Paradoxes and Puzzles in Our Globalized World[1]

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We live in a world of paradoxes and puzzles. Of course it was always so, but now more than ever in history we are both well informed and confused. The collapse of communism and the triumph of "globalization" were supposed to put us all on the same page; instead, near-universal literacy has us reading from a thousand disconnected pages.

Conventional wisdom among some has it that the twin triumphs of free markets and free trade have universalized political and personal philosophies. Nowhere is this belief more prevalent than among professional economists. Indeed, since the collapse of communism and the near-hegemony of Anglo-American economics, one of the joys of practicing the dismal science has become traveling to corners of the newly-capitalist world and meeting like-minded academics who not only speak good English but were trained from the same textbooks. In recent years I have experienced such joys in places like Kiev and Karlsbad, Sofia and Skopje, Prishtina and Phnom Phen, Beijing and Bucharest: places that one or two decades ago were xenophobic bastions of communism, despotism or both.

[1] **I am extremely grateful to Vivek Dehejia for conceiving and creating the Festschrift at Carleton in my honor with his usual meticulous flair. Steven Davis provided not only a multitude of perceptive written comments but also spent a rainy afternoon discussing them with me in a Montreal coffee shop.**

Economic theory and evidence offers the core, coherent rationalization of what's good about capitalism and globalization: free markets and free trade. Everyone who purports to understand the modern world should understand that core message. Its logic is unassailable. The *prima facie* benefits from free markets and free trade derive from the premise of gains from trade. When one person voluntarily sells to a second person, who voluntarily buys from the first, both must be better off: otherwise they wouldn't do it. Hence the premise of gains from voluntary trade is virtually tautological. The premise of mutual gains from free international trade is an extension of this tautology.

Yet economists alienate as many intelligent people as they convince, probably more. The reasons are multifold, but have much to do with economists' arrogance and imperialism. Many economists, not the best of the breed but maybe the bulk of the breed, leave non-economists with the impression they're simply stupid if they don't subscribe to a set of "facts", and if they don't subscribe to a political and even personal philosophy that supposedly derives from the narrow logic of gains from free trade.

Let me offer a fictional example of the arrogance and imperialism that second-rate economists bring to the table: often quite literally to the table. Anyone who has spent much time socially with people in our profession knows how vociferous and venomous dinner table conversation can become.

An economist at the table, after a few drinks, offers the following comment, hoping to draw dissent from his non-economist dinner companions: "When two people voluntarily trade with each other, both are better off." He is confident that he can defend this near-tautology and tout his erudition to all present.

But soon the dinner-table conversation becomes twisted. The committed economist, after a more few drinks, vouchsafes to the ravishing artiste on his left: "Well of course gains from free trade means that government should never regulate trade". "Ok", she agrees, mostly because she's bored and wants to change the subject. "Yes" he goes on, "We must vote the [expletive deleted] Silly Socialist Party out of office because they're killing business." L'artiste is now not so sure she still agrees since the SSP is funding her gigantic city sculpture (costing tax-payers money and also

complicating the lives of real estate developers). "Yes", the silly economist goes on, "if only uneducated voters understood the simple logic of markets they would understand how much better off both artistes and communities at large would be without zoning, planning and other intrusive aspects of governments at all levels. If people really want sculptures they can form an art club, pool funds to buy art work, put a big wall around it and allow paid-up members to come inside. Or just charge admission."

Now my example is itself a bit silly and a bit exaggerated, but not by much. I know hundreds of professional colleagues who love to push *artistes* into corners this way, often under the illusion that they're demonstrating their superior intellects and educations. Of course I know thousands more economists who are not so narrow-minded. Nevertheless most economists leave the other side of the "free trade" coin unexamined, mostly because it's a hard side to defend.

I too find it hard to defend. Any well-trained economist can defeat an anti-free-trader on logical grounds. Yet economists must move beyond that logic if they are ever to communicate meaningfully with *artistes*. Or with left-wingers, anti-capitalists, anti-globalists, and anti-Americans, with whom the world is replete. A common lament among academic economists is that outside the economics department, the entire university is replete with such *ignorami* - sociologists, political scientists, psychologists, 'touchy-feelies' - they've even infiltrated business schools, it is said. How many times have I heard my colleagues say something like, "It's frightening how our students are indoctrinated by those 'diversity' courses they're forced to take these days"?

But I digress. Back to globalization. And paradoxes. Insofar as globalization simply means free international trade, its economic benefits are almost self-evident. But there is a yawning gap between the logic of economic gains from free international trade and people's instinctual yearning for locally- rather than foreign-produced goods, and beyond that, their yearning for 'fairness' and for community.

Paradoxically, in a world that is more globalized than ever before in history, ethically-sensitive people wonder whether free international trade is 'fair'. 'Fairness' in trade is a concept that is anathema to most mainstream economists because it falls outside the logic underlying

gains from trade.[2] Moreover, people in our globalized world want more than ever to band together in communities, communities that may interfere with free trade or free choice. For example, what is the logic, indeed the morality, of passports and restrictions on immigration? Yet voters want them.

