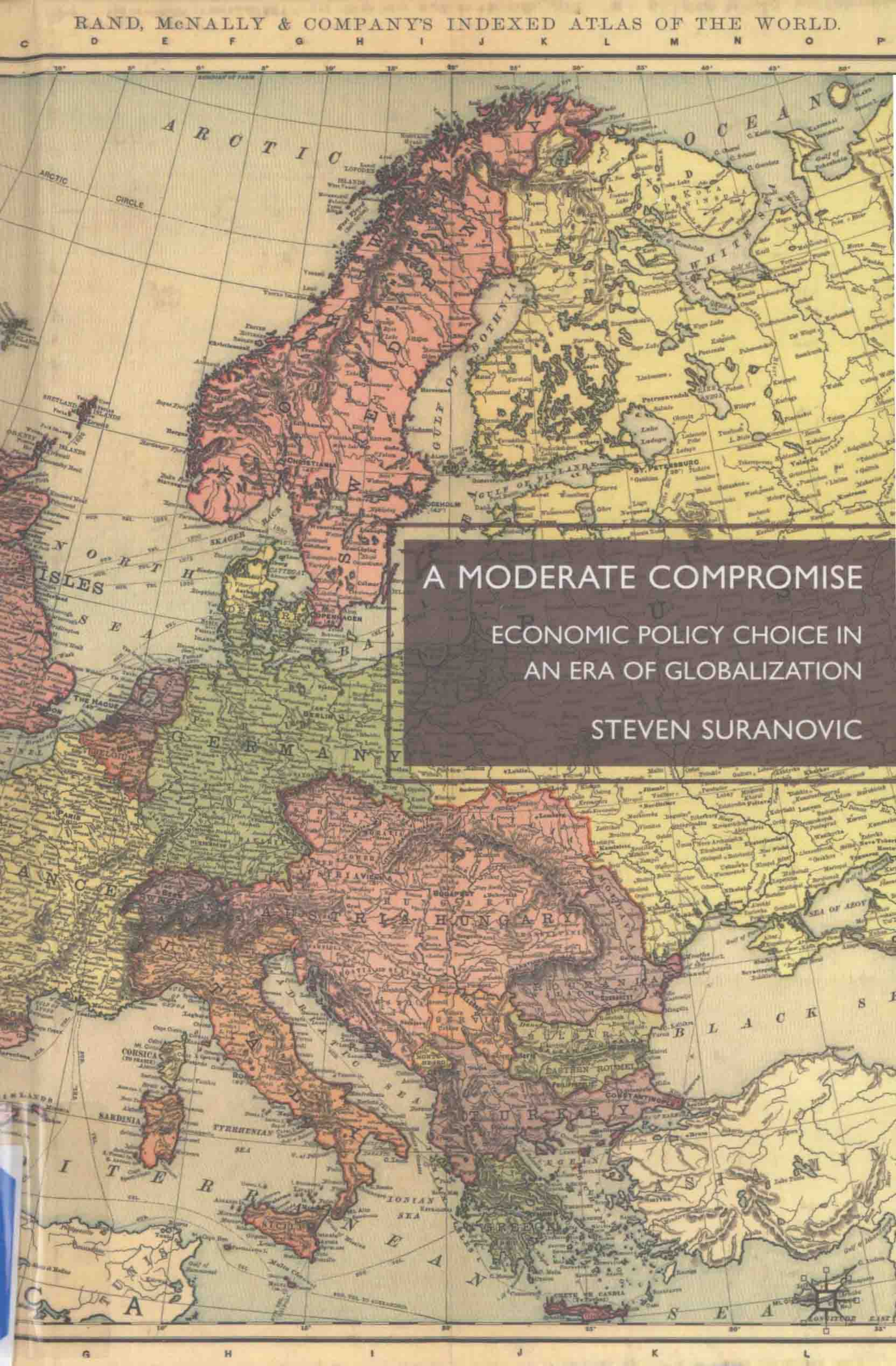

A MODERATE COMPROMISE

ECONOMIC POLICY CHOICE IN AN ERA OF GLOBALIZATION

STEVEN SURANOVIC

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PREFACE

As the twenty-first century began, the world was in the midst of a dramatic new wave of globalization. More than ever before, products and information were moving swiftly around the globe at an unprecedented pace, fueled by an explosion of supercomputing capacity, a burst in worldwide telecommunications, discoveries of new energy resources, and a dramatic reduction in transportation costs. The pace of change, both economically and socially, was probably faster than any human society has experienced before.

