

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

Chapter 1: Introduction

We study economics because we care about people. The economic system produces and distributes goods and services to over 6 billion people around the world. These goods and services contribute to people's sustenance, shelter, warmth, security, entertainment, knowledge, and self-worth, which, in turn, affect their happiness.

If we can understand how the economic system generates the positive effects on well being, then we might also learn what can be done to make the system work most effectively. How well the system works depends upon *policy*, which includes a country's legal system, the laws and regulations that are in place, and the practices and customs of a country's businesses and households. Thus, if we study economics because we care about people, then we must also care about policy. Every theory and empirical evaluation relates in some way to policy evaluations.

Which set of policies is best for a country is a subject of continuing and never-ending debate. Although the collection of knowledge about the economy and how it works is extensive, this body of knowledge has not produced anything close to a consensus identifying the very best set of policies or practices. A lack of consensus exists in many areas; health care provision, energy policy, industrial policy, tax policy, environmental policy, monetary and fiscal policy, and all other policies areas as well. In each of these areas, debate about appropriate policy rages on.ⁱ The policy debate is especially contentious with regard to globalization.

Globalization can refer to many different things: the expansion of trade and investment flows across countries; the advancement of telecommunications and the widespread use of the internet; the changing cultural and religious attitudes and beliefs in many regions; and the conflicts that arise between peoples. The debate about globalization involves discussions about trade and finance, the environment, global climate change, cultural identities, labor laws, natural resource usage, economic sustainability, agriculture, national security and much more. Although the issues are extremely diverse, in terms of the discussion about policy that follows, we will focus primarily on *economic* globalization.

After the Great Depression in the 1930s, many nations embarked on a gradual systematic dismantling of trade barriers. The General Agreement on Tariffs and Trade (GATT) facilitated this movement by engaging countries in successive multilateral trade liberalization rounds committing member countries to reciprocal tariff reductions. The Uruguay round, the last completed GATT round, created the World Trade Organization (WTO) and countries committed themselves to an expanded set of trade liberalization measures involving agriculture, services, intellectual property rights, and import quota systems. As barriers to trade came down over the years, the volume of international trade and investment grew rapidly. This expansion of economic activity is clearly one of the more significant aspects of globalization. Nevertheless, as movement to freer trade became more widespread around the world, doubts about free trade as an appropriate policy choice also began to grow.

Although many developing countries joined the WTO in the 1980s and 1990s, some representatives from those countries now feel that the WTO agreements are tilted in

favor of the large economies like the US and the EU. The latest WTO round of trade liberalization efforts (the Doha round) has been stalled for several years. Protests against the WTO and other international organizations have become commonplace.ⁱⁱ In the US, fast-track authority, the Congressional green light enabling the US President to negotiate free trade agreements, has expired and seems unlikely to be renewed anytime soon. Finally, fears about the rapid expansion of two new economic giants, China and India, are sending shivers across the globe. In the US, dozens of pieces of legislation have been proposed in the last few years (though none yet approved) targeting Chinese imports. Doubts about trade have extended to doubts more generally about globalization.

In the popular press there are numerous suggestions that the traditional view about freer trade is overly optimistic and even that economists themselves are beginning to rethink the standard prescriptions. Some have argued that although the principle of comparative advantage may have been true decades ago, it is not longer valid because production factors like labor are mobile internationally like never before. In addition the advent of telecommunications have opened up opportunities for service sector trade that now affects high wage jobs in developed countries. One notable economist, Alan Blinder, although not denouncing free trade, has nonetheless suggested that the current wave of globalization may result in a loss of as many as 40 million service sector jobs in the US.ⁱⁱⁱ The Wall Street journal reported Dani Rodrik, a noted Harvard economist, saying, "... global trade negotiations should focus on erecting new barriers against globalization, not lowering them, to help poor nations build domestic industries and give rich nations more time to retrain workers."^{iv} Even Nobel laureate Paul Samuelson, the

founder of modern economics, emphasized in a recent article that free trade may not always lead to national gains.^y

To outside observers these statements seem to announce a paradigm shift in the profession. It seems that economists are realizing that free trade may not be so good after all. However, to insiders these statements really don't reveal anything that hasn't been known to economists for the past half-century and more. Although the patterns of trade are different and the pace of change is faster than anyone is accustomed to, the underlying principles and processes require few adjustments in our thinking. Modern economics really does tell a very consistent story, however in many ways, the presentation and dissemination of those ideas has not been very effective.

