

**A Moderate Compromise: Economic Policy Choice in an Era of Globalization**  
**(Excerpt) - by Steve Suranovic (Palgrave MacMillan, 2010)**

**Chapter 5 - Why Democracies Won't Choose the Best Policies**

Economic theory supports the contention that many people will suffer losses because of globalization, but also clearly shows that many other people will benefit. Because globalization will not affect everyone equally, and because there are many winners and losers, globalization is naturally contentious. The contentiousness inspires a continual discussion of appropriate policy.

What should producers and consumers, governments and international organizations do about globalization? Should present policies be maintained or should they be adjusted some way? Perhaps free trade is best and we should continue the slow progression of trade liberalization. However, maybe freer trade isn't such a good idea. Perhaps interventionist policies should be implemented to compensate those whose lives are most disrupted. Are current policies contributing to increases in poverty and economic inequalities? Are we doing enough to protect the environment? Are natural resources sufficiently abundant to sustain the world's growth and economic development? More importantly, can we ever know what are the best set of policies to deal effectively with all of these issues?

Economics proposes that we choose those policies that raise economic efficiency. When changes in policy cause some to lose, as they almost assuredly will do, then implement an appropriate compensation scheme transferring money from winners to losers so that all will gain. In contrast, social justice advocates argue that policies that are fair and just be implemented. Although, in principle, both approaches are reasonable, for

reasons discussed in previous chapters, neither approach can *convincingly identify* a set of policies we ought to choose; instead, regardless of the policy suggested there are always sound counterarguments.

In addition, policy prescriptions sometimes seem to ignore the fact that decisions are not made by someone who can simply declare what policies will be enacted. Instead, policies are chosen in a political process. In the world today, that means mostly in a democratic setting with a representative government.

The political process is important to the discussion about globalization policy choice for several reasons. First, democracy provides a mechanism by which choices are actually made. The process isn't theoretical; the process is real. Perhaps a democratic political process can translate the diverse interests and opinions of a country's citizens into policies representing reasonable compromise solutions. If so, then the political process offers a possible answer for how best to make policy choices. Secondly, policy choices are made by representatives of the people. Policies are made on behalf of the citizens who are in turn affected, both positively and negatively, by these choices. For the choice process to work effectively, information transmission is important. Information about what the people want or need flows from the citizens to the representatives. In between there are researchers, interest groups and journalists, who are also citizens. The researchers, interest groups and journalists convey additional information to both representatives and citizens to help them evaluate the options and make better policy decisions.

To be an effective policy choice mechanism, the democratic process requires that the information transmitted between parties be as reliable as possible. Unfortunately

though, because the collectors and transmitters of information typically have a stake in the policy outcome, information is not completely reliable. This poses a problem for achieving good policies and also makes it difficult for students of globalization to learn about the phenomenon objectively.

Because of politics in a democratic society, information presented by opposing sides in the globalization debate (or any policy debate) is purposefully biased. The process encourages the display of abundant confidence in the supporting information used to bolster one's case. The implication for outside observers is, don't believe everything you hear or read. Perhaps more importantly, don't think that one side has it right and the other wrong. The truth of the matter is more likely to be found in a convex combination of the extremes.

The fact that information is imperfectly known has important implications both for how a direct democracy would work and how its more practical variation, representative democracy, functions. In either case, imperfect information opens up a market for influence. The influence market is the topic of discussion in this chapter.

One of the best early accounts of decision making in a democracy was provided by Anthony Downs in his 1957 work titled *An Economic Theory of Political Action in a Democracy*. The paper provides an excellent description of the political choice process in a democracy by incorporating two important features. Downsian theory, as it is sometimes been called, first incorporates the standard economic assumption that agents seek to maximize their own well being. In the case of politicians, they seek the income, power, and prestige that come with running the political apparatus. The second critical assumption Downs makes is that information is imperfect. Indeed he states that, "lack of

complete information on which to base decisions is a condition so basic to human life that it influences the structure of almost every social institution. In politics especially, its effects are profound.”<sup>i</sup>

In this chapter we’ll use a series of simple games to illustrate some of the information problems associated with policy choice in a democracy. The policy choice I’ll consider is whether or not to implement free trade. I’ll begin by assessing the economic proposal to provide compensation under an assumption of perfect information. This outcome is untenable though, both because of insufficient information and because policies are chosen democratically. Next we’ll consider situations with perfect information when transfers (sometimes also called bribery) can be used. These cases suggest one reason why secrecy or a lack of transparency may arise in political contexts. Finally we’ll consider the most realistic cases where decisions are made democratically and with imperfect information about the outcomes. In these cases it is shown why information is twisted to suit political objectives, why lobbying arises and how lobbying creates a drag on the productive capacity of the economy. Although policy choices are made in the process, it also appears that democratic choice in the presence of uncertainty may produce some extremely unsatisfactory results.

### *Choosing Policy – The Game Setup*

Imagine a society with three agents, A, B and C. We can think of these agents as three individuals, but it is probably better to think of them as three distinct groups whose members share similar interests. Suppose that no single group has a majority share, but that a coalition of A-B or B-C do make up a majority. For simplicity suppose the coalition A-C is not a majority. Thus, if A and C each make up 20% of the voters and B

was the remaining 60% then these conditions are satisfied. It seems reasonable to imagine that the groups immediately affected by trade liberalization (TL) may be small compared to the whole economy. This may well be true in a country like the US since trade amounts to just 30% of the GDP. Also, trade liberalization is just one of many public policy issues under consideration at any one time. Thus, many people may have other higher priority issues and be relatively indifferent to this one issue.

*Choosing Free Trade: The Benevolent Dictator Case*

Suppose a government must choose whether to implement a TL agreement. The alternative to implementing TL is to maintain the status quo. Suppose the returns, or payoffs, to each agent for each policy are as shown in Table 5.1.<sup>ii</sup> Initially, imagine that information about the returns is perfectly known to the three agents; however, we'll relax this assumption in various ways later. The payoffs are set up to mimic possible outcomes shown in standard trade theory; namely one group gains, another group loses, while a third group, which may have no connection to that market, is left unaffected.