One result of this rapid change has been the significant improvement in living standards, hundreds of millions of people being lifted out of poverty, and a rapid increase in the number of billionaires around the world. Another result has been significant dislocations of peoples, some who have migrated either into cities or across national boundaries, some who have lost jobs because of the fervent rise of international competition, others because multinational companies move factories and jobs to the countries where the costs are lowest. Along the way ideas have changed and institutions have been disrupted from one generation to the next. Cultures have adjusted and evolved, leaving people disconnected from the safety and security rooted in tradition.

It is easy to blame globalization as a root cause of these newfound insecurities. In a single word, globalization captures the complex interconnectedness and fast-paced changes that are affecting every country and every society worldwide. Globalization captures the dynamism and opportunities as well as the struggle and strife.

Using the term "globalization" to describe these complex changes is fitting because the term itself is nebulous. It is not restricted to economic changes but also encompasses political, social, cultural, and religious adjustments. Thus, to say that globalization is responsible for the perceived positive or negative effects on individuals, businesses, and countries, is much like saying no one is responsible. Furthermore, when no identifiable entity can be charged with inducing globalization, it becomes easy to resign oneself to the proposition that globalization is inevitable. Certainly this is one of the conclusions reached after reading Thomas Friedman's popular and detailed accounts of the globalization phenomenon in *The Lexus and the Olive Tree* and *The World Is Flat*.[1]

Nonetheless, even though globalization has a certain inevitability to it, individuals, businesses, and especially governments can influence the way in which globalization affects people. Consequently, one of the most provocative and engaging debates in recent years has been about what to do with globalization policy. In its simplest form, the debate about globalization policy refers directly to international trade and investment. For example, the question of whether governments should pursue free trade or should restrict trade and investment flows has been a debate raging in policy circles for hundreds of years. In a broader sense, globalization can relate to almost every public policy under consideration. Indeed, because of the world's interconnectedness, one country's labor policy, environmental policy, health care policy, or regulatory system can easily affect people far across the globe. Thus virtually all public policy concerns have become a part of the discussion over globalization policy.

At the end of the first decade in the twenty-first century the debate over globalization policy intensified. The bursting of the U.S. housing bubble and a subsequent financial crisis quickly spread around the globe. Real estate and stock market prices plummeted over 50 percent in some countries, and more than $15 trillion of wealth was wiped out within several months. With risk and uncertainty rising, household and business demand for autos, steel, chemicals, and many other products began to fall, resulting in massive worker layoffs, rising unemployment, and negative GDP growth rates worldwide. A global recession had begun, more severe than any in recent memory.

Whenever things go wrong, it is natural to place blame on whatever events immediately preceded it. Looking back several years or decades, one feature of the world that stands out prominently is rapid globalization. Consequently, policies that have clearly promoted globalization, such as free trade, deregulation, business outsourcing, and lenient enforcement of immigration policies, are now under intense scrutiny and reevaluation as policy makers decide how to cope with the crisis.

However, if one were to ask an average person what was the main cause of the world's 2008–2009 economic crisis, a more common response than "globalization" would most likely be "greed." Many people believe that excessive greed was the source of overlending in the housing market, the source of the complex derivatives that were poorly understood and difficult to value, the source of overconsumption and overborrowing, and even the source of expanded international trade and investment. Indeed, to many people greed is the root cause of globalization itself.

Concerns about greed and its effects are not new and have been a part of the debate about international economic policy for a long time. As early as the WTO ministerial meeting in Seattle in 1999, opponents of free trade and globalization voiced concerns about the allegedly greedy, profit-seeking, multinational corporations, who have supported and promoted institutions such as the World Bank, the IMF, and the WTO; institutions that in turn have facilitated the rapid movement toward globalization. Protesters at the annual meetings of the G8, at the World Economic Forum at Davos, or at the G20 meetings, decry the high salaries earned by the CEOs of large corporations and the growing inequality of income around the world. In their view the rich are getting richer and the poor are getting poorer. They contend that corporations, greedy for profit, exploit poor workers, threaten endangered species, despoil the environment, and endanger the sustainability of the planet. If these opponents of globalization were wary about the economic system before the crisis, they are even more wary after it.

Indeed, in the wake of any major economic recession, democratic popular sentiment allows for, and even demands, dramatic policy changes. In the 1930s, at the onset of the Great Depression, governments around the world reacted to rising unemployment rates by significantly raising import tariffs and increasing regulatory control over the economy. Similar interventions occurred in the midst of this recent crisis with government takeovers of financial and manufacturing firms, emergency government stimulus packages, and subsidies to keep important industries afloat. In contrast to the 1930s, only minor increases in protection occurred, largely because countries have mostly maintained their trade liberalization commitments under the WTO.