Ineffective communication has resulted in a popular misunderstanding about what economic theory and empirical studies tell us about free trade and globalization. Rodrik (1997; p. 72) wrote that,

International economists in particular have been too Panglossian about the consequences of globalization. ... They have been too quick to paint those who have taken a more concerned stance as ignorant of economics or as closet protectionists (and sometimes both). Largely as a consequence they have shut themselves out of the broader policy debate.”

As a consequence, groups with different interests have become increasingly polarized, thereby contributing to a rising contentiousness over trade and globalization issues and a growing uncertainty about how best to step forward.

Globalization is complicated. Because it touches upon so many separate issues, it also touches many different people with different occupations, cultures, and nationalities. Each person looks at the globalization phenomenon from a different perspective, drawing upon a unique set of personal information, shaped by one's education, one's cultural

identity, and one's distinct view of morality. It follows that there are a multitude of views about what's right and wrong about globalization and what the most appropriate set of policies should be. As such, the globalization debate provides an ideal issue around which to discuss the more general problem of how to determine the most appropriate policies; especially policies that can appeal to a wide set of interests.

This book is largely about method; what is the most effective way to choose policies. The book approaches the issue by first outlining the traditional arguments supporting both free trade and free markets as well as the arguments supporting policy interventions in trade. The focus of this discussion is to assess how certain we can be of the conclusions reached via alternative investigative methods. In other words, we carefully reflect upon the results of models, both theoretical and empirical evaluations, along with the ethical and political considerations, and ask if the answers researchers provide should convince an *objective observer* what are the best policy choices.^{vi}

Outline of the Book

The question of policy choice is clearly normative; seeking to identify what “should” be done, rather than merely asking positive questions like, “how” do things work? Nevertheless, to discuss what is best, one must also know something about how things work. The study of positive economics is needed to tackle the normative issues.

The book is laid out in two parts. The first part examines the intellectual arguments and political methods used to support and choose policies. This part examines the theoretical approach, the empirical approach, the fairness and social justice approach, and the political approach. It concludes that although we have extensive knowledge about many important interrelationships in the world economy, the extent of our

knowledge does not rise to the task before us. An objective observer would have to conclude that our current state of knowledge about the effects of policies from either a theoretical, empirical, ethical or political perspective, does not point to a particular set of policies that can be generally accepted to be best.

The first part of the book also emphasizes that while current research suggesting best policy options should not be convincing to an objective observer, it is usually more than adequate to convince non-objective observers. Non-objective observers are those who recognize their position in society and the economy, and act to implement policies that serve their own particular interests. This group includes virtually everyone currently engaged in the political, social and economic debate about policy. In short, non-objective observers refer to what others call special interest groups, and everyone in society is a part of many special interest groups. These special interest advocates use theory and empirical research to infer how their interests will be affected by various policies. Once effects of policies are inferred, these groups enter into the political discussion to sway popular opinion to support their policies. In other words there is considerable bias in the discussion surrounding policy choices: special interest groups are inclined to accept and promote the validity of research that tends to support their positions and deny the research that opposes their positions. Their positions also motivate the political discourse and tend to push policy outcomes in the direction of greatest influence rather than in the direction of what might be deemed best in some more general sense.

It is natural that teachers, professors, and authors all transmit their knowledge and ideas to others through the filter of their own particular experiences and interests. While the degree of objectivity surely varies from presenter to presenter, it is often difficult to

know which presenters are more objective. This poses a challenge to anyone trying to understand our current state of knowledge and who wishes to use this info to identify appropriate policies. This book takes the problem associated with bias and non-objectivity very seriously. Although evaluation bias might be impossible to overcome completely, perhaps, with a pointed awareness of the problem, we can present a mostly objective evaluation of our current state of knowledge relating to globalization policy issues.

Because the objective evaluation in the first part of the book concludes that current methods of policy evaluation are inadequate, there is a clear need for an alternative. The second part of the book suggests an alternative method in the form of a simple heuristic mechanism to guide policy choice. The choice mechanism is derived by focusing attention on the debate about profit seeking, with profit defined very broadly.

Free trade advocates, following the wisdom of Adam Smith, tend to believe that profit seeking by firms and individuals have positive social effects. Many believe profit seeking - greed even - is good. In contrast, supporters of social justice and fairness tend to believe that profit seeking on the part of firms and individuals contributes to many of the problems we witness in the world. For many other people, profit seeking and greed is not only bad, but immoral.

