICY AND ECONOMIC DOCTRINES

And because trade is an economic function, trade is an economic policy issue. Thus, the economic doctrines held by advocates and policymakers play an important role in shaping positions and analysis toward trade. And the four competing doctrines offer significantly different perspectives on global trade questions. Both at the scholarly and popular levels, the debate has been framed by two basic groups: free traders and protectionists, with the former seeking to expand trade at all turns and defending the outcomes of trade at all times and the latter seeking to limit or roll back global trade and investment. Under this framing, conservative and liberal NCs are free traders and NKs are protectionists. IEs could best be described as contingent free traders who support tighter and deeper integration of global markets, but with the critical caveat that this integration come with a strong commitment to open and non-distorted markets on the part of U.S. trading partners and a robust national competitiveness policy at home.

Holders of the neoclassical doctrine largely reject the notion of competitive advantage because it implies that policy, including trade policy, can be used to alter industrial composition—something they see as by definition reducing allocative efficiency.

These fundamentally held positions don't stem only or even principally from different methods of analysis or data sources. While many NC economists state that economic analysis can identify the optimal policy with respect to trade, the reality is that, as in so many other policy areas, the best economics can do is provide information on tradeoffs. Yet as innovation economist Richard Lipsey notes, "There is nothing in neoclassical welfare economics... to tell us the optimum position on this tradeoff."¹² Moreover, the empirical findings that might inform the correct position vis-à-vis trade policy (e.g., the amount of tariff/non-tariff barriers, definition of violations, extent of penalties, etc.) are virtually impossible to generate, not because of data limitations but because there are no natural experiments to be conducted. As a result, deciding how to make these tradeoffs ultimately involves judgments that are significantly influenced by economic doctrine, thus often magnifying differences on trade policy issues.

Conservative and Liberal Neoclassical Economics and Trade

The "Washington Consensus" on trade and globalization is an application of the conservative and liberal neoclassical doctrines as applied to trade. Because the NC doctrine privileges allocative efficiency over innovation, this has become NCs' primary rationale for and defense of free trade. Free trade, according to this view, lets the global economy allocate output on the basis of nations' inherent comparative advantage. Any and all deviations from these market conditions—except, perversely, deviations from the market setting the price of currency, which is justified as defending a strong currency—are rejected as protectionism, "industrial policy," or other pejoratives designed to signal backward thinking.

NCs see the process of trade as involving a set of Pareto improvements designed to reach Pareto optimality: given an initial allocation of goods among a set of individuals, a change to a different allocation that makes at least one individual better off without making any other individual worse off is called a Pareto improvement. A state of allocation of resources is defined as "Pareto efficient" or "Pareto optimal" when no further Pareto improvements can be made. By definition then, according to NCs, because in their textbook theory no two parties trade unless they both improve their welfare, all trade improves allocative efficiency and consumer welfare, and by definition measures that hinder trade (e.g., countervailing duties, antidumping duties, tariffs, non-tariff barriers, etc.) reduce allocative efficiencies for both nations involved in trade. This, more than any other factor, is why NCs are so vociferous in their defense of trade; why they go to such great lengths to deny that a nation might be harmed by trade, even when the counterparty nation engages in mercantilist policies such as intellectual property (IP) theft and subsidizing exports from their high-value-added industries; and why they so quickly brand anyone who questions the NC trade doctrine as a "protectionist." For them, there are only two camps: free traders and protectionists.

But, as discussed below, this idealized, textbook conceptualization belies the way the world really works, where short-term consumer welfare can be at odds with long-term national economic welfare, and where there can be significant market failures, including national monopsony (as in the case of China), increasing returns to scale, and network effects. In this real world, the neoclassical doctrine quickly fails as a guide to effective trade policy.

A key component of NC trade theory is the belief in comparative advantage: the belief that countries all have an advantage in some kind of production relative to others and that it is those products (or services) that they should export and use to trade for things for which their comparative advantage is less. In David Ricardo's famous example offered some two hundred years ago, Portugal should sell wine to England in exchange for woolen goods from England even if it did not have an absolute advantage in wine. According to NCs, comparative advantage is given, not made, and policies designed to change comparative advantage by shifting a nation's industrial mix (e.g., Portugal trying to develop a woolen industry) will only distort allocative efficiency and make both nations worse off.