Table 5.1 Welfare Effects of Two Policy Options			
	Agent A	Agent B	Agent C
Trade Liberalization	10	0	-7
Status Quo	0	0	0

Given these payoffs, agent A clearly favors trade liberalization ( $10 > 0$ ) while agent C favors the status quo ( $0 > -7$ ). Agent B is indifferent, as the policy has no effect. The economic analysis of this situation would suggest what a benevolent dictator might do. A benevolent dictator would notice that trade liberalization offers a net positive overall effect of +3 ( $10 + 0 - 7 = 3$ ). In addition, because there is a surplus, the money

could conceivably be redistributed after the fact to assure that everyone shares in the benefits.

For example, if after trade liberalization, agent A transfers 8 units to agent C and 1 unit to B, as shown in Table 5.1a, then each agent will end up with one extra unit in free trade and everyone will be better off than in the status quo. In general, whenever efficiency improves in the aggregate, there will always be a redistribution that can assure that everyone benefits.

Table 5.1a Implementing Compensation			
	Agent A	Agent B	Agent C
<b>Trade Liberalization</b>	<b>10 (1)</b>	<b>0 (1)</b>	<b>-7 (1)</b>
Status Quo	0	0	0

The diagram shows a curved arrow labeled '8' pointing from Agent A to Agent C, and a smaller curved arrow labeled '1' pointing from Agent A to Agent B.

It is for this reason, economists sometimes argue that societies should always, a) set policies to achieve the most efficient outcome, and b) worry about, and implement an appropriate compensation scheme later.

Ah, if only life were so easy! Unfortunately, compensation, especially the total compensation described above, although easy to imagine, is extremely difficult to implement because of inherent uncertainties. The main problem in a more complex situation is to identify precisely who wins, who loses, how much they win and lose and when they will win and lose it. The answers to these questions can be guessed at, but they really can't be known with a high degree of confidence. And, if one can't know who should give what and who should receive what, then compensation becomes virtually impossible to implement successfully.

However, there is an even more obvious reason why compensation is an unlikely response; that's because decisions are never made by a benevolent dictator with the knowledge and ability to move income around after the fact. Instead, in much of the world, decisions are made in a participatory democratic or semi-democratic process. In these kinds of systems there is no incentive to provide compensation, except when it can tilt votes or support in some direction. In summary, this ideal outcome is unlikely to arise. So, what might happen instead?

### *Direct Democracy with Transfers/Bribery*

If the policy above, TL or status quo, is chosen democratically, say with a direct vote, and assuming information is perfect and everyone votes, the result in the above example would depend essentially on a coin toss by agent B. Agent A will vote for TL, agent C will vote against and with 50% probability agent B will choose TL.

Of course, it is in Agent A's interest for B to vote for trade liberalization while it is in C's interest for B to vote for the status quo. Thus, both A and C have an incentive to try to sway, or capture, B's vote. Let's first consider how transfers can be used.

Start by assuming Agent A decides to act. Agent A needs to find a way to make it in B's interest to support TL. One obvious possibility is a transfer of money or benefits. A's transfer is also known as a side-payment or a bribe. But how much should A offer to B? The answer depends on several other factors.

Agent A will prefer to transfer as little as possible to win B's vote because the greater the transfer the worse off Agent A becomes. In this example, one unit transferred from A to B is the minimum needed to induce B to support free trade. However, Agent B might consider one unit to be insufficient, especially if there is risk. For example, if vote-

buying is illegal and if there is a penalty if caught, then the transfer might need to be larger to compensate for this risk. The transfer might also need to be higher if Agent B is aware of how much A stands to gain with his vote. For example, if B knows that A will win 10 units and he is only getting, say, 3 units for his vote, B may consider that an insufficient sum and demand a higher payoff from A. For this reason, A has a strong incentive to hide information about his total benefits from Agent B. Also, A might wish to pay B extra in order to purchase something more than his vote; namely his silence. Agent A does not want agent C to learn about the transfer since that may induce competing bribes for B's vote. Thus for both legal and strategic reasons, secrecy becomes extremely important in this scenario.

The amount of the transfer is indeterminate in general and will depend on the factors listed and the bargaining powers of the two agents. What we know is that the minimum transfer from A is slightly more than zero, while the maximum amount is 10 units. Anything more than 10 would make Agent A worse off with TL than with the status quo.

### *Competition in Transfers*

Next, let's consider what is likely to happen if there is competition for B's vote. That is, what if both A and C both try to bribe B to win his vote. Suppose Agent A acts first and offers to transfer two units to agent B in return for B's vote for free trade. Since  $2 > 0$ , B should accept this offer. However, agent C, upon learning that A's bribe might step in and up the ante.<sup>iii</sup> Agent C might offer 3 units to B in return for a status quo vote. But then Agent A would come back and up the ante again, and on and on we go.



In the end, the maximum bribe that agent C is willing to offer is 7 units. However, Agent A's maximum bribe is 10 units. Since A can afford to spend more on transfers than C, A will win this perfect information sequential transfer game. The final outcome might look something like that in Table 5.2 with an 8 unit transfer occurring from A to B. In this case both A and B will vote for free trade and that policy will be chosen.

Table 5.2 Competitive Transfers			
	Agent A	Agent B	Agent C
Trade Liberalization	$10 - 8 = 2$	$0 + 8 = 8$	-7
Status Quo	0	0	0

Some interesting effects are worth noting here. First, compare this outcome with that implemented by a benevolent dictator. In this case, Agent C is a much bigger loser. After competitive transfers Agent C will quite likely look longingly at more egalitarian outcomes. Notice also that with competitive transfers, Agent A still wins, but not by as much as in the egalitarian case. Instead the big winner with transfers is Agent B.

Interestingly, even though B had no stake in the original policy choice, he stands to gain the most in a world with competitive transfers. That may not seem fair. It seems especially unfair when we note that Agent A will only get 2 units of benefits rather than the 10 units that would accrue with free trade and without transfers. Remember also that Agent A's benefit arises because free trade allows the group to expand efficient production that in turn generates the monetary profit. Nonetheless, transfers erode these efficiency benefits for the winner; to come out just a little ahead may cost Agent A a lot.