This book suggests that it is not profit seeking, or greed, or egoism, or a lack of altruism, that is the real problem. Rather, it is the way in which profit is achieved. The book distinguishes between three methods of acquiring profit: involuntary transfers, voluntary transfers, and voluntary exchange. Transfers occur whenever one person gains at another's direct expense. Theft is a simple example of involuntary transfers whereas

charity is an example of voluntary transfers. Voluntary exchange arises whenever a mutually voluntary trade between two parties occurs.

The suggested heuristic choice mechanism involves the implementation of laws, policies and institutions that promote voluntary exchange and voluntary transfers while limiting or prohibiting involuntary transfers. It is shown that adherence to these principles are mostly fair with respect to an extensive set of fairness principles described in the first part of the book. The book also argues that the heuristic mechanism can account for many of the concerns of policy proposers from multiple sides of the policy debates. As such, the mechanism provides a moderate compromise solution.

With respect to globalization policy directly, the book unconditionally supports free trade and international factor mobility. The book shows that popular exceptions to free trade, such as trade remedy laws, agricultural export subsidies, and strict immigration laws directly conflict with the heuristic mechanism.

Following the mechanism also helps to delineate an appropriate role for government. The book proposes that government is needed to prevent involuntary transfers and to enable voluntary exchange and voluntary transfers. What is needed is property rights, enforcement of contracts, a national defense, police protections and laws against theft and corruption. These government interventions protect citizens from the losses provoked by others. Similarly, laws to inhibit monopolization, provision of bankruptcy procedures, and avoidance of impediments to trade both domestically and internationally promote voluntary exchanges. Finally, the provision of public goods and social insurance such as unemployment compensation, welfare, and the provision of roads and parks, commensurate with the taxpayers' desires, enable voluntary transfers.

The book is laid out as follows:

Chapter 2 discusses what economic theory can tell us about the effects of globalization and trade on the well being of individuals. The chapter emphasizes several important results. First, any policy action, whether trade liberalization or trade protectionist policies, will cause a complex redistribution of income internationally; in other words, any policy change will generate both winners and losers. The economic solution to redistribution is to compensate the losers with gains from the winners. Effective compensation occurs whenever gains to the winning groups are sufficiently redistributed to the losing groups such that everyone can be left better off afterwards. However, to succeed, compensation requires that the policy change generate net benefits.

The chapter continues with a description of the trade policies that may be national welfare enhancing policies. Although many economic models conclude that free trade is welfare improving, this is only likely in very simple models. When more realistic market complications (a.k.a. *imperfections*) are included in models, it is common to see that well-designed policy interventions, rather than free trade, can raise national welfare.

The chapter concludes by highlighting two significant problems that are apparent from a review of the theoretical literature. First, there is no clear policy prescription that will assuredly improve national welfare. In some instances free trade may be best; in other instances a different type of policy intervention may be best. There is no way to know unless we can measure the magnitudes of the positive and negative effects. Secondly, even if we could identify national welfare improving policies, there will still be winners and losers requiring a compensation scheme in order to assure that everyone benefits from the policy. Here too there is a measurement problem since, for

compensation to be effective, we would need the net total benefits to be positive and how much each person wins and loses. Although theory can teach us about the nature of the effects of various policies, because of the complexity, theory alone cannot tell us what are the best policies. We simply cannot be sure that free trade, or any other type of policy, is best.

Chapter 3 considers the effectiveness of empirical measurement in evaluating policy options. It evaluates the methods used to measure the costs and benefits of different policy options and whether these investigations can; a) determine which policies are national welfare enhancing; and b) determine who are the likely winners and losers. If we can measure the size and incidence of the effects, then we can also identify which policies are best.

The chapter concludes that despite the tremendous advances in data collection and computing capacity, an appropriate evaluation requires a level of detail that we simply do not possess. The studies that are done are either too partial (incorporating only narrow impacts) or too general (measuring aggregated averages that masks the redistributive effects). Thus, a truly objective observer should recognize the inconclusiveness of this research and determine that empirical analysis cannot tell us what to do about policy.

Chapter 4 considers the policy arguments made by proponents of social justice. Many who oppose policies promoting globalization argue that openness to trade and investment is fine and good as long as the policies are just and fair. Many of these arguments are very compelling. Nevertheless, the use of an ethical criterion to judge policy choices proves to be problematic as well.