Because this crisis seems unlikely to resolve itself quickly, it is almost certain that significant policy reevaluations and adjustments are forthcoming in countries around the world. Indeed, a severe economic crisis virtually guarantees policy changes in democratic societies because citizens will demand that governments take action. Additionally, the greater the economic problems, the more accepting citizens will be for larger and more dramatic changes. However, although there is a danger of overreaction, the crisis affords opportunities as well. The key opportunity is that the crisis will fuel widespread interest in how to make the economic system work more effectively.

Because the crisis is severe, many more people than usual will listen to popular opinion around the world and reevaluate their own fundamental philosophy. Although there is great diversity of opinion, popular views tend to gravitate toward one of two poles: those who favor greater regulation and government interventions and those support free and open markets. On the one hand, those who had been wary of globalization before the crisis will argue that the lack of government regulation allowed greed to get out of hand in financial markets and will point to the inherent instability of a free market system. They will tend to support strong new regulatory control by governments. On the other hand, defenders of free markets will make the case that the current economic crisis is not caused by lack of government but rather by government intrusions into the market. Many have said that too much regulation is to blame; for example, that government incentives to expand home ownership and implicit government guarantees to Fannie Mae and Freddie Mac considerably increased the riskiness of the financial system.

Of course, there are extremists on both sides who express their views almost with religious fervor. These more extreme views often seem to dominate the discussion. More often than not, extreme-view holders tend to exaggerate both the positives of their own views and the negatives of their opponents' views. An important consequence is that it is very difficult for new observers in the debate to acquire objective information about how the economy works and the likely impacts of various policies.

That makes this a teachable moment. In the midst of an economic crisis, there is a window of opportunity to argue for policy reform to a larger-than-usual audience. Normally, it is only the academic researchers, policy wonks, and legislators that pay close attention to globalization policy issues. These individuals have studied the issues closely and have contributed to the current state of knowledge. However, the economic crisis will induce many more people to ask what happened, why did it happen, and more importantly, what should we do next?

What is needed most is a simple guide, accessible to a wide range of people, from experts to the average citizen; a compilation of the arguments on all sides of the globalization debate; an evaluation of the theoretical and research methods that are used to support the often conflicting claims; a dispassionate review of the strengths and weaknesses of the different positions; and a simple and comprehensive solution that can bridge the divide that so often seems to separate people.

This book offers a solution to these problems by proposing a simple but comprehensive set of principles to guide policy choice for the next century—a century of globalization. The task is accomplished by looking deeply into the core of the arguments on all sides of the globalization debate, stripping away the rhetorical chaff and academic complexity that obscures understanding, and discovering the kernels of truth that lie at the heart of every opinion.

This book argues that the kernels of truth—behind every policy position taken on any side—invariably involve three simple principles that are shown to be mostly fair using a broad definition of fairness and justice. In other words, adherence to these simple principles is mostly consistent with standard views of social justice. The book then identifies a moderate compromise solution consisting of a set of government policies that are fully consistent with the three principles. The mix of policies that arises are called moderate because they fall in an intermediate position between the extreme left and extreme right policy positions: to accept these principles and guidelines requires all sides to compromise. What makes this proposal different is that the compromise position is shown to adhere to the fundamental principles of justice that all sides are seeking. It is true that accepting this compromise requires everyone to give up or rethink some of their existing assumptions and policies, but it would not require them to give up their fundamental principles.

The book also offers a unique new method to guide to policy choice. Instead of using traditional cost-benefit analysis, which focuses on outcomes, this book proposes we focus on the process. Instead of policy makers responding to every new problem with a new set of policies, this book suggests we establish fixed rules that guide behavior in both good times and bad times. Instead of engineering a better future outcome, this book proposes we give people the freedom to take the economy and their lives wherever they choose.

This book advances these classical liberal traditions in a unique way. The first part of the book, chapters 2–5, looks carefully at traditional economic analysis and concludes that the results are much less certain and convincing as a guide to policy than is typically presented. It also examines in detail the common arguments for social justice and fairness. Here too the book argues that fairness considerations alone are an insufficient guide for policy choice. These weaknesses in the traditional methods are obscured in the popular rhetorical discussions largely because of the realities of the political process in a democratic society. The book also argues that simply relegating policy decisions to whatever comes out of the democratic political process is fraught with complications and is unlikely to result in outcomes that conform completely to basic principles of justice. Nonetheless, despite the weaknesses in these traditional methods, we have no choice but to continue along in the same old way, at least until there appears a simple, obvious, and convincing alternative rationale and mechanism for policy choice.