Finally, we can see the importance of secrecy to Agent A and why there is an incentive to keep these actions under cover. For strategic reasons, secrecy would be desired even if transfers were perfectly legal or recognized as a common practice. The incentive for secrecy described here also helps explain the desire for transparency by groups who seek more egalitarian outcomes. In this story Agent C would certainly look upon a secret meeting between A and B with suspicion. Demands for transparency are motivated, in part, by a desire to prevent these kinds of secret dealings.

The second important point worth noting is that with transfers - and perfect information - the outcome chosen will be the one that maximizes national welfare, that is, it is the most efficient. Had we tilted the original payoffs to make the gain to agent A only 6 units rather than 10, then the net national welfare effect from TL would have been negative at -1. However, in this case, agent C would have won the transfers game and the status quo - which is the most efficient outcome now - would have been chosen.

To see that competitive transfers can lead to more efficient overall outcomes, consider the alternative set of payoffs shown in Table 5.3. In this case, with no transfers, perfect information and direct voting, the status quo would be chosen since both Agents B and C would support it. However, the status quo is NOT the most efficient policy outcome. Trade liberalization provides a net welfare benefit of 2 units ( $10 - 1 - 7 = 2$ ).

However, if Agent A were allowed to bribe, or transfer money, it could offer several units to Agent B to switch his vote. As before though, competition would mean Agent C would get into the bidding war and up the stakes. In the end, A would have to offer B at least 8 units (anything  $> 8$ ) to win out over C. The final outcome is displayed in parentheses. Agent A transfers 8 units to B, leaving it with just two units. Agent B

ends up with 7 units since it loses one from the natural effects of free trade, but gains 8 from the bribe.

Table 5.3 Welfare Effects of Two Policy Options			
	Agent A	Agent B	Agent C
Trade Liberalization	10 (2)	-1 (7)	-7
Status Quo	0	0	0

Again Agent B gains tremendously and Agent C loses again. But interestingly, as before, the policy chosen with competitive transfers remains the one that is most efficient. On the other hand, the one chosen in the absence of transfers is less efficient. This suggests that despite some obvious inequities, transfers nonetheless can have some positive effects. Indeed, as we'll see next, public policy choice in a transfers game is better in some ways than the outcome in a lobbying game.

Notice that efficiency rises in both cases with "competitive" transfers and full information. If information remains secret or hidden however, then inefficient outcomes are more likely.

Consider the game presented in Table 1 again. However, now imagine that transfers are not allowed so that if it is attempted it must be done secretly. Earlier we considered what would happen if A tried to bribe B to support free trade. Instead, suppose agent C surreptitiously bribes B to support the status quo. A transfer of, say 2 units would make B better off and may be sufficient to induce B to support the status quo. As long as Agent A doesn't compete in transfers, the less efficient status quo outcome may obtain. Hence, this demonstrates the significance of full information and competition to assure that the most efficient outcome does indeed arise.

Perhaps because of the negative effects felt by the loser in transfer situations and because there is never perfect information about outcomes, transfers, or bribery, is generally illegal in most settings. Thus, next we'll consider the implications for policy choice in a scenario with no transfers and a lack of perfect information.

### *The Lobbying Game*

Consider the same three-agent story from above with the same payoffs to the agents as listed in Table 5.1. Now let's imagine that transfers are either not allowed or are impractical. Perhaps bribery is illegal and the cost of being caught is sufficiently large to deter the practice. Alternatively, transfers may be impractical, especially if Agent B is not an individual but rather a large group of voters. In that case there could be significant costs associated with identifying and transferring benefits to members of a large group. The larger the group, the higher will be the transactions costs and the more impractical transfers become.

Let's suppose Agent B remains indifferent between the two outcomes, but now assume this is largely because he doesn't have adequate information about the effects of the different policies to know which is better. Agent A would still like him to prefer free trade, and Agent C wants him to prefer the status quo. But Agents A or C cannot use transfers, or bribery, to sway B's vote. So what can be done?

The alternative is to play a lobbying game instead of a transfer game. The objective remains the same; convince Agent B to vote for your preferred policy. However, now this is accomplished not with a direct transfer to B, but by convincing him with ideas and information that one or the other policy is really in B's interest. In other

words, Agent A wants to convince B that free trade is better in some sense than the status quo. Agent C wants to convince B that the status quo is better.

However, in order for persuasion to work there must be imperfect information. The effects of the policies must be uncertain, at least to Agent B, if agent B is to be swayed merely by ideas. But persuasion requires resources and effort. To convince B will require communication; it is not costless. If B is a group rather than an individual, communication can occur through various media: newspapers, magazines, television, and the internet. These methods require money or resources be spent. The information must be substantiated too. The more valid or true the information appears, the more likely B will accept it. Thus, research into the policy effects by experts and other professionals can be funded to provide evidence that can be used to convince B. These studies are costly too.

The maximum amount of money that agents A and C would be willing to spend to gather and disseminate information to convince B will be equal to the amount they would be willing to spend on transfers. If we imagine a sequential decision process, it might proceed something like this.

First suppose agent C spends 2 units on research studies and lobbying supporting the status quo and broadcasts this information to Agent B. Given that B was indifferent between the policies initially we might imagine that upon hearing only from C, agent B will be convinced to support the status quo. However, Agent A cannot sit back and watch. Agent A might now spend 4 units to conduct research and disseminate information confirming the benefits of free trade and broadcast this info to agent B. With a larger amount of money spent and more effort by A, it might be sufficient to sway B to

vote for free trade instead. However, Agent C cannot sit idly by and watch this, so C ups the ante and raises its lobbying budget to 6 units to support research and dissemination, and so on.

In the end A can spend up to 10 units on lobbying while C can spend up to 7 units. These are the maximums each agent can spend although the limits may not be reached if some sort of détente agreement is achieved. Much will also depend on the marginal productivity of lobbying and its ability to sway Agent B to support one's position. If one unit spent on lobbying is equally effective for agents A and C then whoever spends the most money will win B's vote and because A can spend more, Agent A would win.

