For: Daedalus

Public Interest and Economic Policy

by

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Economists, whose discipline has always had a strong relationship to moral philosophy—Adam Smith, the author of The Wealth of Nations, was also the author of the celebrated Theory of Moral Sentiments—have always seen their role in society as that of pursuing the public good. They properly see themselves as guardians of the public or general interest, and to be engaged in public policy debates against special interests who wish to "capture" policy to advance their narrowly circumscribed, self-serving agendas.

Preliminary Observations and Caveats

Of course, I must note at the outset that, as one analyzes the public debates on questions of economic policy, one sees cynical attempts by special interests to gain the higher ground. One might observe wryly that, in the battle for public support, you try to gain advantage by claiming that your opponent's interest is "special" and your own is "general." We have long known that special interests have learnt their Orwell well: they understand that words matter in public debates.

Thus, protectionists have typically used the inviting phrase "fair trade" to mask their protectionism.[1] This was true at the end of the 19th century when Britain, the longstanding proponent of free trade, was facing the rise of Germany and the United States: "fair trade" became a cry of the protectionists then, with these newly emerged and protectionist trading nations charged with "unfair trade" and Britain's free trade policy condemned as inappropriate, as Britain faced its "diminished giant syndrome". The United States would face the same syndrome a century later with the dramatic rise of

[1] Throughout this essay, I draw on examples from the theory of commercial policy where my scholarly expertise is the greatest. Similar examples can surely be drawn from other areas of economic scholarship and policymaking.

Japan in the 1980s and the dreaded prospect that the 21st century would be Japan's as the 20th was America's and the 19th was Britain's. Thus, exactly as in the case of Britain at the end of the 19th century, the United States witnessed the growth of demands for "fair trade", the charge against Japan being that it was a wicked "unfair trader" that excluded imports and dumped its exports. Soon the public policy space was filled with demands for "free and fair trade". The latest proponents of such demands are the AFL-CIO, and the New Democrats and (therefore the Old Democrats who must fall in line) who are concerned instead with competition from the poor countries and desperately seek ways to protect themselves from such competition by again claiming that these poor nations are indulging in "unfair trade" because they have labor and domestic environmental standards that are not identical to those in the United States. Raising these standards in the poor countries, in the name of "fair trade" is nothing but a form of "export protectionism": it is aimed at raising the cost of production in these countries and thereby moderating the competition they provide. Of course, these lobbies are equally adept at disguising this protectionist agenda by claiming simultaneously that their demands to have the poor nations to raise their labor standards to US levels are inspired by empathy and altruism for the workers in the poor countries: a claim that is belied by reading the political campaign speeches of the New Democrats who always spoke instead of the unfairness of losing jobs to rivals with lower standards, i.e. about import competition.

Then again, economists frequently see themselves painted as venal fronts for "corporate interests" on issues such as free trade, by lobbies that forget John Stuart Mill's observation that no general interest was ever advanced unless someone's special interest was advanced alongside it. In a democratic society, where votes matter, free traders such as myself realize that free trade cannot be advanced by ideas alone: it is not enough to have the generals, you also have to have the troops. Also, if special interests like corporate interests happen to see their profit in what you propose, that does not subtract from the fact that the policy you advocate is prompted by the general interest.

One moral for the economists who see to influence public policy, however, is to ensure that they do not open themselves to the charge that they have been "bought." Thus, when I was almost alone defending Japan in the years of Japan-bashing in the United States during the 1980s and early 1990s, and arguing against exaggerated and hysterical attacks by Detroit and other US producers, and by the media and the politicians, on Japan, I was careful not to accept any moneys for even a Lecture or a Conference paper in Japan. I recall that when I went to a MITI (Japanese Ministry of International Trade and Industry)-associated Conference organized by my good friend Professor Ryutaro Komiya (whom I got to know well when he was at Harvard and I was at MIT in 1956-57), we were all being offered $2,000 for our papers. All the Japan-bashers readily accepted the money but I said I would write but would not accept the honorarium.. So, I was given an extra lunch coupon! I spent it on eating tempura in the Okura Hotel, telling all my friends that I had had a $2,000 tempura in Tokyo. The punch line, however, was that prices in Tokyo were so high, and even more outrageous in the big hotels, that I could well have been tempura for $2,000!