The chapter identifies and describes multiple fairness and justice principles used in globalization policy debates. Each fairness principle, while individually reasonable, also tends to contradict other fairness principles. The larger implication is that every policy, whether interventionist or not, can be justified as being either fair or unfair, simultaneously. This conclusion should lead an objective observer to conclude that fairness and justice cannot tell us how to choose the best policies.

Chapter 5 considers the policy decision process in a democratic society focusing on the question of whether democracy can provide a mechanism by which the best policies might be chosen. One possibility is that disparate individual interests are aggregated within a representative democratic framework resulting in policy choices that reflect a kind of collective-average ideal.

The chapter explains why the economic ideal, in which overall benefits are maximized and losers are compensated with the gains of the winners, is unlikely to arise in a representative democracy. Instead, special interest groups are more likely to initiate policies that result in concentrated benefits for a few at the cost of dispersed losses to the many. The democratic process is also a contributing factor explaining why objective evaluations, especially those revealing significant uncertainties, tend to be ignored in the policy debates. In the end, an objective observer would conclude that because of the prominence of non-objective influences (i.e., special interests), democratic processes are very unlikely to effectively choose the best policies.

Chapter 6 begins the second half of the book by introducing the alternative approach to choosing best policies. This approach involves the application of a heuristic choice mechanism applying three simple principles. The mechanism states that policies

should be chosen that a) support free and voluntary exchange between individuals, b) oppose involuntary transfers between individuals, and c) enable voluntary transfers between people.

The approach is practical because it eliminates the need to conduct complex empirical investigations to determine the welfare impacts of policies. Instead attention focuses on the rules-of-thumb and whether they are supported or opposed by the policy. It is labeled a moderate compromise approach because it promotes the strengths and mitigates the weaknesses of the previous approaches. The chapter emphasizes with several examples how many objections to policy proposals on various sides of the debate are essentially violations of one or more of these fundamental principles. The succeeding three chapters examine each principle in turn.

Chapter 7 considers the many ways in which involuntary transfers arise. The most common example is simple theft or violence against another person. To protect individuals against these threats, countries have laws that inflict penalties to offenders that are found guilty of these infractions. These types of policies are shown to be consistent with the heuristic policy choice mechanism and as such begin to build a case for appropriate government policies.

The chapter extends the analysis to many other situations including cases where government interventions themselves enable involuntary transfers. In these cases, proponents of the policies are those whose special interest is satisfied, while those opposed tend to recognize the involuntary nature of the policy. Strict application of the no-involuntary-transfer rule though, would eliminate from consideration many policies

that have been implemented largely because special interests have, over time, exerted their influence in the democratic process.

Chapter 8 highlights the well-known result that all parties benefit from voluntary exchange. The chapter proceeds to explain the dynamic workings of a competitive system. Although such a system will generate mutual benefits to the trading parties, it will often not work to the benefit of other people who are external to that pair-wise trade. In other words, although every individual trade is win-win, because new pair-wise trades will often substitute for previous trading patterns, some firm's successes will cause other firms injury. This is akin to what Schumpeter called the process of "creative destruction."

The chapter also highlights the positive incentive effects that come from the fear and anxiety generated by the competitive process. In other words, the positive effects of competition are actually inspired by the negative aspects of competition. Without the destructive process, there are fewer incentives to produce goods and services that are more desirable to consumers; that is, without the pain, there will be less gain.

Understanding these features of the competitive process is very important to recognize; first, because supporters of free markets often exaggerate the benefits of trade and globalization; and second, because opponents tend to use the negative effects that arise from competition to tilt policy choices in the direction of their special interests. Both reactions make it much more difficult for an outside observer to ascertain the objective truth about the effects of policy options.

Chapter 9 explores applications of voluntary transfers. The innate desires that people have to help others in distress motivate a substantial amount of charity and

philanthropy throughout the world. Much of this occurs within households as income earners transfer benefits to others in both their immediate and extended families. Much also occurs as individuals contribute to support their churches, synagogues and mosques. Voluntary charitable contributions fund many non-governmental organizations (NGOs) such as the Red Cross, the United Way, and Doctors without Borders. Finally, the charitable giving of very wealthy individuals has resulted in the formation of many philanthropic organizations like the Gates and Ford Foundations.