However, lobbying effectiveness per dollar spent will likely be highly variable. Thus, just because agent A spends more than agent B, it will not guarantee that A wins B's vote. So the lobbying game will be highly uncertain for Agents A and C especially since in reality there are many different strategies and approaches that can be tried beyond simply spending money to advertise the benefits of your position.

Also, the amount spent will depend on the initial likelihood of winning without lobbying. If the contest is very close then each dollar spent on lobbying has a high chance of tipping the balance in your favor. However, if you have only a 20% chance of winning without lobbying, then you may need to spend an enormous amount just to get it back to an even contest. If you believe that your opponent has a large amount of resources, then it may not make sense to spend anything at all.

### *Resource Use in Lobbying*

There are several important differences in the way the resources are used in the lobbying game compared to the bribery game. First, the resources spent in lobbying finance information gathering and dissemination. Resources - i.e., workers and capital - must be used to gather this info and disseminate it. With transfers, money is merely transferred from one individual, or group, to another. Transfers change who consumes the final goods and services, it does not represent a newly created resource-using service.<sup>iv</sup>

The labor and capital used in the lobbying effort, however, do not produce anything directly used by consumers. Lobbying is a service, it's true, but it is not a service that enters into a consumer's utility function. To see this note that the lobbying information presented to Agent B is unlikely to be sold to him. Instead, in most cases it will be given away freely as will occur with campaign ads that appear in newspapers, magazines and television. Lobbying is an activity entered into in order to shift benefits from some agents towards others. It is engaged in to win a contest. The true cost of lobbying is the opportunity cost; namely the value of the goods and services that could have been produced had the lobbying resources been employed in a directly productive activity. For these reasons lobbying is referred to by economists as a "directly UNproductive profit seeking activity" or DUP for short.<sup>v</sup> Another term commonly used as a synonym for lobbying is "rent seeking." The term rent seeking refers to the motivation for the process while DUP refers to the impact or effect of the process.

Once we recognize that lobbying is a DUP activity, we should also see a problem with the way in which we measure economic activity. Since lobbying is a service to the

companies that hire people to engage in this activity, it is counted in the measurement of a country's national income. If workers are shifted from producing goods and services to lobbying activity instead, the GDP does not change, however the quantity of goods and services that sustains the national standard of living falls. In contrast, transfers simply rearranges who consumes what. There is no loss in valuable output, just a transfer from one agent to another.

The second difference between lobbying and transfers is that almost twice as many resources can potentially be spent on lobbying. In the transfers game depicted in Table 2, Agent A wins the game by transferring 8 units to Agent B. With that transfer, Agent C will not need to transfer anything, hence the total transfer will be 8 units. However, in the lobbying game, expenditures by one side are likely to be countered with expenditures by the other side, lest the other gain an advantage influencing Agent B. Competition for support doubles the expenditures. In the extreme, Agent A can spend up to 10 units while Agent C can spend up to 7 units. If the expenditures and the effectiveness of persuasion are about equal for both sides, then up to 17 units may be spent on lobbying.

As mentioned above, these 17 total units of expenditures to win the game are directly unproductive. Furthermore, the more competition there is in lobbying and the greater the potential gains and losses for the two sides, the greater the unproductive activity will be. In this example, 17 units might be diverted from useful production in order to win a contest in which the net benefit to society is only 3 units.

Thus, if free trade is chosen in the absence of lobbying, 3 additional units of useful goods and services will be available to society. However, when the potential



winners and losers compete against each other in a lobbying game, the net effect for society will be a 14-unit loss in useful goods and services. ( $3 - 17 = -14$ ) – assuming they choose free trade. If instead, the lower lobbying expenditures by C were more effective in convincing B, then the status quo would be chosen and the net effect on society will be ( $0 - 17 = -17$ ), an even bigger loss. Thus although measured GDP would rise after free trade is chosen, the average standard of living in the economy will fall because fewer useful goods and services will be produced. This is a very important, but often unnoticed, aspect of lobbying in a democratic society.

One last feature of the lobbying game is similar to the transfers game, namely that the big winner in the contest, curiously, is not one of the two agents trying to win. Recall that with transfers, it was agent B, the swing voter, who gained the most. With lobbying, it is the lobbying agents themselves that gain the most. The lobbying agents are the people Agent A and C hire to engage in the lobbying activities. These information providers, who we can think of as a fourth agent in the game – Agent D - or, if the Agents represent groups, as a set of individual's drawn from a subset of these groups, are the big winners.

One final inequity: because the benefits in the lobbying industry are likely to be larger than the benefits in the productive industries trying to win the contests, it is likely that this profession will attract the best and brightest individuals; which indeed it does. Lobbying firms hire individuals trained in some of the best universities and law schools and these individuals are earning high incomes. Although It may be more accurate to say that these individuals are “capturing” large incomes, since their incomes come as a

result of a transfer from the groups trying to win the contest, rather than from directly productive activity.

### *Incentives to Refrain from Lobbying*

Because of the problems associated with lobbying, one might ask if there are incentives for either agent to refrain from the lobbying game. After all, if the possibility of large-scale success is low and the cost high, why do it?

Let's consider the outcomes under various scenarios – again from Table 5.1. First, suppose almost-maximum lobbying occurs and Agent A wins B's vote. In this case, Agent A will gain 10 units from free trade but will pay, let's say, 9 units for lobbying activity for a net gain of one unit. Agent C will lose 7 units from free trade but will spend, let's say, 6 units for lobbying activity for a net loss of 13 units. It seems senseless, especially for Agent C, to bother to engage in lobbying in this instance. If agent C recognizes that it will lose 13 units with lobbying, it may choose to refrain so that its loss would be only 7 units. However, if C does refrain from lobbying, then Agent A will recognize that it needs to do much less to convince B to support free trade. That could inspire A to lower its lobbying expenditures. Suppose A reduces all the way to one unit. This represents just a little lobbying to guarantee support. However, by spending only one unit, agent C now would have an incentive to reenter the competition. By spending only 2 units it may have a chance to win. However, as before Agent A can't allow this and would be inspired to increase its expenditures to 3 or 4 units, and so on.