For much the same reason, I have refused to consult with multinationals or to sit on their Boards of Directors. I generally defend multinationals against knee-jerk attacks from large numbers of agitators who treat multinationals and their "profits" the way moneylenders and "usury" were treated in the Middle Ages. I have little doubt that my refusal to get rich in the way many economists today by such self-imposed restrictions has enabled me to be more credible when I defend corporations against unjustified assaults.

In this regard, let me also add that corporations are often buying our reputations, not our analytical judgments. Their game often is simply to say, at a suitable price, that Professor Jagdish Bhagwati or Professor Paul Krugman or Professor William Baumol (Princeton and NYU) is on our side. I think we would be wise not to yield to such blandishments. We may give our advice anonymously but to give it with our names attached to it is a way to throw our reputation in the face of their opponents and also in the mud. Once, I was asked by an important beverage company operating in India to calculate the Indian elasticity of demand for canned sodas, and they clearly hoped to argue that it was so high that a reduction in the sales tax on them would raise more, not less, revenue (a la the Laffer curve). This surprised me since I am an economist who works with ideas and I do not ever crunch numbers, until I realized that they must know that I was a very good friend of the Finance Minister who is now the Prime Minister. So, I replied mischievously: I am afraid I cannot do this until the Finance Minister changes, and so I naturally never heard from them again.

Economists are also tempted today by large fees that accrue when they testify in the courts on behalf of corporate clients. Lawyers do this all the time, though I daresay that outstanding jurists abstain from such practice. Once I was giving a keynote speech at the Yale Law School and a lawyer teased me with the old chestnut, that where there are six economists there are six opinions (though Keynes had said seven opinions, two being his own). So, I teased him back from the lectern: that is bad enough; but with the lawyers the situation is worse: each lawyer has six opinions if he has six clients.

Pursuing the Public Interest

But even when these pitfalls are avoided by a scrupulous economist, there are real, substantive problems in pursuing the pubic interest. These arise from two different directions.

First, if we are to pursue the public interest by arguing that one policy is to be preferred over another (say, freer trade over retreat into further protectionism), we need to be able to analyze persuasively how the different policies will work. Then, we must have a criterion by which we choose among these policies, in light of this analysis. Economists call the first, "positive" analysis, and the second, "normative" analysis. Evidently, if either is defective, the economist's ability to say that public interest is advanced by a specific policy is compromised.

In truth, even the positive analysis leads often to irreconcilable differences, not just between economists and others but among economists themselves, vexing politicians who would prefer clearer guidance. Thus, Prime Minister Robert Peel, who abolished England's Corn Laws in 1846 and introduced free trade to the world for the first time, that too unilaterally, was clearly converted to free trade by the writings of economists starting with Adam Smith, though the celebrated Chicago George Stigler has written unpersuasively that "economists exert a minor and scarcely detectable influence on the societies in which they live… If Cobden [who led the anti-Corn Law movement] had spoken only a little Yiddish, and with a stammer, and Peel had been a narrow, stupid man, England would have moved toward free trade in grain as its agricultural classes declined and its manufacturing and commercial classes grew."[2] But Peel also famously lamented the fact that he often found conflicting analysis of the central questions in what was then called "political economy." Thus, he argued in the Parliament that:

"Far be it for me to depreciate that noble science which is conversant with the laws that regulate the production of wealth and seeks to make human industry most conducive to human comfort and enjoyment…. I find the difficulties [faced by us in accepting their less-than-compelling analysis] greatly increased by the conflict of authorities… The very heads of Colonel Torrens's chapters are enough to fill with dismay the bewildered inquirer after truth. These are literally these:--'Erroneous views of Adam Smith respecting the value of Corn'… 'Errors of Mr. Ricardo and his followers on the subject of rents.' 'Error of Mr. Malthus respecting the nature of rent,' 'Refutation of the doctrines of Mr. Malthus respecting the wages of labour.'"[3]

Little has changed since then, of course. At the heart of the problem is the fact that every economist does not share another's "model," whether explicit or implicit, which provides the map of how a policy will work. Thus, macroeconomics is plagued by different schools: monetarist (Milton Friedman), Keynesian, rational-expectations (Robert Lucas) and varying versions of each going under the names of neo-monetarist et.al. But even if we were to agree on a model to look at the world, we can and will disagree on the "parameters" to feed into the model.

