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CHAPTER 5

Through a Glass, Darkly

An Economic View of Fairness, Globalization, and States

CHRISTOPHER GRANDY

This chapter takes up terms central to the focus of the conference—fairness, equality, globalization—from a distinctly economic perspective. As an economist working closely with non-economist social scientists, I feel the occasional barb of the economist caricature: exclusively focused on efficiency; seeing the web of social relations as a self-propelled, optimizing mechanism; the comments of whom are counterintuitive, callous, and (most distressing of all) wholly beside the point. One purpose of this chapter is to challenge some of those characterizations.

The first of the following three sections describes a serious attempt by economic theorists to define “fairness” in a way that makes the term susceptible to rigorous economic (including mathematical) analysis. These ideas yielded some fascinating results that, while having little influence on public policy, challenge a view of economists as apologists for the status quo. The second section moves to a discussion of inequality, an idea related to, but not antonymous with, fairness. Here the economist’s penchant for counterintuitive argument comes forward in exploring the social virtues of inequality. The chapter’s final section then makes the argument that just as ideas of fairness and equality are important to individuals, the relative merits of globalization must be decided ultimately by its impact on individuals. In particular, concerns about the impact of globalization on political entities (states) are relevant only in the context of the welfare of their constituents.

From Efficiency to Fairness

Economists often seem obsessed with efficiency. At a minimum, they certainly have more to say about economic efficiency than about equity or fairness. Perhaps efficiency issues are more tractable than fairness issues, or perhaps developing

ideas on the efficient allocation of society's resources requires more effort—and hence more resources.

Yet issues of equity and fairness regularly come to the mainstream economist's attention. For example, economists often point to a trade-off between efficiency and equity. The trade-off might arise with respect to policies that promote greater equality of wealth or income but that weaken individual incentives to produce. In addition, economists have contributed to a variety of measurements of inequality including the Gini coefficient, the coefficient of variation, and entropy. Economists also contribute to debates and empirical work on the inequality of income or wealth at a moment in time, over an individual's life cycle, and intergenerationally.

Still, prospectively, we rarely, and reluctantly, make policy proposals with respect to equity or fairness. Many of us feel that we have no particular comparative advantage when discussing such issues.

Yet since the late 1960s a strand of economic research on equity and fairness developed that is consistent with standard economic theory. Moreover, in the spirit of much economic reasoning, this research has policy implications. The following discussion reviews the basic notion of economic efficiency and its associated ethical problems. This provides a background to the description of an innovative treatment of equity and fairness from an economic perspective.

Efficiency

The economist's notion of efficiency is named for the Italian theorist Vilfredo Pareto. In some ways, the concept of Pareto efficiency (or Pareto optimality) skirts issues of equity and fairness by focusing on situations in which a change implies that no one is harmed while at least one person is made better off. Thus relative to existing conditions, such changes are arguably socially acceptable.

However, a Pareto-efficient allocation of society's resources is one in which it is *not* possible to reallocate resources to improve the well-being of at least one person *without* harming at least one other person. The idea is that if, conversely, we could change the current allocation of society's resources so as to make at least one person better off *without* making someone else worse off, then the current allocation of resources cannot be efficient: we could do better by effecting the proposed reallocation.

Note the focus of this definition of efficiency on individual welfare. Economists employ the concept of a *utility function* to characterize an individual's welfare. And they define this function over virtually everything relevant to the individual: all goods and services, all states of nature, all time periods. Also note that the definition of efficiency is not (in this context) a statement about how well inputs (such as land, capital, labor, and technology) can be combined to produce

outputs (cars, haircuts, computers, and music). In fact—critically—the notion of efficiency is defined with respect to whatever each individual cares about.

From a policy perspective, an important problem with Pareto efficiency is that it insufficiently narrows the set of desirable resource allocations. That is, one may agree that a “good” allocation of society’s resources should be Pareto efficient (if not, then by definition we could reallocate resources to improve the welfare of at least one person without hurting anyone else—a proposal difficult to oppose). But the set of Pareto-optimal allocations is usually quite large. How to choose among them?