What this implies is that while the no-lobbying outcome with A winning the vote is actually better for agent A, agent C, and society overall, nonetheless neither A nor C has an individual incentive to refrain from lobbying. Instead each can raise its own

chances of winning the contest through lobbying expenditures and will be inspired to do so to maximize its chances of success. This outcome is a classic prisoner's dilemma outcome. Individual self-interested behavior leads both parties to an overall inferior outcome.

The likelihood that agents will engage in lobbying is also higher when there is more uncertainty about the outcomes. If the payoffs are not perfectly known, or if the effectiveness of lobbying to sway B's vote is highly uncertain – which is most assuredly a real-world feature – then agents will be even more likely to try their luck in the lobbying competition.

On the other hand, if all information about payoffs were perfectly known and if lobbying effectiveness were perfectly correlated with expenditures, then Agent A might be inclined to cut a deal with C. The deal could consist of compensation if C agrees to refrain from lobbying. For example, if C recognizes it will lose any lobbying game, it can either refrain from lobbying completely, or threaten to inflict injury on A by competing in lobbying. Agent A could conceivably buy off Agent C by agreeing to transfer, say 2 units to C if it promises to refrain from lobbying. In this outcome, Agent A might spend 2 units to bribe C and, say, 1 unit on lobbying to sway B's vote. In the end, when free trade is chosen, Agent A receives 7 units ( $10 - 2 - 1 = 7$ ), Agent C only loses 5 units ( $-7 + 2 = -5$ ), and there is just one unproductive unit wasted on lobbying. However, unfortunately this outcome may be unlikely in reality since it assumes near perfect knowledge about both the payoffs and the effectiveness of lobbying.

## *Lobbying and Rhetoric*

In the previous section we discussed the nature of lobbying and its effects under the simple assumption that the more resources devoted to persuasion, the greater the chances of winning the contest. In this section we'll look more carefully at the way in which persuasion is most likely to be effective. It matters not just how much money is spent, but also the way in which information is used to convince people. This is especially important because lobbying efforts can greatly affect our knowledge and understanding of what is true about the world. Unfortunately, as we're about to show, to learn what is true, it is insufficient to merely to listen to what is presented by the experts. Instead one needs to consider the motives and incentives of the groups presenting information, because these motives can bias the presentation. Let's see how.

Persuasion is only possible, or necessary, if some agents don't know something; that is, if information is imperfect. If all agents knew everything perfectly about the effects of different policies, then nothing one agent could say would affect what the other "knows" to be true. However, information is imperfect in several ways; ways which are not mutually exclusive.

One possibility is that some agents know the truth about the effects of policies, but other agents are uninformed. The informed agents are the "experts." Experts conduct scientific studies and careful analysis to identify the effects of various policy options. The uninformed agents are those people who simply have not taken time to learn what the experts already know. In this context, lobbying involves transferring information from the informed agents to the uninformed; a process of teaching and learning.<sup>vi</sup>

A second type of imperfect information arises if no one can be certain what is true. Experts on the subject conduct analysis and do research studies but each study has a margin of error that makes it impossible to know with a high degree of confidence what the true effects of policy options will be. In this case lobbying involves persuading people that the *likelihood* they will benefit is higher if they support a particular policy.

The true nature of imperfect information is a mixture of these two cases. When considering the effects of various policy options, a small group of agents are likely to know with a high degree of confidence what the effect of a policy will be, or at least the effects for themselves. For example, import-competing industries know with high confidence that trade liberalization will harm their industry, at least in the short run. Similarly, export industries will know with high confidence that trade liberalization will benefit them in the short run. However, for most other people in the economy, the effects will be highly uncertain. Indeed it may even be highly uncertain for those who believe they will almost surely gain or lose in the short term. In the end though, decisions are made not on the basis of what is “known” to be true, but rather what is “believed” to be true. Beliefs matter more than truth. The objective of lobbying is to sway beliefs about outcomes.

For example, consider the same game as before with two policy options; trade liberalization and the status quo, and three agents A, B and C. Consider the payoffs to the agents listed in Table 5.4. In this game though, instead of definite payoffs to each agent, the payoffs are given as a range. The range gives the high and low values that will arise for that agent with each policy choice.

Table 5.4
-----------

Welfare Effects of Two Policy Options			
	Agent A	Agent B	Agent C
Trade Liberalization	(9, 11)	(-4, 4)	(-8, -10)
Status Quo	0	0	0

For simplicity we can imagine a uniform distribution of values. This means the probability is equal, or uniform, for any particular triple-value (one value for each agent). Thus, the outcome (9, -4, -10) for Agents A, B and C is equally likely to (11, 4, -8) which is equally likely to every other possible triple, where each number drawn is from each agent's range. The expected value for the three agents is calculated by finding the mean value for each agent. This computes to (10, 0, -9) respectively, implying that there is an expected net gain to the world economy because  $(10 + 0 - 9 = +1)$ .<sup>vii</sup>

This example is constructed to highlight several features. First, since any number in each range is equally probable, another equally probable outcome is, say, (9, -4, -8), in which case trade liberalization would cause a net national welfare loss. This implies that because of imperfect information, no one knows with certainty what the final impact of the policy choices will be for themselves or for others. Nonetheless, Agent A is certain trade liberalization will benefit him and Agent C knows trade liberalization will harm him. What A and C don't know is the final realization of their gains and losses and the direction and magnitude of the effects upon Agent B. They also don't know whether the net effects from TL will be positive or negative.

This simple account of the lobbying game is a fair representation of the situation we face in democracies in the real world. As was discussed in Chapters 2 and 3, trade liberalization, or globalization more broadly, will certainly generate winners and losers. A few of the big potential winners will have a high degree of confidence that they will gain, like Agent A. In trade theories, Agent A corresponds to export industries or a

country's abundant factor. A few of the big potential losers will also be highly confident that they will lose, like agent C. In trade theories, Agent C corresponds to import competing industries and a country's scarce production factors. Most people, probably the vast majority, will be like Agent B. This corresponds to workers and capital owners in the non-tradable sectors. They won't have a clue whether they will gain or lose.