The concept of comparative advantage differs from that of competitive advantage: comparative advantage states that a country will produce the goods for which it enjoys the lower relative opportunity cost, while competitive advantage occurs when a country develops or acquires attributes (e.g., worker skills, technological capabilities, managerial competencies, scale economies) that allow it to increase its global market share of a particular industry.

But NCs largely reject the notion of competitive advantage because it implies that policy, including trade policy, can be used to alter industrial composition—something they see as by definition reducing allocative efficiency. This is the principal reason why most NCs simply deny the notion that nations compete with each other. For to acknowledge that nations compete economically is to acknowledge that sometimes exchanges are made that are not Pareto-optimal, and once that crack in the logic is opened up, the entire NC trade edifice is at risk of collapse. For example, Paul Krugman asserts that “the notion that nations compete is incorrect . . . countries are not to any important degree in competition with each other.”¹³ The lead economist at Congressional Research Service agrees, writing that international (economic) competitiveness is a “term without rigorous meaning.”¹⁴ As conservative NC economist Kevin Hassett claimed with all-too-typical economist conceit, “Non-economists regularly appeal to competitiveness when motivating a wide array of policies, while economists protest or look the other way.”¹⁵

This is why NCs are fundamentally unconcerned about a nation's loss of any particular industries from trade, for they hold to the “potato chips, computer chips: what's the difference?” view. In other words, for them, there is no fundamental difference between industries; if trade leads to the loss of one industry; it simply reflects a process where a nation's true comparative advantage is revealed. In this tautological thinking, losing any particular industry is good because it brings a nation closer to its “true” comparative advantage. Indeed, no loss can be bad and all loss must be good. We see this reflected in the writings of NC economist Alan Blinder, who wrote, “The TV manufacturing industry really started here...But as TV sets became ‘just a commodity’ their production moved offshore to locations with much lower wages. And nowadays the number of television sets manufactured in the United States is zero. A failure? No, a success.”¹⁶ In other words, there can be no unwanted loss of industry; by definition, such loss has to be welfare-maximizing because consumers were making Pareto-optimal decisions.¹⁷

For the NC trade policy establishment, job loss from trade is evolutionary, not devolutionary, because it benefits consumers and frees up resources to enable America to concentrate on its “true” comparative advantage. But NCs equate welfare only with short-term consumer welfare (e.g., consumers benefitting from cheaper TVs, toys, etc.), and ignore the negative impact to welfare from reduced production capability, especially higher-value-added production. And their definition of competitive advantage is self-reinforcing—whatever we lose is by definition lost because we didn’t have comparative advantage.

However, by assuming that all jobs lost from trade are positive evolution, these advocates avoid the hard work of really understanding the causes of the loss of an industry. No need to worry that high U.S. corporate tax rates caused this because we should have lost the industry anyway; and, after all, we don’t even compete with other nations. No need to worry about unfair, predatory foreign trade practices. It’s all just free trade and welfare-enhancing Ricardian comparative advantage working its way out.

This is why it is so easy for NC economists to contend that America does not need an industrial base, even an advanced-technology one. Kenneth Green, a resident scholar at the conservative American Enterprise Institute (AEI), has written, “As long as China is selling us the products we need, the location of manufacturing isn’t really that critical for the economy.”¹⁸ When asked how much manufacturing the United States could really lose and still be economically healthy, the head of one Washington, D.C.-based international economics think tank replied, “Really? Really we could lose it all and be fine.” Former Obama economic policy head Larry Summers spoke for NCs when he stated that “America’s role is to feed a global economy that’s increasingly based on knowledge and services rather than on making stuff.”¹⁹

Because manufacturing is such a large part of U.S. exports, losing it all would make the chronic U.S. trade deficit even worse. As a result, the NC view of trade includes a rationalization to dismiss the trade deficit as a problem. For if the chronic U.S. trade deficit were acknowledged to be a problem, it is a short step to the conclusion that there may be something wrong with the global trading system as currently structured.