The second part of this book, chapters 6–11, suggests an alternative to our current policy choice process. The conclusions are most consistent with the views promoted by Adam Smith, Ludwig von Mises, Friedrich Hayek, and Milton Friedman. The book promotes the advantages of individual freedom and free markets, arguing for acceptance of an unencumbered spontaneous economic order, Hayek's term for Adam Smith's "invisible hand." The book argues that a principled moderate position is neither conservative nor liberal, at least as those positions are currently defined in the United States. Instead, the moderate compromise is best described as classical liberal, or libertarian.

Along the way the book explains the key economic lessons about international trade. It integrates economic theory, empirical analysis, political economy and ethical considerations. Most importantly, the presentation is simple. The most effective ideas are those that can be explained even to nonexperts. Among some of the issues discussed are:

- Why trade liberalization will redistribute income making some people better and others worse off
- Why we cannot know precisely who will gain and who will lose from free trade
- Why free trade may not improve the well-being of some countries
- Why a compensation policy (compensate the losers with gains from the winners) is both impractical and inoperable in a democracy
- Why empirical methods cannot determine which policies are best
- Why the democratic political process affects the objectivity of information in the globalization discussion
- Why fairness is multifaceted and contradictory in its application, despite its inherent reasonableness
- Why the competitive process is misunderstood
- Why business often seeks to prevent competition, not promote it

- Why free markets and competition do not generate good outcomes for all participants
- Why the relatively disadvantaged will suffer more in the competitive process
- Why the losses caused by competition should be tolerated nonetheless
- Why there are widely disparate opinions about the suitability/morality of profit seeking
- Why not all profit seeking by firms is good
- Why some profit seeking is imperative for a well-functioning economy
- Why altruism is not the answer to egoism
- Why a generalized social safety net is the best way to establish a compassionate free market economy
- Why nonprofit institutions can play a critical road providing for the social safety net, and
- Why the application of three simple principles can ensure that public policies generate outcomes that are both socially just and highly efficient.

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CHAPTER 1

Introduction

We study economics because we care about people. The global economic system produces and distributes goods and services to over six 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 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 on 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 endless debate. Although the collection of knowledge about the economy and how it works is extensive, it has not produced anything close to a consensus identifying the best set of policies or practices. A lack of consensus exists in many areas, including health care provision, energy policy, industrial policy, tax policy, environmental policy, and monetary and fiscal policy. In each of these areas, debate about appropriate policy rages on.[1] The policy debate is especially contentious with regard to globalization.

Globalization can refer to many different things: the expansion of trade and investment 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, this discussion focuses primarily on economic globalization.

After the Great Depression, 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); 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 were dismantled 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 United States and the European Union. 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.[2] In the United States, fast-track authority, the congressional green light enabling the U.S. president to negotiate free trade agreements, has expired and seems unlikely to be renewed anytime soon. Finally, the rapid expansion of two new economic giants, China and India, is arousing fear across the globe. In the United States, 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 about globalization in general.

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 (such as labor) are able to move between countries as never before. In addition, the advent of telecommunications has opened up opportunities for service sector trade that now affects high-wage jobs in developed countries. One notable economist, Alan Blinder, does not denounce free trade, but has suggested that the current wave of globalization may result in a loss of as many as 40 million service sector jobs in the United States.[3] The *Wall Street Journal* quoted Dani Rodrik, a noted Harvard economist, "... 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."[4] Even Nobel laureate Paul Samuelson, the founder of modern economics, emphasized that free trade may not always lead to national gains.[5]

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 do not reveal anything that has not been known to economists for at least the past half century. Although the patterns of trade are different and the pace of change is faster than before, 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 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, 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 result, 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 on so many separate issues, it also touches many people with a myriad of 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, cultural identity, and distinct view of morality. It follows that there are a multitude of views about what is 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 the theoretical and empirical evaluations, together with the ethical and political considerations, and ask if the answers researchers provide should convince an *objective observer* what are the best policy choices.[6]

Overview of the Book

The question of policy choice is clearly normative, seeking to identify what "should" be done, rather than merely asking positive questions about "how" 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 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 nonobjective observers. Nonobjective observers are those who recognize their position in society and the economy, and act to implement policies