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Economic policy in the public interest

Economists, whose discipline has always had a strong relationship to moral philosophy (Adam Smith, the author of *The Wealth of Nations*, also wrote 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 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.

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, one tries to gain the advantage by claiming that the opponent's interest is 'special' and one's own is 'general.' We have long known that special interests have learned 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 nineteenth century when Britain, the long-standing proponent of free trade, was facing the rise of Germany and the United States. As Britain experienced what I have called 'diminished giant syndrome,' 'fair trade' became a cry of the protectionists, who charged these newly emerged and protectionist trading nations with 'unfair trade' and condemned Britain's free-trade policy as inappropriate. The United States would confront the same syndrome a century later, with the dramatic rise of Japan in the 1980s and the dreaded prospect that the twenty-first century would be Japan's as the twentieth was America's and the nineteenth was Britain's. Exactly as in Britain at the end

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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.

of the nineteenth century, the United States witnessed the growth of demands for 'fair trade,' and charges against Japan that it was a wicked 'unfair trader' that excluded imports and dumped its exports.

The latest proponents of such demands are the AFL-CIO and the New Democrats – and therefore the Old Democrats who must fall in line. They are concerned with competition from the poor countries instead. Desperately seeking ways to protect themselves from such competition, they claim that these poor nations are indulging in 'unfair trade' because they have labor and domestic environmental standards 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 pose.

These lobbies are equally adept at disguising this protectionist agenda by simultaneously asserting that their demands to have the poor nations raise their labor standards to U.S. levels are inspired by empathy and altruism for the workers in the poor countries – a claim that is belied by reading the campaign speeches of the New Democrats, who always speak instead of the unfairness of losing jobs to rivals with lower standards, i.e., import competition.

Moreover, these lobbies frequently paint economists as venal fronts for 'corporate interests' on issues such as free trade. These lobbies 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 like myself realize that free trade cannot be advanced by ideas alone: it is not enough to have the generals; one must also have the troops. Also, if special interests, like corporate interests, happen to see their profit in what one proposes, that does not subtract from the fact that the policy one is advocating is prompted by the public interest.

One lesson for the economists who seek to influence public policy, however, is to ensure that they do not open themselves to the charge that they have been 'bought.' In the 1980s and early 1990s, the years of Japan-bashing in the United States, I was almost alone in defending Japan against exaggerated, hysterical attacks by Detroit and other U.S. producers, and by the media and the politicians. At the time, I was careful not to accept any moneys for even a lecture or a conference paper in Japan. When I went to a conference associated with the Japanese Ministry of International Trade and Industry (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 – 1957), we were all offered $2,000 for our papers. All the Japan-bashers readily accepted the money; I said I would write but not accept the honorarium. So I was given an extra lunch coupon! I used it to eat tempura in the Okura Hotel. Later, I told my friends that I had had $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 very well have had 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 agitators who view multinationals and their 'profits' the way moneylenders and 'usury' were regarded in the Middle Ages. Undeniably my refusal to get rich in the way many economists do today has enabled me to be more credible when I defend corporations against unjustified assaults.

Let me add that corporations are often buying an economist's reputation, not his or her 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 is on our side. We would be wise not to yield to such blandishments. We may give our advice anonymously, but to give it with our names attached is to throw our reputation in the face of their opponents and also in the mud. Once, an important beverage company operating in India asked me to calculate the Indian elasticity of demand for canned sodas. It clearly hoped to argue that the elasticity was so high that a reduction in the sales tax on them would raise more, not less, revenue (à la the Laffer curve). This request surprised me – since I am an economist who works with ideas and never crunches numbers – until I realized that they had to know that I was a close friend of the finance minister (now the prime minister). So I replied mischievously: I am afraid I cannot do this until the finance minister changes. Naturally, I never heard from them again.

Economists are also tempted today by large fees that accrue when they testify in court on behalf of corporate clients. Lawyers do this all the time, though outstanding jurists abstain from such practice. Once, I was giving a keynote speech at Yale Law School, when 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). I teased him back from the lectern: That is bad, but with lawyers the situation is worse. Each lawyer has six opinions if he has six clients.

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But even when a scrupulous economist avoids these pitfalls, substantive problems still arise in pursuing the public interest. These come from two different directions.