Moreover, Pareto-efficient allocations can include very skewed distributions of resources. For example, one can imagine a society in which a single individual controls virtually all resources and the remainder of society lives in abject poverty. Nevertheless, this allocation of resources could be Pareto efficient in the sense that moving to a more equitable allocation would harm the wealthy individual—and thereby violate the condition for what is called a “Pareto-improving” reallocation. Thus Pareto efficiency gives only limited insight into “desirable” ways of allocating society’s resources.

It is worth noting the relationship between this definition of efficiency and the workings of competitive markets. They are captured in two prominent theorems in the field of “welfare economics.” First, an equilibrium allocation in competitive markets for all relevant resources is Pareto optimal. Second, almost any Pareto-optimal allocation of resources can be achieved using competitive markets and an appropriately chosen initial allocation of resources. Both propositions are “theorems” in the sense that given certain assumptions, they can be proven mathematically.¹

This is the essence of the economist’s infatuation with competitive market forces. Put another way, competition will lead to an allocation of resources such that all “win-win” (indeed, “all win-no lose”) exchanges have been exhausted. While this is no mean trick, the normative problems with Pareto efficiency mentioned above suggest that people may care about more than exhausting mutually beneficial possibilities.

Envy

In 1967, Duncan Foley published his Yale doctoral dissertation, which contained an interesting refinement of resource allocation characterizations.² Foley defined the term “envy” to refer to a situation in which an individual preferred someone else’s allocation of resources to his own. In this characterization, individuals use their own preferences to consider the allocations of other people. Thus the question becomes, Would I rather have your set of goods and services than the set that I, in fact, have? If yes, then I envy you.

A Pareto-optimal allocation of resources can easily exhibit envy. The ex-

ample above illustrates that if one individual enjoys most of society's resources while the remainder of the community has almost nothing, then presumably at least some of the destitute envy the wealthy individual. On the other hand, the wealthy individual probably does not envy anyone.

Equity

The concept of envy leads immediately to the question of whether there exist allocations of society's resources that are envy free—that is, allocations in which no individual prefers the set of goods and services of another to the set he or she currently enjoys. Such allocations, if they exist, have been called “equitable.” A moment's thought will suggest that there is at least one such allocation—the distribution of resources such that everyone has an equal division of the available resources. Since everyone has the same allocation, there is no envy.

Note that an equitable allocation need not be efficient (Pareto optimal). One can imagine that tastes differ sufficiently so that one person would prefer more of good A and less of good B, while another person would prefer the reverse. Thus the equal-division allocation of resources may well be inefficient in the sense that a different—“unequal”—allocation of resources could make some people better off without reducing the welfare of anyone. In other words, relative to an equal division of resources, there may be many opportunities for “win-win” (Pareto improving) exchanges. This is one example of the trade-off between equity and efficiency mentioned in the introduction.

Fairness—equity *and* efficiency

Combining the concepts, an allocation that is *both* equitable (in the sense of being envy free) and efficient (in the sense of Pareto optimality) has been called “fair.”

Interesting, though specialized, analytical results stem from these ideas. One of the most intriguing is an extension of the relationship between competition and efficiency mentioned above. Recall that the first fundamental theorem of welfare economics says that under specified conditions competition will lead to a Pareto-efficient allocation of resources. It turns out that if an economy starts from the equal-division allocation of resources—which we know is equitable (envy free)—then competitive forces will lead to a fair allocation—an allocation that is both efficient (Pareto optimal) and equitable.

The ideas described here, and their implications, developed in the economic literature of the 1970s and 1980s.³ While the strand of literature continues, it is fair (no pun intended) to say that it has had little direct influence on public policy. Yet it is also the case that the strand treats the concepts of equity and fairness with a conceptual rigor for which economics has shown itself useful. Perhaps at some point this work will contribute to making economics a bit less dismal.