The nature of imperfect information in this example makes it a situation ripe for lobbying. Agent A clearly prefers trade liberalization while Agent C clearly prefers the status quo. However, each agent needs the support of Agent B in order to adopt its policy. In the example, not only is Agent B uncertain whether he will gain or lose from trade liberalization, but the magnitude of his uncertainty is also greater. (Here the degree of uncertainty is easily measured as the range of values. Thus the degree of uncertainty for Agents A and C is two units, while for Agent B it is 8 units). Thus, Agent B is a prime lobbying target.

Next, let's consider effective lobbying strategies in this context. What are the best ways for Agents A and C to convince B to support their favored policy? And what are the implications and outcomes from this kind of lobbying competition? Let's take a look.

### *Lobbying Effectiveness*

To implement any policy in a democracy requires political support. Political support is obtained by convincing people that a policy is in their interest. The art of persuasion is called rhetoric and its techniques have been discussed since the time of Socrates, Plato and Aristotle.

The issues discussed in ancient Greek times have changed little two and a half millennia later. As discussed in Nichols (1987), Plato and Aristophanes both expressed

serious concerns about the use of rhetoric in political contexts. In Aristophanes' play, the *Clouds*, the protagonist seeks the assistance of rhetoricians who will help formulate an argument to convince a judge to forgive his debts to others. Rhetoric is imagined to be like the clouds that can take whatever shape is necessary for the circumstances at hand. Similarly, in Plato's *Gorgias*, Socrates argues that rhetoric is mere cookery; something that is designed to please the listener but which may have no regard for what is true and what the listener truly needs. In both cases, rhetoric is used to achieve private interests regardless of what is true.

In rebuttal, Aristotle argues that the rhetorician cannot be deceitful and hide behind his arguments. As Nichols states, "if a rhetorician is to be persuasive, he must show that his advice is advantageous to his audience, that what he is praising is noble, or that he has justice on his side. In such cases, his premises, his conclusions and his examples all reveal his character." Aristotle acknowledged that concepts such as justice and the common good can never be as precise as the sciences, but through rhetoric they can become knowledge whose truth holds for the most part. (Nichols, p 657)

In the context of the simple lobbying game presented in Table 5.4, the objective of agent A is to persuade agent B to support free trade, while the objective of Agent C is persuade B to support the status quo. B's support will depend on what B is most concerned about, thus, there are several possible approaches each agent can take. One possibility is that B is self-interested, caring only about the effect of the policy on himself. Alternatively, Agent B might be socially conscious, in which case he might care more about the overall aggregate effects of the two policy options. Finally, Agent B



might have a special interest that he is most concerned about. Perhaps he cares most about the environment, or sustainable development, or income distribution.

From Agent A's perspective, if Agent B's concerns are mostly self-interest, then A needs to persuade B that his payoffs will be in the range  $(0, 4)$ . If Agent B is concerned mostly about the overall social effects, agent A must persuade B that the sum of the payoffs to all agents is positive. If B has other concerns, A will need to focus attention on those issues and convince B that trade liberalization will have a positive outcome vis-à-vis those concerns. In like fashion, Agent C will wish to convince B that the payoffs to trade liberalization lie in the range  $(-4, 0)$ , or that the sum total value of all effects are negative, or that the environmental quality will decline, or income distribution will widen with trade liberalization, etc.

More realistically, we can think of agent B, not as one individual, but rather as a large group of individuals; some percentage of which care mostly for their own self interest, another percentage that is socially conscious about a variety of issues. Effective lobbying will involve identification of the most significant of these concerns among the group so that resources can be directed towards appropriate campaigns. Gaining B's support will mean convincing a significant proportion of this middle group to support your favored policy.

But what is an appropriate campaign?

If Agent A and C both determine that Agent B is mostly self interested, then Agent A's task is to convince B that TL will benefit him, while C must convince him of the opposite. If the agents conclude that Agent B is mostly socially interested then Agent A will argue the overall benefits will be positive, or that TL will be fair and just in some

sense. Agent C will do the opposite. In any case, both agents A and C will conduct research studies that tend to support the conclusions that will help make their preferred case. Since there is great uncertainty about the overall effects, it will be relatively easy for different researchers to come to completely different conclusions. Also, as was argued in Chapter 3, it is impossible for any research study to incorporate and measure all of the impacts the policies may have. Thus, Agent A researchers can simply overemphasize the components that seem to make Agent B better off, or to make trade liberalization welfare improving. For example, they can point out that lower prices will be good for all consumers, or, they can focus on overall efficiency effects arising in standard economic models. At the same time Agent C researchers may argue that the threat to jobs may affect many industries and will emphasize adjustment costs that accrue to the import-competing industries.

Notice that the truth is not really important for effective lobbying. If the “true” effect of trade liberalization on B were (+1), Agent C would have no incentive to reveal that truth if indeed Agent C knew it to be the truth. Of course, Agent A would be perfectly happy to reveal the truth in this case if he knew it, but would be equally unconcerned about the truth if the effect on Agent B were (-1) instead.

It is also worth noting that neither agent has any incentive to point out that the truth is really unknowable. If either Agent were to take that position, it would immediately destroy its credibility and any hope that it could convince B to support its policy. Thus, each side is induced, by the nature of the game, to argue that the effects of policies are more certain than they truly are.

Because uncertainty decreases the effectiveness of lobbying, the more credible or believable these studies are to Agent B, the more likely the information will persuade B to vote in that direction. Thus Agents A and C will do whatever they can to enhance credibility. Research studies that are more sophisticated and complex will seem more credible than simple studies. This can work even if Agent B doesn't understand what the study is showing.