Between 2002 and 2012, the United States accumulated a \$6.3 trillion trade deficit in goods and services.²⁰ Yet holders of the NC doctrine put the blame on America by asserting that low U.S. savings requires overseas borrowing, which by definition requires running a trade deficit. Former George W. Bush economist Greg Mankiw reflects this conventional view when he writes, “The trade deficit is not a problem in itself but is a symptom of a problem. The problem is low national saving.”²¹ Typically Neo-Keynesian economist Joseph Stiglitz also chimes in on this issue, saying, “A change in the exchange rate would not, moreover, affect the United States’ overall trade deficit, which is related to its macro-economic imbalances—the fact that it is saving less than it is investing, a problem exacerbated by the huge fiscal deficit.”²² Surprisingly, given their name, the Council on Competitiveness agrees, stating, “These threats [e.g., the trade deficit] stem from global financial imbalances rather than from the inability of American companies or American workers to compete in global marketplaces.”²³ If this is so, why does this organization even

bother worrying about U.S. competitiveness? Indeed, as non-neoclassical economist Robert Blecker writes, “This identity does not prove causality, and is consistent with other causal stories about the trade deficit.”²⁴ Some even go so far as to state that by the United States running a large trade surplus, mercantilist nations help America by shipping capital back that finances American financial deficits. For example, NC economists Fehr, Jokisch, and Kotlikoff argue that China, in saving so much (e.g., by running large trade surpluses), helps the United States by providing cheap capital.²⁵

This view that trade is always welfare-maximizing also explains why holders of the NC doctrine go to such great lengths to deny any real problems in the U.S. economy, including the trade deficit, that might have been caused by trade. For to admit that trade might have done something more than harm some individual workers (while boosting overall economic welfare) is to speak the unspeakable. The very notion challenges the entire edifice upon which NC trade theory is premised.

For NC’s to admit that trade might have done something more than harm some individual workers (while boosting overall economic welfare) is to speak the unspeakable.

We see this no better demonstrated than by how NCs address the loss of U.S. manufacturing jobs in the 2000s. Indeed, the debate over the structural health of U.S. manufacturing is one wrapped up in the trade debate and has become a proxy for views on whether one supports globalization or not. Unfortunately, rather than present unbiased analysis of the performance of U.S. manufacturing, most NCs go to great pains to paint a picture showing that all is well with U.S. manufacturing. They do so for fear that an accurate portrayal of U.S. manufacturing performance will fan the flames of protectionism.

Perhaps no one has gone further down the road of trying to defend the notion that U.S. manufacturing has not been hurt by trade (albeit unfair trade) than Theodore H. Moran and Lindsay Oldenski, who recently published a report through the Peterson Institute for International Economics titled “The US Manufacturing Base: Four Signs of Strength.”²⁶ The report tortures the data in order to claim that U.S. manufacturing is perfectly healthy even though it is anything but.²⁷ But other NCs tell the same story.

This is not to say that NCs view trade as an unalloyed good. There are losers from trade; they just aren’t nations as a whole. NCs readily admit that trade can and does impose costs on individual workers who might lose their job because of trade. But this is a cost to be borne in the service of the greater good and is only resisted at a nation’s economic peril. The two NC camps do differ on what to do about workers who are hurt by trade. Most conservative NCs generally argue that there are significant risks from policies to help those who are hurt by trade, including increased government spending and blunting incentives for workers to work and take risks. In contrast, most liberal NCs argue for helping workers who are hurt by trade, in part because they believe that by doing so they will limit political opposition to trade.

Finally, one reason NCs are such staunch supporters of trade in the face of mercantilist distortions from other nations is that most believe that as long as the United States is not mercantilist it still benefits from its trading relationship with mercantilist nations. William Buiter, Cambridge University economist and former head of the European Bank for Reconstruction and Development, summed up this standard view when he stated,

“Remember: unilateral trade liberalization is not a ‘concession’ or a ‘sacrifice’ that one should be compensated for. It is an act of enlightened self-interest. Reciprocal trade liberalization enhances the gains, but is not necessary for the gains to be present.”²⁸ When asked whether Chinese mercantilist policies hurt the U.S. economy, one congressional subcommittee chairman responded, “Remember, Adam Smith proved that mercantilists only hurt themselves.” Thus, NCs argue that worrying about trade enforcement is unnecessary, and moreover, that fighting mercantilism with our own trade barriers would hurt the much sought-after Holy Grail of allocative efficiency. This is a key reason why NCs often oppose the U.S. government taking a stronger trade enforcement role, as they view it as acting on the interests of industries America should be losing anyway by simply replicating other nation’s mercantilist practices. Better for us to be free trade and them to be mercantilist, NCs argue, than for both nations to engage in a “trade war” that consumers will pay the price for.

Neo-Keynesian Economics and Trade

If NCs privilege consumer welfare, neo-Keynesians privilege worker welfare, viewing economic prosperity as largely synonymous with worker well-being. In the NK model, the demand for goods and services drives growth and therefore a central task for policy is to keep demand high through robust government spending and measures to keep wages high (e.g., effective unions and minimum wage laws).