[2] George Stigler, The Economist as Preacher and Other Essays, Chicago University Press: Chicago, 1982, pp. 63-64.

[3] Quoted in the brilliant article by Douglas Irwin, "Political Economy and Peel's Repeal of the Corn Laws," Economics & Politics, Vol.1(1), Spring 1989. Adam Smith was of course the dominant figure in the new science of political economy (Economics); but David Ricardo enjoys a nearly equal reputation and Malthus and Torrens were also major writers, active in the debates of their time.

But even when there is substantial consensus on an issue, such as whether freer trade is a better policy than protectionism, there will be some dissent among economists. There is, however, socially useful dissent; and then there is socially unproductive dissent. The case for free trade, and its historical evolution since the time Adam Smith wrote of its virtue over two centuries ago, illustrates this distinction well.

Take first the useful dissent. Since Adam Smith, there have been repeated episodes when prominent economists expressed dissent. . The reason was very simple in retrospect. Put heuristically, the case for free trade depends on our faith in the ability of markets prices to reflect social costs. When there are "market failures," an empirical issue, the Invisible Hand (which depends on market prices being socially correct guides to efficient allocation of resources) could be pointing in the wrong direction. Thus, when there was massive unemployment after the Great Crash of 1929, evidently (the positive) market wages did not represent the true social cost of labor (which was zero); and Keynes became a famous dissenter advocating protection. In modern times, since the Second World War, economists have analyzed imperfections in the labor and other "factor" markets; and my eminent students Paul Krugman and Gene Grossman, both now at Princeton, have analyzed imperfections in the product markets.[4] However, I managed in 1963 to restore the case for free trade in the presence of domestic market failures by arguing that all we needed to do was simply to add to our policy menu an appropriate policy to remove the market failure. So, for example, if producers in an industry were polluting without having to pay for the pollution, , then their social cost exceeded their private cost and society would be overproducing in that industry, and free trade might

[4] I have reviewed and systematized the repeated episodes over two centuries of theoretical departures from the case for free trade, for different types of market failures, in several places during the last decade. The easiest to access is Free Trade Today, Princeton University Press: Princeton, 2002, based on lectures at the Stockholm School of Economics.

well be harmful relative to protection. But then if we only introduced a "polluter pay" tax, the market failure would be removed and we could go back to free trade. This simple insight has transformed the postwar theory of commercial policy, restoring to free trade its pre-eminence and widespread support in the profession.

Today's few dissenters on free trade, however, are unlike the earlier dissenters and fall into the category of unproductive dissenters. I suspect that their activities are a response to the perverse incentives that characterize economic dissent. Unlike the political dissenters (such as Vaclav Havel) who typically lived strained lives under grueling conditions, the economic dissenters today flourish. When there are just two or three of you who express dissent on free trade, and nearly all of the profession is on the other side, your scarcity value raises immensely. And today there are many in the populace who want icons to cite on their side. The Foundations that fund the pandemic of conferences today also want the "opposing" point of view represented. So, these dissenters are always in the air, going to Oslo, Tokyo, Port Allegre, Paris, and other exotic places, addressing seminars and conferences where their contrary viewpoints reflect their scarcity value. They also find themselves addressing adoring crowds, at for a such as the World Social Forum, whose intellectual competence in these areas of expertise is outweighed by their passions. And if you are a Nobel Laureate, the incentive to behave as an economic dissenter is greater still: after all, you have the Nobel Prize, so why worry about what your peers think?[5] Instead, you can cultivate a new "market," a populist audience, and aspire to join the ranks of Naomi Klein or Arundhati Roy whose

[5] It is reassuring that very few Noble Laureates behave like this. The danger with a Nobel Laureate dispensing errors is particularly great when it comes to developing countries. These countries typically tend to be ascriptive and also do not have the local expertise to challenge erroneous pronouncements and advice. By contrast, in the developed countries, there is a lot of expertise and debate and there are many Nobel Laureates, and also other distinguished scholars, who can counter nonsense propounded by their peers who play to the gallery.

conclusions are more obvious than their arguments. These few dissenters are a terrible nuisance, diverting economists into fighting rubbish within their own ranks; but they present no real threat to the ability of the profession to advance the public interest.