If we are to pursue the public interest by arguing that one policy is preferable 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. If either is defective, the economist's ability to say that a specific policy advances the public interest 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. Prime Minister Robert Peel, who abolished England's Corn Laws in 1846 and introduced free trade to the world for the first time, was clearly converted to free trade by the writings of economists starting with Adam Smith, though the celebrated Chicago economist 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]

2 George Stigler, *The Economist as Preacher and Other Essays* (Chicago: University of Chicago Press, 1982), 63 – 64.

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:

> 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. At the heart of the problem is the fact that not all economists share the same model. A model, whether explicit or implicit, provides the map of how a policy will work. Thus different schools plague macroeconomics: monetarist (Milton Friedman), Keynesian, rational expectations (Robert Lucas), and varying versions of each. But even if we were to agree on a model to look at the world, we can and will disagree on the parameters that feed into the model.

So we can take it for granted that some economists will dissent even in cases where there is substantial consensus, such as whether free trade is a better policy than protectionism. 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, prominent economists have disputed the merits of free trade. The reason was simple. Put heuristically, the case for free trade depends on our faith in the ability of market 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. During the period of massive unemployment after the Great Crash of 1929, (the positive) market wages did not represent the true social cost of labor (which was zero), and Keynes became a famous advocate for protection.

In modern times, since World War II, economists have analyzed imperfections in the labor and other 'factor' markets; and my students Paul Krugman and Gene Grossman have likewise examined imperfections in the product markets.[4]

However, in 1963, I restored the case for free trade by arguing that all we needed to do was apply an appropriate policy to remove the market failure. For example, if producers in an indus-

3 Quoted in Douglas Irwin, "Political Economy and Peel's Repeal of the Corn Laws," *Economics & Politics* 1 (1) (Spring 1989). Adam Smith was 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.

4 In several publications during the last decade, 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. The easiest to access is *Free Trade Today* (Princeton, N.J.: Princeton University Press, 2002), based on lectures at the Stockholm School of Economics.

try were polluting without having to pay for the pollution, then their social cost would exceed their private cost. Society would be overproducing in that industry, and free trade might well be harmful relative to protection. But if we introduced a 'polluter pay' tax, we could remove the market failure and go back to free trade. This simple insight transformed the postwar theory of commercial policy, restoring to free trade its preeminence and widespread support in the profession.

The few dissenters to free trade today are unlike earlier dissenters. They 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 under grueling conditions, today's economic dissenters flourish. The sheer dearth of these dissenters raises their value immensely. The foundations that fund the current pandemic of conferences want the 'opposing' point of view represented. So these dissenters are going to Oslo, Tokyo, Port Alegre, Paris, and other exotic places to attend seminars and conferences where they are welcome simply because economists who espouse their viewpoints are scarce. They also find themselves addressing adoring crowds, such as at the World Social Forum, where passion outweighs intellectual competence in these areas. And if one is a Nobel Laureate, the incentive to behave as an economic dissenter is greater still: after all, if one has the Nobel Prize, why worry about what one's peers think?[5] Instead, one can cultivate a new 'market,' a populist audience, and aspire to join the ranks of Naomi Klein and Arundhati Roy, whose conclusions are more obvious than their arguments. These few dissenters are a nuisance, diverting economists into fighting rubbish within their own ranks. Yet 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 in 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 in perception, from the use of 'older' models, carry over into different views of the 'positive' issues at hand. In the recent debate on globalization, some have argued that as economies such as India's and China's grow more like us in their endowments (i.e., develop scientists, engineers, and doctors), 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: one can observe this by walking down Madison Avenue and observing the many men's fashion designers, such as Giorgio Armani, Christian Dior, Ken-

5 It is reassuring that 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.

zo, Calvin Klein, and Pierre Cardin, compete and coexist in the same fashion industry while offering the customers much gain. Both 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 have estimated these gains from similar products and concluded that they are huge. Once we admit into our thinking a new 'model,' our view of reality changes: in this instance, toward a more benign view of globalization.

In normative analysis, the economics profession runs into difficulties as genuine as the ones that afflict it in positive analysis. Contrary to what public-policy debates might suggest, economists do try to answer 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 multiperson economy one can call a policy better than another. If Robinson Crusoe were 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 a society, how do we determine if a policy change improves welfare if one person's welfare increases but another's declines?