It is for this reason that holders of the neo-Keynesian doctrine are so skeptical of and resistant to globalization and trade, especially with low-wage nations.²⁹ Because rising demand based on rising worker incomes (and government transfer payments) drives growth, trade, especially with low-wage nations, might lead to lower prices, reduce wage growth and therefore stifle growth. As the neo-Keynesian Economic Policy Institute (EPI) writes, “Trade and globalization policies have major effects on the wages and incomes of American workers.” In this case, they mean negative effects.³⁰

But it’s not just that trade negatively affects growth; more importantly for NKs, it hurts average Americans. In other words, because NKs’ focus is more heavily tilted to redistribution rather than to growth, they are particularly averse to trade because they see it as leading to increased inequality. As EPI writes:

The standard trade theory that links falling trade costs and rising inequality in rich countries like the United States is clear that this rise in inequality is accompanied by *absolute* (not just relative) income declines felt by the losing group. In the United States, the losing group is generally proxied by either production and nonsupervisory labor, or workers without a college degree—in either case the majority of the workforce.³¹

And just as NCs will go to great lengths to deny any negative economy-wide impacts from trade, NKs will do the same with regard to the benefits of trade. For example, a standard NC argument for expanded trade is lower consumer prices. But EPI writes:

Expanded trade driven by lower trade costs will indeed lower import prices, but it also *raises* export prices. The rough intuition is that by lowering foreign trade costs, foreign consumers will demand more U.S. output, and this will raise the price U.S. consumers have to pay for it, hence higher export prices.³²

Despite the fact that this is wrong (domestic supply expands in the face of higher foreign demand), it reflects NKs' desire to paint trade as welfare-reducing, rather than welfare-enhancing.

The NK tilt toward nationalism, rather than globalization, also stems from their desire to tilt the playing field in favor of labor and away from capital. For 30 years after WWII, when the U.S. economy was much less exposed to harsh international competition and businesses were much more constrained in their locational choices, the balance had in fact tilted more toward labor. The federal government was able to maintain strong environmental and labor laws, as well as impose strongly progressive taxation. And in the NK doctrine, these constraints on capital were not only progressive, they were pro-growth.

Neo-Keynesians often oppose stronger enforcement of trade rules against foreign mercantilism, especially if those rules are designed to enable multinational companies in the United States to become more competitive.

But with globalization and increasing capital mobility, the ability of governments to constrain capital is much more limited; businesses that don't like a particular national regulatory regime can simply move production elsewhere. This more than any other factor is behind the opposition of NKs to globalization, or at least the form of globalization we see today. It is why most NKs oppose virtually all new trade agreements, not just ones with developing nations, such as the Trans-Pacific Partnership (TPP), but also with developed nations, as with the Trans-Atlantic Trade and Investment Partnership (T-TIP).³³ And because they want to blunt low-wage competition, neo-Keynesians' preferred solution to globalization is to push for stronger labor and environmental standards in other nations, assuming that if corporate costs go up in other nations, American workers will benefit.³⁴ In addition, in order to reduce the competitive pressure on U.S. workers, they also support market-closing steps, such as instituting "Buy America" provisions. These include the Buy American Provision of the American Recovery and Reinvestment Act (ARRA), which imposed a general requirement that any public building or public works project funded by the new stimulus package must use only iron, steel, and other manufactured goods produced in the United States. This is also why many neo-Keynesians oppose high-skill immigration; they see it as coming at the expense of the wages of high-skill workers.³⁵

Additionally, NKs often oppose stronger enforcement of trade rules against foreign mercantilism, especially if those rules are designed to enable multinational companies in the United States to become more competitive. Indeed, many NKs oppose stronger trade enforcement on issues such as intellectual property and forced technology transfer. Because they see the world as a conflict between capital and labor, trade agreements that protect the interests of capital must come at the expense of workers. As EPI writes:

The overwhelming majority of economic gains from intellectual property enforcement accrue to high-income households and corporations, and a genuine "free trade" agreement would aim to actually lower the costs of this enforcement. But if past practice is any guide, these treaties will surely aim to *increase* trade

costs by forcing other countries to devote resources to become bill collectors for American holders of intellectual property (entertainment, software, and pharmaceutical companies, mostly).³⁶

In other words, because many NKs believe that “what is good for GM” is not actually good for workers (and is more often than not bad for them), they often usually oppose trade provisions that would defend the interests of U.S. producers in global markets. In this sense they share a belief with NCs that the U.S. economy does not compete with other nations. For NCs the only relevant unit of analysis is consumers, and they don’t compete with each other. For NKs the only relevant unit of analysis is workers—and they compete with capitalists, but the overall U.S. economy does not compete with other nations.