The Virtues of Inequality

The discussion above focused on specific definitions of equality and fairness. This section reverts to more standard usage of those terms. At this point these familiar understandings seem more relevant to public policy.

Those troubled by globalization often point to increases in income and wealth inequality. But they usually leave the reasons unstated. Perhaps the reasons are obvious. Certainly, as discussed in this volume (and above), issues of equality and fairness are related. Of more urgency, perhaps we fear that people will respond violently to inequality. Yet this need not happen. People could also respond to inequality in socially positive ways. Distinguishing among the environments in which inequality exists may prove decisive in determining whether we should worry about it.

Inequality concerns us when people are likely to respond negatively. At a mild level, feelings of unfairness and resentment in the face of inequality can lead to socially disruptive behavior. Productivity may suffer as people act from apathy, anger, or retaliation. Managers see this every day in work situations involving disgruntled employees who feel they have been treated unfairly or inequitably—that is, who perceive that they face unjust inequality. At the extreme, income or wealth inequality can lead to revolution, as in France, Russia, or Cuba. Revolution can liberate, but it is destructive, and one would hope to find policies that address the underlying issues without such cataclysms.

When pushed, objections to inequality often refer to situations in which individuals feel trapped: they cannot do anything about their relative position. Such circumstances seem unfair. Henry George conceived of his land tax as a response to rising wealth inequality that appeared structural—a part of the social framework against which individuals felt powerless. The perception that you can do nothing to improve your position in life, that your life's opportunities were fixed at birth, creates anger, frustration, and desperation—emotions that can undermine society.

Yet where individuals can respond positively, inequality may lead to socially valuable behavior. Inequality often motivates people to act productively. Seeing someone with something you want can lead to a return to school, a search for a better job, or the start of a new business venture. In these cases inequality induces action that confers social benefits. Moreover, where positive action seems a plausible response to inequality, our measures of inequality may mislead us. Individuals at the bottom of the scale at one point in time may appear at a higher level at the next measurement date.

This observation carries policy implications. Public policy could address inequality by lowering the cost of positive responses relative to the cost of responding negatively. Examples might include making continuing education accessible,

facilitating the search for employment, or easing entrepreneurial activity. In such an environment, these avenues of response may make more sense—and therefore become more common—than clubbing a wealthy capitalist or manning the barricades.

Even in cases where unequal wealth or income seems the result of luck, rather than merit, inequality may not be socially objectionable. Lotteries perceived as “fair” in the sense of open access and equal probabilities of winning do not cause people to take up arms. It is “natural lotteries” buttressed by undue influence in political and economic spheres that make people see red. Thus, again, the circumstances surrounding inequality are crucial.

In itself inequality is not objectionable. What matters is the context within which the world is unequal. This has everything to do with social structure, institutions, and public policy. It has everything to do with making sure that positive responses to inequality are more effective than negative responses. Perhaps we can make a virtue of necessity: the poor(er) may be always with us, but if the possibility of a better life is perceived as real, then differences in relative positions can prove healthy rather than destructive.

Globalization and States

At a number of points during the conference from which this book is derived, participants expressed concern about globalization’s effects on the survival of states. These concerns beg the question of why we should care. If globalization works to the net benefit of people, should we be concerned if it also happens to undermine state authority? We might feel concern if globalization undermines state authority that helps individuals. The real issue seems to be whether individuals benefit more from the protective functions of the state or from the liberating features of globalization. I suspect this is an empirical issue to be resolved differently in different contexts.

Thomas Friedman’s “golden straitjacket” describes one version of the dilemma that globalization poses to states.⁴ In his view globalization requires countries to forego certain policies over which they previously enjoyed discretion so that their legal and economic environments become compatible with the needs of global trade. For example, nations that adopt high protective tariffs would find themselves giving up the benefits of trade, improving technology, and falling costs that come from other countries. Similarly, the economies of nations that protect traditional cultural practices, establish high labor standards, or protect valued environmental areas could be undermined by the competitive pressure from foreign firms not faced with those constraints. In other words, globalization presents countries with a trade-off between policy discretion and the promise of higher (by some measures) standards of living.