However, all charitable giving is not created equally; not all charity represents voluntary transfers. Instead, some charity involves a kind of payment for the provision of goods or services. For example, much of the giving to religious organizations finances the building of a church and supports the clergy who in turn provide religious teaching and other services to the contributors. As such, this is more like voluntary exchange than voluntary transfers. Similarly, contributions to NGOs like Greenpeace fund the lobbying and education services related to the promotion of a particular cause or special interest. To the extent these activities are successful, they may represent payment for the successful invocation of involuntary transfers towards the special interest group members.

Also, some activities that may seem to be involuntary transfers, such as government taxation, can be interpreted as voluntary transfers instead. This is because the problem associated with free riding in the provision of public goods can motivate a desire on the part of a collective of people to relent to taxation, coupled with punishment for non-payment, to support the provision of a social safety net.

In Chapter 10 the heuristic mechanism, described in detail in the previous four chapters, is applied to a series of globalization and public policy issues. This chapter highlights the alternative approach that does not rely on aggregate cost-benefit analysis. There is no need to determine who wins or loses, and no need to discern whether a country is better or worse off. Indeed we can throw much of that analysis away since it will never be any better than inconclusive. We can also ignore many of the common appeals to justice and fairness since these are often involve partial applications that are ultimately contradictory.

Evaluation of policies in light of the three heuristic principles is shown to be straightforward with respect to some policies, but much more difficult with respect to others. For example, the policy of free trade is easily shown to be consistent with the three principles. On the other hand, intellectual property rights provisions are more difficult to evaluate since they involve granting anti-competitive monopoly rights to motivate the incentives to innovate.

The final Chapter 11 concludes with a bold globalization policy suggestion for the US; a graduated and unilateral movement to free trade and international factor mobility. Acceptance of the heuristic mechanism as a reasonable approach to policy choice makes this suggestion a logical next step. However, such a policy is fraught with obstacles; the first being a general lack of understanding of the way in which a truly free market system can work. Hopefully this book will clear up some of the misunderstandings. The second obstacle is the political system, which acts more to promote concentrated special interests rather than what a truly objective observer might promote. Suggestions for overcoming the political obstacles are beyond the scope of this book though.

In the end the book provides a critique and analysis of our current methods of globalization policy evaluation, draws the conclusion that an objective observer should find all of these methods to be inadequate, and provides a viable moderate compromise alternative involving a simple heuristic mechanism derived from three simple principles. However, while the simple principles should be non-controversial, the policies derived from those principles will more than likely conflict in one way or another with many common ideological positions, save perhaps the classical liberal tradition. Thus, general acceptance of this approach requires a compromise, especially on the part of those who hold more extreme ideological positions.

ⁱ In contrast, in scientific fields near consensus on many issues is much more common. For example, although there are some individuals who still object to the use of modern medicine, most doctors and patients (a near consensus) would accept that antibiotics are the most effective way to treat a bacterial infection or that surgical removal is the most effective treatment for a ruptured appendix.

ⁱⁱ The first major WTO protest took place during WTO ministerial meeting in Seattle in 1999. The protestors, representing an extremely diverse set of interests, became labeled antiglobalization since they were all objecting to an agreement designed to promote international trade and investment. However, it is perhaps more accurate to describe the groups as supporters of fairness and social justice, variously defined.

ⁱⁱⁱ Offshoring: The Next Industrial Revolution?, Alan S. Blinder, Foreign Affairs, March/April 2006

^{iv} Pain From Free Trade Spurs Second Thoughts, By David Wessel and Bob Davis, March 28, 2007, Wall Street Journal Online, Retrieved on 3-17-08 at http://online.wsj.com/article_email/SB117500805386350446-1MyQjAxMDE3NzI1ODAyMDg4Wj.html?

^v See Samuelson (2004)

^{vi} The hypothetical objective observer is akin to John Rawl's decision maker in an "original position," or under a "veil of ignorance." Rawls (1971) argued that the choice of a political and economic system should be done by a decision maker who does not know what position he or she will be in once the final outcomes in the system are realized. This *veil of ignorance* prevents the decision maker from using power or influence to shift outcomes in his preferred direction

since, not knowing who he will be, he would not know in which direction to shift. As such it is a useful construct to imagine how an individual would evaluate a policy when he doesn't have a direct interest in the outcome, but at the same time has some interest, since he expects to be randomly placed into some position at some future time. In this way the objective observer is thought to care equally, or non-discriminately, about the outcome for everyone. This book will imagine the perspective of an observer in this original position when making judgments or comparisons about policy options.