If the research was done by someone at a prominent university or research center, all the better. If one can enlist the support of "Nobel-Prize-winning" economists, that too can help garnish support. If your policy is supported by someone famous, even though fame has little to do with knowledge or understanding of the policy effect, that is also beneficial. Thus, Hollywood movie stars can influence voters even though they are rarely experts on the subject

More insidiously, if enhancing credibility can win more support, then reducing credibility can reduce support. This then becomes a strategy for the opposition. Each study released by Agent A, identifying positive effects of trade liberalization, will be criticized by Agent C. Weaknesses in the study are emphasized. Aspects that have been overlooked or ignored in the study are highlighted. This is easy to do, of course, because as discussed in Chapter 3, every study is incomplete in its coverage; every study makes a series of assumptions each of which may not be true.

Even the very best empirical research study can be picked apart by someone who is an expert in econometric methods. This is true even when the study employs all of the latest empirical tools and techniques. The reason is that despite using the very best research "technology," every study must make an enormous number of assumptions.

Challenge the validity of any of these assumptions and one challenges the entire set of conclusions.

To be fair, the best empirical research studies are conducted with the utmost scrutiny and completeness. Thus, of course, the very best studies are less easily criticized. Nevertheless, even though the results of these studies are the very best the profession can muster, they remain the best possible in the face of extremely incomplete, inexact, or overly aggregated data. Although the results of these studies are “suggestive” of patterns or relationships, they remain quite distant from providing definitive “proof” of anything. This is one reason why virtually every research study concludes with the words, “.. and thus there is a need for further research.”

### *Ad Hominem*

Since the reputation of an individual making the argument can raise the credibility of a study, so then, impugning the reputation of the individuals associated with a study can reduce credibility. This often leads to the ad hominem arguments that are, unfortunately, all too common. As an example, consider Sen. Byron Dornan’s remarks about economists prior to arguing about the invalidity of the principle of comparative advantage in today’s world. He says,

“These economists, puffing on their pipes, doubtless sitting in their sunrooms wearing their sweaters with leather-patched sleeves are meditating on the theory developed by David Ricardo in 1815.”<sup>viii</sup>

So, economists are pipe-puffing, sunroom-sitting, leather-patch-sweater-wearing, meditators! Even though his ad hominem remarks are relatively tame, they nevertheless build upon a popular stereotype suggesting that academics are holed up in an “ivory tower” and completely divorced from the realities of the world.

Although these types of arguments are not germane to the issues at hand, they are used because they are often very effective. The intention is to portray the person making the opposing argument in such a way as to make him or her undesirable. In this way, a person whose opinion is not yet fixed will feel, even if only subtly, that he does not wish to be associated with that “type” of person. And if he doesn’t wish to share company with the person, perhaps he won’t wish to share opinions either. Psychologically these can be very effective statements even though logically they ought to be considered immaterial and even mean-spirited, especially since they develop or build upon stereotypes.

### *Exaggeration*

For both agents, persuasion is more likely to be successful with an overemphasis of the strengths of your preferred policy and an underestimate (or by ignoring) the weaknesses. When two competing policies are being considered, successful persuasion is also enhanced by overemphasis of the weaknesses of the opposition policy and of course an underestimate of its strengths.

The reality of effective lobbying is that neither side has any incentive to present an *unbiased* account of the strengths and weaknesses of the policy proposals along with an accurate revelation about the degree of uncertainty. In political discourse it seems any leaning in the direction of objectivity (meaning recognition that the opposition may be making some valid points) becomes fodder for the opposition to attack and almost assuredly reduces support for your policy. Because the general public is smart enough to recognize that most policy choices will have some negative effects, each side will pay

minor lip service to the negatives aspects of their own policy. Mostly though, these references will suggest that the negative effects will be very small and temporary.

Hence, objectivity is locked in a kind of prisoner's dilemma because of the nature of political debate. Outside observers of the debate should be cautious. The truth may lie in some convex combination of the statements made by all parties to the debate, but it is unlikely to be found in the statements of any one party.

Can we expect more objectivity from the academic community? More so, perhaps, but probably not completely. Academics who study policy and advise policymakers will realize that taking a policy position and supporting it rhetorically (preferably using as much scientific empirical support as possible) is the best path towards success in the profession. Publishing opportunities and consulting jobs are all driven by demand for one's output and if the output conforms to the political rhetorical needs, then it is more likely to be used and cited.

### *Conclusion*

Policies are chosen via a political process. That means that ultimately, any discussion of appropriate policy choices must consider the interface with politics. This chapter has highlighted several important features of the democratic political process as it impinges upon the discussion over globalization policy.

First, the standard economic prescription to maximize economic efficiency and compensate any losers seems unlikely to be chosen in a democracy. If agents are self interested and well informed, those who stand to gain from a policy change merely need to convince a majority of decision makers to choose that policy. Winners stand to gain much more when compensation is not made and when only 51% is needed to secure a

policy change, compensation need not be implemented. Indeed, it may be that compensation can be adequately implemented only if there is a benevolent dictator who is egalitarian minded and who has perfect information about the total effects of the policy. These conditions are never, even nearly, satisfied. An alternative is for most citizens to give up their self-interest motive and vote for egalitarian outcomes such as compensation. This too would seem to be quite unlikely.

Second, democracy may inspire the use of transfers, either money or some other benefits, to induce support for one's favored policies. But transfers, or more nefariously, bribes, are more likely to be effective if they can be done secretly. With secrecy it is possible to avoid the more costly outcome if there were competition in bribes. Secrecy also puts the non-bribing party at a distinct disadvantage and is one reason bribery is illegal in many contexts; but not all.

In some societies bribery is almost an accepted way of life, even if only grudgingly accepted. In these cases, competition in bribes may be the norm, which could assure that the most efficient outcomes are chosen. However, even with an efficient outcome, all parties will not share in the benefits. Indeed, differing practices regarding the use of bribery to secure outcomes in both private and public venues creates difficulties for firms engaging in international trade and investment. If some agents use bribery freely when others are restricted because they are forced to follow their own country's laws, then those firms may be at a competitive disadvantage. Lastly, to assure efficiency, the parties must have good information about the effects of the policies.

Because generally convincing information is not available for reasons outlined in the previous chapters, the democratic political process opens the way for lobbying.