The typical criterion that economists have settled upon is the Pareto criterion: if the policy change improves Robinson Crusoe's welfare but decreases Man Friday's, the policy change increases overall welfare 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 pathbreaking work, that this is only a 'possibility' criterion: if Man Friday is left *in reality* with his reduced welfare, few would agree that the welfare of Robinson Crusoe's island society actually improved.

Economists, with increasing sophistication culminating in work such as Samuelson's, have shown that free trade is a Pareto-better policy. But suppose, as we liberalize trade, that the rich get richer and the poor get poorer, and no actual compensation takes place. Should we call Freer Trade a better policy than increased Protection? If we cannot compensate the losers, then many would reject this conclusion.

So, if positive analysis leads one 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's prediction of the immiseration of the proletariat did not materialize in the nineteenth and most of twentieth centuries but may now be striking again with the aid of globalization), and if one thinks that actual compensation to the losers is not feasible because of the decline of the welfare state, then that person would reject freer trade. This may well describe the state of thinking on free trade in the United States today.

But this is as good as the positive analysis of the effects of trade (and immigration and multinational investments). As I have argued in many places,[6] the assertion by the AFL-CIO, and the New Dem-

6 E.g., chapter 10 of my book, *In Defense of Globalization* (New York: Oxford University Press, 2004); the afterword in the new edition issued in August 2007, which offers more analysis of the issues; and several recent *Financial Times* op-ed articles and letters on U.S. trade policy,

ocrats they support and capture, that globalization is placing the economic pressure on the wages of the unskilled and even the middle class is not tenable. Their policy prescription against free trade, though justified by a normative criterion that many of us share as citizens and economists, is vitiated by erroneous analysis, and thus handicaps, not advances, the public good.

Indeed, there are many other instances in the public-policy domain today where bad analysis married to good normative criteria has created counterproductive results, setting the public interest back instead of advancing it. The renowned philosopher, Peter Singer, wrote a book against globalization, which marries his utilitarian analysis with large amounts of antiglobalization 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 recent and from the 1960s through 1980s, on why aid could be unproductive and, more important, counterproductive.[8] If aid results in less, not more, development, how can one say that aid is good for the recipients? Or that we *should* give aid, as Singer proposes?

Furthermore, economists must respond to intergenerational income-distribution problems in addition to Robinson Crusoe versus Man Friday problems. A typical question we grapple with is: what is the 'optimal' rate of saving? Now with environmental concerns at the forefront, we must also wonder: what do we owe to future generations? These are income-distribution questions over time, not just within a given society.

There are questions of income distribution over space as well. Immigration is one example. How do we evaluate a freer immigration policy versus a restrictionist one in situations where the immigrants gain but their outmigration 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, or with both, or with neither? The sophisticated discussion of these issues is to be found in economists' writings from time to time; but it is virtually lost in the din of heated debates over immigration.

Economists are aware that in discussing public good, they must also allow for what another of my Oxford teachers, Roy Harrod, 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 we arrive at that efficient solution. As Richard Posner once argued,

especially "Technology, Not Globalization, is Driving Wages Down," January 4, 2007.

7 His book, *One World: The Ethics of Globalization* (New Haven, Conn.: Yale University Press, 2002), was reviewed jointly with my book, *Free Trade Today* (Princeton, N.J.: 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 have a malign impact, and might even be given with malign intent, is ignored by the proponents of a substantial surge in aid like my colleague Jeffrey Sachs; but that is neither persuasive to scholarly economists nor calculated to advance the public good.

a market in baby adoptions would distribute babies efficiently, but most of us would find such a market distasteful. Or should we 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 to the nonhandicapped? Or should Al Gore be allowed to buy offsets (i.e., finance CO_2-emission reductions) from others when he emits a lot of carbon in his home? It is fine if Al Gore wants to finance CO_2-emission reductions, but it should not be used to justify a lifestyle where he assumes no responsibility to cut down his own emissions.

These 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 learned in 101 classes from indifferently written textbooks, assume to be the case. Familiarity breeds contempt, but contempt does not breed familiarity.