Many neo-Keynesians believe that it is impossible to significantly roll back foreign mercantilist practices, and because these practices are so harmful (at least the ones other than weak intellectual property protection, forced technology transfer, and other policies targeted toward U.S. multinationals), they adopt an “if you can’t beat ’em, join ’em” attitude. Thus, they support the United States adopting protectionist policies of its own, such as the strong “Buy America” provisions discussed above, not just as a bargaining tool against other nations, but to match foreign mercantilism.

Finally, just as there are two NCs camps, there are two camps—or at least two versions—of NK trade policy. One, represented by organizations like EPI and organized labor, is more focused on how trade hurts American workers. But there is another faction of neo-Keynesians who are more global in orientation and whose sympathies lie with foreign workers, not American ones.

Perhaps no one articulates this perspective better than Joseph Stiglitz. Stiglitz, an economics professor at Columbia University, has long railed against globalization, not because it hurts American workers, but because in his view it is stacked in favor of profit-hungry corporations determined to exploit poor people across the globe. In his jeremiad against globalization, *Making Globalization Work*, Stiglitz writes that “there are too many losers from globalization in the developing world to allow the developed world to try to reshape globalization unfairly in its favor.”³⁷ These global Keynesians are more than willing to have the results of trade hurt working class Americans, even if this is caused by mercantilist practice, so long as poor people in developing nations benefit. As Stiglitz writes, “For America, coping (with globalization) means recognizing that globalization will mean downward pressure on unskilled wages.”³⁸

But like conventional Keynesians, these global Keynesians are still all about redistribution, not innovation and growth. In this case, they want a trade regime that is tilted toward helping poor people in poor nations, even if it comes at the expense of market-based trade and incentives for global innovation, like reasonable intellectual property protection. As Stiglitz writes, “one of the most important issues facing the entire world today is poverty in the Third World. Developing countries need more resources.... What separates developed from developing countries ... is a gap in knowledge and the intellectual property regime can make closing that knowledge gap either easier or more difficult.”³⁹ Stiglitz clearly favors

a weak IP regime that lets developing nations get access to knowledge without paying for it, regardless of the negative impact on global innovation.

The problem is that this neo-Keynesian global orientation is based on the short-term interests of workers and consumers around the globe and not on the interests of longer-term innovation or the interests of the U.S. economy.

Finally, like domestically oriented NKs, the global NKs like Stiglitz see the trading system as rigged in favor of corporate interests, and hold that these interests are antithetical to public interest. Stiglitz writes that “the negotiations to create a free-trade area between the U.S. and Europe, and another between the U.S. and much of the Pacific (except for China), are not about establishing a true free-trade system. Instead, the goal is a managed trade regime—managed, that is, to serve the special interests that have long dominated trade policy in the West.”⁴⁰ Stiglitz also writes that “there is a real risk that it [the TPP] will benefit the wealthiest sliver of the American and global elite at the expense of everyone else.”⁴¹

Innovation Economics and Trade

While NC economics focuses on maximizing allocative efficiency, innovation economics focuses on maximizing productive and dynamic efficiency (e.g., innovation), even at the expense of allocative efficiency. As innovation economist Joseph Schumpeter pointed out over half a century ago, “a system which is efficient in the static sense at every point in time can be inferior to a system which is never efficient in this sense, because the reason for its static inefficiency can be the driver for its long-term performance.”⁴² In other words, NC economists tend to overvalue the static gains from trade in the short run (maximizing allocative efficiency and consumer welfare), against the dynamic gains from innovation in the long run. This key difference in goals drives key differences in orientations to trade policy. In some cases, it leads both camps to strongly support trade, but in others it leads to divergence.

IEs support global trade in part because globally integrated markets enable larger markets, which in turn help drive innovation. Because innovation-based industries have high fixed costs of design and development but relatively low marginal costs of production, larger markets better enable innovative enterprises to cover those high fixed costs, so that unit costs can be lower and revenues for reinvestment in innovation higher. This is why firms in most innovation industries are global. If they can sell in twenty countries rather than five, expanding their sales by a factor of four, their costs increase by much less than a factor of four. Thus, efforts to lower tariffs, but more importantly break down barriers to market access, especially forced localization, are so important.