Indeed, lobbying, which involves transmitting information to persuade others to support your policy, cannot arise unless information is imperfectly known. The key concern with lobbying is that it is a directly unproductive activity; that is, lobbying diverts resources. The more lobbying, the fewer resources available to produce goods and services that contributes to standard of livings. Furthermore, when there is competition in lobbying, as there most assuredly will be, directly unproductive activity can multiply. The prime beneficiaries of the lobbying process may be the lobbying groups themselves since the groups who advocate alternative policies all transfer income to the lobbyists to help them win the political contest.

The second important aspect of lobbying in the democratic choice process is its effect on the way information is disseminated. Policy choices in democracies are made with majority support. Those groups who recognize they will gain or lose from a policy will disseminate information – lobby - to garner that majority support. The majority needed may be amongst members of the legislature or among the voting public, depending on the circumstances.

Lobbying involves the use of rhetorical methods to convince people to support a group's favored policy. Effective rhetoric often involves some bending of the truth. For example, supporters of a policy have incentives to overemphasize the positive effects of that policy and the negative effects of the alternative policies. This is why, for example, there is a popular impression that economists and other supporters of free trade believe that free trade is good for everyone; when in fact theory does not support that view. Also, the previous chapters argue that our knowledge about the global economy and the effects of policies is much more uncertain than commonly described. Rhetorical



necessities can explain why there is an under emphasis on the weaknesses of research results. However, as a counterbalance, opponents of a policy do tend to emphasize the negative aspects of the opposing studies. Finally, rhetorical needs in the democratic political process may inspire bias in the investigation process itself. Research is more likely to be done in areas of current interest. Research papers are more likely to be read and cited when they offer clear support for a particular policy. In addition, groups who stand to gain from certain policies under discussion, will commission studies that tend to support those policies. The result is a clustering of studies supporting particular policy options, rather than an unbiased and objective assessment divorced from the objectives of special interests.

The entire lobbying process and its misrepresentation of information is also a potential source of disillusion for the electorate and may explain a drop in political participation. People regularly complain that they can't believe politicians – and to a degree, this is correct. Politicians purposely frame arguments to support their proposed policies. While they do not necessarily *lie*, they do adjust the emphasis on the positives and negatives considerably. This is a natural consequence of the political system.

Most individuals are not specialists in international economics and have only a modest amount of knowledge about the global marketplace. As a result they must base decisions, such as who to vote for, or which legislation to support, on the experts who study, interpret and communicate the workings of the world. However, these experts are engaged in a kind of ideological tug-of-war, using all techniques possible to sway a few more individuals to join their side. Because the true nature of the world is extremely complicated and messy, it becomes impractical to express a nuanced argument supporting

your favored position. Nuance is not describable in a 30-second sound bite. Nuance also breeds confusion and that means there is less chance the average person will understand it. In addition, to express the true nature of the world, with all its ups and downs and all its uncertainty, will very likely lead people to switch to the rosier (and clearer) scenario provided by one's opponent.

For some people there is no predicament because they eventually join one camp or the other, grab hold of the ideological rope along with their fellow believers and begin PULLING! Many of these individuals begin to believe all the "truths" that their side is presenting.

However, for the moderates, or the confused, or the seekers of truth, or those who just can't make up their mind, there remains an uneasy feeling about the whole process. I suspect this is a prime source of political apathy. Many people believe that no one is telling them the truth and with the increase in distrust comes a quiet disillusionment with the entire system.

Although democracy does provide a mechanism to choose policies, the tendency for the process to distort information makes the process problematic. Perhaps, Aristotle's notion is valid: that political discourse can arrive at a compromise solution between groups with heterogeneous interests.<sup>ix</sup> Alternatively though, it is possible the political system is not *leading* towards any particular outcome. Perhaps it is leading us in circles. For example, lobbyists will support maintenance of the political system, because, as long as there is contentiousness in public policy circles, money will keep being transferred in their direction. Next, since there really is no way to be certain of the overall effects of policies – at least not definitively or convincingly to all – and since there will always be

expected winners and losers from every policy change, contentiousness is self-propagating. Third, governments, that implement policy changes, always need to be *doing something* to justify their existence. Hence “new” policies are always being proposed. Finally, policy researchers have little to no incentive to upset the process. No side can admit the degree of uncertainty in their own studies lest the opposing side gain an advantage. No side can waver from the position that its own analysis is asking the right questions, building the right model, collecting the right data, using the most appropriate empirical technique and discovering the most appropriate policies. Thus, while democracy may have the potential to solve the policy choice problem, it is not clear it does so effectively in its current configuration.

The remaining part of the book will suggest a new method for choosing policies. That method involves description of set of compromise principles that can guide policy choices. These principles will provide a justification for policy choices that are likely to generate outcomes that are pretty good from both a cost-benefit perspective and from a fairness perspective as well.

---

<sup>i</sup> Downs, Anthony, (1957), “An Economic Theory of Political Action in a Democracy,” *Journal of Political Economy*, (65) 2 p 139.

<sup>ii</sup> The payoffs could be measured as monetary payoffs; perhaps millions of dollars accruing to each group.

<sup>iii</sup> Here we’re imagining perfect information, albeit with a bit of a lag.

<sup>iv</sup> Although, bribery could involve some unproductive activity if there were transactions costs to make the bribe.

---

<sup>v</sup> See Bhagwati, J. (1982), "Directly Unproductive Profit-Seeking (DUP) Activities," *Journal of Political Economy* 90, (October), pp. 988-1002.

<sup>vi</sup> Economists use the term asymmetric information to denote the situation where one agent has knowledge about something but another does not. There is a large literature in economics that addresses problems such as these.

<sup>vii</sup> Of course this assumes the agents know the ranges and the distribution of probabilities, which by itself is a lot of information. In reality agents don't even know this. However, in all economic analyses assuming uncertainty it is necessary to assume that agents at least know the nature of the uncertainty.

<sup>viii</sup> Dorgan, Byron, L, (2006) , *Take This Job and Ship It: How Corporate Greed and Brain-Dead Politics are Selling Out America*, New York, St. Martin's Press.

<sup>ix</sup> See Nichols (1987) p.661.