Then again, the aging population, and the speed with which science changes, creates intergenerational differences of analysis as the older scholars find their modes of analysis being replaced by new ones. Several scholars age gracelessly. When Paul Samuelson was asked how often science changed, he replied: with every funeral. But even when they do accept the new gracefully, differences of perceptions, from the use of "older" models, carry over into different views of the "positive" issues at hand. Thus, in the recent debate on globalization, some have argued that as economies (such as India and China) grow more like us in their endowments (as they develop scientists, engineers, and doctors like the US), the gains from our specialization in skill-intensive products will decline. But we now know, from theoretical work on "trade in variety" or "trade in similar products" that specialization takes place within industries. So, as countries grow similar in endowments, trade in similar products breaks out: something you observe as you walk down Madison Avenue and see many men's fashion designers such as Georgio Armani, Christian Dior, Kenzo, Calvin Klein, and Pierre Cardin compete and co-exist in the same fashion industry, offering the customers much gain. My student Robert Feenstra, who is the leading econometrician of trade today and heads the NBER Program on International Trade, and my colleague David Weinstein both have estimated these gains from similar products and concluded that they are huge. So, once we admit into our thinking a new, later "model," our view of reality changes: in this instance, toward a more benign view of globalization.

But then let me turn to the second area of "normative" analysis where the economics profession runs into difficulties as genuine as the ones that afflict it because of the divisions coming from disagreements on "positive" analysis. Economists, keen to pursue the public good, have debated the "normative" questions with equal alacrity. Contrary to what the public policy debates reveal, economists have been seized with the question of how to judge whether a policy is "better" than another. Suffice it here to indicate some of the ways in which they have grappled with the issue.

Perhaps the most important observation I can make is to indicate how, in a multi-person economy, one can call a policy better than another. If Robinson Cruse was to put man Friday on a boat, leaving us to judge his one-person welfare as total welfare, life would be simple. But as soon as you have two (or more) people in society, the question we must confront is how to judge welfare improvement with a policy change if one person's welfare increases and that of another declines. In essence, the typical criterion that economists have settled upon is called the Pareto criterion: if Robinson Crusoe improves his welfare and Man Friday losses his with the policy change, the policy change is better if Robinson Crusoe can compensate Man Friday and still have enough gravy left over to make himself better off. This sounds great until you realize, as my famous Oxford teacher Ian Little noted in his path-breaking work, that this is only a "possibility" criterion; and that if Man Friday is left <u>in reality</u> with his reduced welfare, few would agree that there was a welfare improvement in Robinson Crusoe's island society.

Thus, economists, with increasing sophistication culminating in recent work such as that of the Nobel Laureate Paul Samuelson, have shown that free trade is a Pareto-better policy. But suppose that the rich get richer and the poor get poorer as we liberalize trade, and no actual compensation takes place, should we call Freer Trade a better policy than increased Protection? If we cannot compensate the losers, then this conclusion would be rejected by many, especially because the poor are getting poorer (whether you buy into John Rawls or not).

So, if your positive analysis leads you to argue that trade (with poor countries and other forms of economic Globalization such as multinational investment outflow to these countries and inflow of unskilled immigrants from them) is causing the poor to get poorer in the rich countries --- Marx, whose prediction of the immiseration of the proletariat did not materialize in the 19th and most of 20th centuries but who may now be striking again with the aid of Globalization --- , and if you think that actual compensation to the losers is not feasible because of the decline of the Welfare State, then you would reject freer trade. This may well describe the state of thinking on Free Trade in the US today.

But this is as good as the positive analysis of the effects of trade (and immigration and multinational investments). And, as I have argued in many places[6], drawing on the empirical studies of the question, the assertion by AFL-CIO and the New Democrats they support and capture that the economic pressure on wages of the unskilled and even the middle class is not tenable. So, their policy prescription against free trade, though justified by a normative criterion which many of us will share as citizens and economists, is vitiated by erroneous analysis, and will handicap, not advance, the public good.