But not all trading regimes, even if they maximize short-term U.S. consumer welfare, are structured in ways that boost organizational productivity and innovation of firms in the United States. Indeed, some policies that NCs would support because they improve consumer welfare (e.g., low currency values in foreign nations, export subsidies, etc.), IEs would oppose because they are so harmful to productivity and innovation. For example,

among other harms, currency manipulation lowers the incentives of firms to invest in labor-saving technology.

By the same token, while NKs support weak intellectual property regimes—both at home and abroad—because they believe they enable working people to pay lower prices for goods and services, IEs support stronger IP regimes because they enable higher rates of return from investments in innovation and, therefore, more innovation investment. In this sense, IEs see globalization and trade as a key tool for productivity and innovation, but only if the global trading system is structured in ways that limit mercantilist policies.

One reason for IEs' more conditional support of trade compared to NCs' wholehearted embrace is that IEs are not indifferent to industrial composition; for them, “computer chips” are more important than “potato chips.” Hence, to the extent that trade enables the ability of high-wage nations like the United States to specialize in high-value-added production, this is a positive step. Indeed, the natural evolution of the global trading system should naturally benefit high-wage countries by creating a new global division of labor where the industrial base of these economies evolves toward more high-value-added and innovation-based goods and services. But this will only be the case if other nations are not systemically distorting the trading system for competitive advantage. When this happens, the industrial composition can shift to lower-value-added industries that decidedly are not the source of U.S. comparative or competitive advantage.

As such, trade policy becomes in part not simply an attempt to create a vast marketplace, but a challenge to ensure that the United States can win in global competition in high-value-added industries. And therefore, unlike adherents of the NC framework who go to great lengths to deny that the U.S. economy could have been harmed by trade with particular nations, the IE framework seeks to identify and acknowledge causes of harm in order to better inform the kinds of trade and domestic policies that are needed to support U.S. innovation-based competitiveness, while also being consistent with global economic growth.⁴³

At the same time, IEs view the trade deficit as a problem, not just because it is a debt that has to be repaid by future generations in the form of lower consumption (reduced imports and expanded exports), but because, as currently constituted, it contributes to a hollowing out of U.S. productive capacity that will be difficult to replicate in future years.⁴⁴ For unlike some industries (such as call centers) which are easily replaced if terms of trade turn more favorable in the future, a large share of the U.S. economy is made up of industries with large barriers to entry and system-externalities, meaning that if those industries are lost due to foreign competition, so is much of the capability to recreate them even if overall terms of trade become more favorable.

All of this has important implications for trade policy. Unlike NCs, who believe that trade is always Pareto-optimal, IEs see not just trade, but all economic activity—especially as it relates to more complex, innovation-based industries—as involving systemic market failures, to the point where it makes more sense to view advanced economies less as markets and more as complex, innovation systems.⁴⁵ And nations are engaged in competition with each other to gain innovation advantage.⁴⁶ As such, it is possible for nations to lose when it

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IEs believe that any trade policy must be linked to a robust national competitiveness strategy particularly focused on high-value-added industries.

comes to trade, especially if they have weak national competitiveness policies at home (as the United States does) and fail to craft the right trade policies vis-à-vis competitors, both in terms of market access and in terms of trade enforcement.

This is why IEs reject the NC notion that one-sided free trade is welfare-maximizing for the United States. IEs believe that the United States will not benefit from globalization unless trade policy effectively contests mercantilist distortions. Indeed, adherents of innovation economics temper their support for global trade with the concern that manipulation of the trading system by countries embracing mercantilist policies (e.g., tariffs, unfair taxes, currency manipulation, discriminatory standards, forced localization, forced technology transfer, intellectual property theft, etc.) not only hurts richer nations' productivity and innovation, but also leads to lower levels of global growth as companies make investments in places and in types of production that they would not make absent these mercantilist policies.⁴⁷ This is why IE adherents advocate concerted international efforts to move the global trading system away from national economic policies that promote exports in a beggar-thy-neighbor fashion (as is currently the case today in most nations), and toward policies that support domestic innovation and productivity.⁴⁸