State Purpose

Individuals form groups and institutions—including governments—to achieve goals. Thus society might wish to ban child or prison labor even though it is in the interests of employers to oppose such bans. Or governments can help achieve the commonly shared goal of preserving valuable natural resources by adopting strict environmental controls.

Global competition can undermine these efforts. The ban on child or prison labor will threaten domestic industries in the face of products imported from other nations lacking such bans. Similarly, the products of countries that have not adopted similar controls may undercut strict environmental regulations.

Yet in the real world these issues often get resolved through the adoption of standards across countries. No one any longer views slavery as an ethical form of economic activity, and it is universally illegal (though not necessarily stamped out). Despite private incentives to ignore external costs, issues like global warming, eradication of species, and excessive harvesting of the Amazon rain forest succeed in reaching the international agenda.

The real issue is that globalization makes it more difficult for a country to adopt standards out of step with others. Some worry about a “race to the bottom” in standards. Yet this often does *not* happen. For example, the United States (sometimes a leader in establishing high standards) has faced criticism for its resistance to the Kyoto Protocol and its opposition to the International Criminal Court—two attempts to adopt international standards and procedures. The Kyoto Protocol has recently been adopted and the International Criminal Court is still very much alive.

States Can Hurt People

Unfortunately, some states seem primarily interested in promoting the welfare of only their “most influential” citizens. Examples include the prosperity of the Suharto family in Indonesia, protection of the *chaebols* in Korea, and so on. More generally, tariffs or quotas on trade, restrictive labor regulations, business entry requirements, discriminatory taxes, and so on, protect some local producers but harm larger groups of entrepreneurs and consumers. In these cases the state authority favors the few at the expense of the many. Richard Katz has argued that Japan’s economic development between 1960 and 1990 involved favoring specific industries such as steel, automobiles, and agriculture at the expense of higher prices and lower standards of living for the Japanese people than might have been possible under alternative policies.⁵

Presuming the economic purpose of government is to help the general population achieve high standards of living, such cases of favoritism suggest the state

has failed in this arena. It is hard to understand why we would want to protect such states from being opened and made more responsive to the majority of their people. Globalization forces may have that effect.

Globalization Can Hurt People

Of course, globalization can also trample individuals. Many call for international labor standards to address the negative fallout of globalization. As voiced by organized labor in developed countries, such demands may be self-serving. But few would argue with calls that something be done to prevent actual slavery in workplaces. The drive to lower costs and to increase profits through transnational activity can allow the unscrupulous to act in universally condemnable ways.

The process of globalization treats different people in different ways—creating losers as well as winners. Those already familiar with international trade and relatively free economic exchange will likely benefit. In contrast, low-productivity workers, those entrenched in their jobs, or people highly resistant to change will likely suffer from the effects of global competition. They simply are unable, or even unwilling, to adapt.

While people generally prefer the status quo, often the most effective responses to change take place at the individual level. Because individual situations and skills differ, it may be better for individuals to find ways to respond and adapt to global pressures. But change is uncomfortable. It requires thought and effort. It often requires bearing some personal costs. From a policy perspective, an important mitigation of globalization's negative effects may lie in making change easier and more comfortable for people.

But what about the victims of globalization who cannot change? A state that adopts policies to protect such people may find its work undermined as globalization breaks down social protections. Fortunately, responding to economic change is not unique to globalization, and we have plenty of experience with it. Standard economic prescriptions recognize better and worse ways to help people who have trouble adapting to changing environments. Positive responses can involve transfer programs mixed with education and training. Change is ubiquitous, however, and it may be necessary to accept that some people's living standards will fall if they fail to respond and adapt. Putting floors under such living standards, perhaps mixed with incentives to adapt, should play an important part in the public response to globalization.