Indeed, there are many other instances in public policy domain today where bad analysis married to good normative criteria creates counterproductive results, putting back the public interest instead of advancing it. Thus, the renowned philosopher, Peter

[6] E.g. Chapter 10 of my book, In Defense of Globalization, Oxford University Press, 2004; the Afterword in the new Edition issued in August 2007 which offers more analysis of the issues, and several Financial Times op.ed. articles and Letters on US trade policy recently on the subject, especially "Technology, Not Globalization, is Driving Wages Down", January 4, 2007.

Singer, has a book against Globalization which marries his utilitarian analysis into large amounts of anti-Globalization nonsense, marring an otherwise interesting book.[7] He also recently wrote a New York Times Magazine article on foreign aid which argued that there was a moral case for more foreign aid but betrayed absolutely no awareness of the enormous analytical, empirical and econometric literature, both today and from the 1960s through 1980s, on why aid could be unproductive and, more important, counterproductive.[8] If you argue for more aid and aid results in less, not more, development, how can you say that aid is good for the recipients? Or that you "should" give the aid, as Peter Singer proposes?

But let me get back to the ways other than income-distributional in which the welfare criterion used must be augmented. Thus, economists typically must face inter-generational questions, not just Robinson Crusoe versus Man Friday problems. We typically grapple with questions like: what is the "optimal"rate of saving? With environmental questions in full display today because of the Global Warming alarms, the question typically to be addressed is: what do we owe to future generations? These are income-distributional questions over time, not within a given society like Robinson Crusoe's. Then, there are questions of income distribution over space as well: how do we evaluate the welfare consequences of immigrants? How do we evaluate a freer immigration policy versus a restrictionist one in situations, for example, where the

[7] His book, One World: The Ethics of Globalization, ZYale University Press, 2002, was reviewed jointly with my book, Free Trade Today, Princeton University Press, 2002 in The New York Review of Books, March 25, 2004.

[8] See Peter Singer, "What Should a Billionaire Give --- and What Should You?, New York Times Magazine, December 17, 2004. The large literature on how aid may create a malign impact, and might even be given with successful malign intent, is totally ignored by the proponents of substantial surge in aid like my colleague Jeffrey Sachs; but that is neither persuasive to scholarly economists nor calculated to advance the public good.

immigrants gain but their out-migration harms those left behind (as with some poor countries suffering from "brain drain")? Should immigrants' welfare be aggregated with that of the countries receiving them or with that of the countries losing them, with both or neither? The sophisticated discussion of these issues is to be found in the economists' wrti8ngs from time to time; but it is virtually lost in the din of heated debates over immigration.

Then, economists are aware that in discussing public good, they must allow for what another of my Oxford teachers, Roy Harrod (the biographer of Keynes and a truly great economist whom death deprived of a certain Nobel Prize), called "process utilitarianism". Often, economists (who are generally utilitarians) will consider a policy to be better because it augments efficiency and therefore the availability of goods and services. But one might object to the process (e.g. markets) by which that efficient solution is arrived at. Thus, as Judge Richard Posner once argued, a market in baby adoptions would distribute babies efficiently: but most of us would find such a market distasteful. Again, would you allow rich people to park in spaces for the handicapped just by buying special permits to do so: should not everyone have to assume the obligation to keep these spaces off limits for the non-handicapped? Should again Al Gore be allowed to buy offsets (i.e. finance CO2 emission reductions) from others when he emits a lot of carbon in his home? If Al Gore wants to finance CO2 emission reductions, that is fine; but it should not be used to justify a lifestyle where he assumes no obligation to cut down his own emissions.

These and several such issues are very much what we economists deal with as we discuss the public good. Our analysis, and our appreciation of the nuances involved, is much richer than what many critics, who are not familiar with the ways of sophisticated economists and go by what they learnt in 101 classes from indifferently written textbooks, assume to be the case. Familiarity breeds contempt; but contempt does not breed familiarity.