Related to this, IEs believe that in a knowledge- and technology-driven global economy, the notion of comparative advantage is an anachronistic throwback that does more to obscure than to clarify. When trade was largely composed of “northern” industrial goods and “southern” raw materials, the framing of comparative advantage may have once made sense. But in a globally integrated economy—where most trade takes place between nations with similar factor endowments; an increasing share of trade is in innovation-based industries (e.g., information and communication technologies, clean energy, life sciences, aerospace, scientific instruments, etc.); and a large share of trade consists of inter-company transfers—the idea that comparative advantage is revealed makes little sense. Much of what nations now produce is not ordained, it is created. As such, competitive advantage has to be created and continually recreated. And that occurs in significant part by public policy, including foreign trade policy and domestic innovation policy.⁴⁹ This is why IEs believe that any trade policy must be linked to a robust national competitiveness strategy particularly focused on high-value-added industries.

In addition, because trade is not always welfare-maximizing, especially if it is mercantilist or one-sided, IEs are willing to let analysis show that the United States has experienced challenges from globalization—including the loss of manufacturing capabilities, a massive trade deficit, and declining global competitiveness. And when this is the case, IEs are much more willing than NCs to support the U.S. government taking aggressive actions to limit trade mercantilism—including ensuring strong IP protection, which NKs reject, and strong efforts to limit currency manipulation, which NCs reject. This is because IEs see the risk of the loss of integrity of the global trading system and the harm to core U.S. industries as much greater than the hypothetical risk of a devolution into a trade war.

Finally, like NKs and liberal NCs, innovation economists favor policies to help workers and communities adjust to trade-related dislocations. However, unlike NKs, they would generally oppose policies to protect domestic business establishments from legitimate

impacts from trade (e.g., U.S. firms losing out in global markets to competitors offering superior products or services or lower prices due to inherent advantages, including low wages). However, to the extent that U.S. establishments lose market share due to predatory foreign mercantilist policies, IEs would support protecting them from the impacts of those.

CONCLUSION

As noted, Washington’s trade policy debate is akin to World War I trench warfare. Both predominant sides (neoclassical and neo-Keynesian) are devoted members of their doctrinal “tribe”, unwilling to consider alternative perspectives. Indeed, each side remains sure that if they are the most prevalent and loudest viewpoint, their vision for trade policy will prevail.

But like an increasing number of other policy areas, this kind of Manichean thinking—the belief by NKs that trade and globalization is largely a force for ill, and by NCs that it is a brilliant and liberating force—only serves to obscure reality and retard progress.

To break this stalemate, the Keynesian left will have to once and for all embrace U.S. integration into global markets and accept “natural” loss from trade. But NCs will have to abandon their focus on short-term consumer welfare and their naïve, textbook beliefs that markets are perfect, wonderful things without failure or political distortion. This will mean recognizing that nations compete, that trade can be a negative sum, that if markets apply to goods and services, they also have to apply to currency, and that the only way to save the soul of the global trading system is to risk down at least part of the way down the protectionist road—in other words, to risk aggressive trade enforcement used in the service of pressing other nations to roll back their mercantilist regimes. And both sides need to put their shoulder to the political wheel and advocate for a new national trade enforcement and competitiveness strategy that will enable enterprises in the United States to win in global competition.

One wishes it were easy and that deeply entrenched advocates and scholars—individuals who have committed their entire careers and public reputations to viewing the trade world one way—would be swayed by logic and reason. Alas, human nature seldom works that way. But what we can hope for is that by better understanding the relationship between economic doctrine and trade policy—and recognizing that what advocates, particularly NCs claim as scientific reality are, in fact, doctrinal beliefs—policymakers will be more open to considering a range of approaches to trade policy, ideally the ones embedded in the innovation economics perspective. The debate over issues such as Trade Promotion Authority, and the corresponding free trade agreements it will cover, including TPP and T-TIP, will not be decided by peer-reviewed articles. They ideally will be decided in greater part by a deeper and fresh rethinking of U.S. trade policy overall, framed by an understanding of innovation economics.

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ABOUT ITIF

The Information Technology and Innovation Foundation (ITIF) is a Washington, D.C.-based think tank at the cutting edge of designing innovation strategies and technology policies to create economic opportunities and improve quality of life in the United States and around the world. Founded in 2006, ITIF is a 501(c)3 nonprofit, non-partisan organization that documents the beneficial role technology plays in our lives and provides pragmatic ideas for improving technology-driven productivity, boosting competitiveness, and meeting today’s global challenges through innovation.

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