Globalization's Promise

Yet for all those harmed, globalization can also expand the well-being of individuals. Globalization expands economic opportunities and improves people's

standards of living by lowering the costs and raising the quality of goods and services. That most international trade takes place among developed nations suggests the force of this lesson. Moreover, the forces of globalization may work to ameliorate the problems created by states that fail in their function of advancing the welfare of their citizens. Political developments in Korea and China over the last two decades and in Taiwan and Indonesia in the last several years suggest that increasing transnational interactions (both economic and non-economic) work toward the improvement of people's lives in those countries. Global economic forces may induce self-interested public officials to treat their citizens better with an eye to gaining some of the economic benefits of the globalization process.

This discussion suggests that the ultimate goal of globalization and states is to advance the welfare of individual people. Concerns about states and globalization are ultimately concerns about their effects on people's well-being. Individuals do have interests in collaborating with one another to achieve shared goals. Pooling resources to provide for national defense is an age-old example. But not all goals or desires are shared. The potential benefits of globalization include rising income and wealth, improved standards of living, increased knowledge, and so on. The concern about globalization undermining the independence of countries is relevant only as it applies to individual welfare.

The state is not an end in itself. Nations, provinces, cities, and wards are all formal groupings of individuals presumably motivated by promoting their interests. If alternative means of promoting individual interests come along, then it may make sense to abandon a previously useful institution. For example, a variety of economic and political forces reduced the power of and the demand for guilds of skilled labor. While some might regret the passing of guilds, on balance their demise seems the result of having outlived their usefulness. The welfare of individuals—both workers and consumers—was better met in other ways.

States or Globalization?

Where there is a conflict between globalization and the independence of states, the real issue is where the net benefits for individuals lie. In some cases, independent national authority may be most effective in advancing individual welfare—as in monitoring unacceptable working conditions or in protecting people from financial fraud. In other cases, the forces of globalization may offer such large increases in standards of living that state-protective trade barriers or restrictions on foreign business activity should fall. The concern that globalization will undermine states really makes sense only as a shorthand for concern that the benefits to individuals of a well-functioning state may be sacrificed for the benefits to individuals of globalization—and that the net balance is negative. In this guise, the proposition comes down to an empirical issue, likely to be answered differ-

ently in different situations. The state, like the globalization phenomenon, can work for either good or ill with respect to people's welfare. See Dick Pratt's Further Thoughts, "The Contested Terrain of Outsourcing," below.

Conclusion

This chapter has ranged rather widely. But that seems consistent with this volume's themes. Economists sometimes feel like the (barely) tolerated party guest at such meetings. Some of us see our role as telling rude truths; others may see us as merely rude. Yet as I hope these discussions on fairness, equality, globalization, and the role of states suggests, the sometimes bizarre economic perspective on the world can offer thought-provoking insights. Perhaps that is why a few of us keep getting in the door.

FURTHER THOUGHTS

The Contested Terrain of Outsourcing

Dick Pratt

"OUTSOURCING" is the word used to refer to the process by which a product or service once done within a firm is done somewhere else. Until fairly recently a word unknown to most Americans, it has become an everyday part of our language.

Outsourcing first gained visibility in the United States as a domestic process in which a large producer would elect to use smaller, highly specialized firms to produce things it would be less cost effective to handle internally. The automobile industry provides a good model of this. The major producers obtained critical parts of their cars from firms with which they subcontracted.

In more recent times outsourcing moved from firms within a nation to firms in other countries. The motivation was of course cost savings, and the primary sources of these savings were cheaper wages, fewer health and safety rules, and lax environmental laws. Global outsourcing has turned what began as a trickle of unskilled work into a torrent. That torrent now carries much more than unskilled jobs from one place to another. India currently is the beneficiary of professional work that requires masters' and doctoral degrees. Americans who had felt they or their children would obtain secure, high-paying jobs if they achieved higher education now are uncertain. This uncertainty has done as much as anything to force Americans to think differently about globalization's effects.

Today the largest recipient of outsourcing from the United States is China. Consumers in the United States have come to expect that many of the products they buy from well-known American firms will carry a note informing them that