Beyond people's yearnings and perceptions, our globalized world is paradoxical in practice as well. A world that is more globalized than ever before ought to be homogeneous, or at least converging toward homogeneity. This would imply more political union: more inclusive political and military alliances and fewer and fewer independent countries. As a byproduct it would imply fewer regional wars. It would also imply more economic union: fewer and fewer barriers to trade, fewer independent currencies, and more cross-border cooperation in monetary, fiscal and regulatory policies.

It would imply more universal thinking, in terms of politics, geography, ethnicity, philosophy and religion. It would imply complicit convergence toward cultural homogeneity. It would imply dominance of academic disciplines and philosophical ideals that both describe and prescribe rational behavior, at the expense of those that emphasize "unscientific" singularity. By corollary, it would imply the commercialization of art and the death of religion.

Instead, what do we find in our globalized 21st century world? Here is a laundry list of puzzles and paradoxes.

More countries than ever before in history.

No diminution of regional conflict, despite replacement of bipolar, nuclear-backed military hegemony with unipolar American military hegemony.

More regional trade agreements than ever before in history, in the context of stalled multilateral trade talks.

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[2] Joseph Stiglitz is one of the first mainstream economists to take seriously the complaint that "free" trade is not always fair. He argues that in practice international trade is often not truly free: instead it is distorted by tariffs, subsidies and other rules of trade that benefit rich and powerful countries, to the detriment of the poor and weak. See Stiglitz (2002, 2005, 2006).

"Multinational" corporations that primarily operate regionally[3]*.*

More currencies than ever before in history.[4] *Academic controversy about flexible versus fixed or common currencies that is as intense as it was fifty years ago.*

Heightened geographic hubris at regional, national and community levels.

Heightened ethnic awareness, despite unprecedented migration and also inter-marriage.

Heightened religious hubris, and polarization toward fundamentalist extremes.

Intense concern about cultural identities in the context of globalization and "Americanization".

Less equitable income and wealth distribution both within most 'globalized' countries, and between most countries.

Poor countries lending much more money to rich countries than vice-versa.[5]*,*[6]

Developing countries that borrow capital from the rest of the world grow more slowly than those that lend to the rest of the world.

No consensus about the universal feasibility or even desirability of democracy.

No consensus even among democratic, capitalist countries about optimal government involvement in their economies.

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[3] On this, see Rugman (2005).

[4] This is not quite true. The number of currencies peaked in 2000 at 159, and now stands at 147: see a remarkable new book advocating a single global currency, Bonpasse (2006).

[5] A concise and seminal analysis was Lucas (1990). The starkest single manifestation of this phenomenon currently is the hundreds of billions of dollars in U.S. Treasury bonds currently held by the People's Bank of China.

[6] In 2006, emerging economies (led by China and a few oil exporters) will run a current account surplus greater than $500 billion, whereas the developed economies combined will run a current account deficit of $700 billion (the U.S. deficit alone will be larger than this).

Many people in ex-communist countries claiming to be worse off under capitalism.

Increasing awareness among economists that other disciplines, particularly psychology, can shed light on human behavior. Accumulating evidence that even economic and financial behavior is sometimes systematically non-rational.

These are paradoxes and puzzles that inhabit a world that by many measures is more globalized than ever before in human history. The common threads are diversity, disparity, anomaly, inconsistency, and incongruity. But are these really paradoxes? Are they really puzzles? And are they really new?

I will talk today about only a few of them. The rest will be part of a forthcoming book.

New countries

Consider new countries. A proximate reason for the proliferation of new countries since World War II is the demise of colonialism and then of communism. In 1947, India won independence from Britain and then split along religious lines into three countries.[7] In the 1950s and 1960s, more than a dozen African colonies became countries, as well as several in the Caribbean and Asia.

In 1989, when Solidarity beat the communists at the polls in Poland, the signal to Central and Eastern Europe sounded strong and clear: Moscow would no longer block local democracy. East Berliners stormed their Wall, and communist governments in Czechoslovakia, Hungary, Bulgaria, Romania[8] and the Baltic states were ousted. In 1991, after the Soviet Union collapsed, half a dozen "Socialist Republics" declared independence. In the same year, encouraged by the

[7] More precisely, India won independence from Britain in 1947 and remained secular, while Pakistan (west and east) broke away from India and formed itself into an Islamic state. East Pakistan then broke away in 1971 to form Bangladesh.

[8] Romania's revolution did not come at the polls but rather with the execution in late December 1989 of Nicolae Corcesceau, whose brutal rule culminated with the slaughter of dozens of protesting students.

rise of new states surrounding them, four Yugoslavian Republics fought for their independence from Serbia; in mid-2006, a fifth (Montenegro) voted itself out of its union with Serbia, and soon a sixth (Kosovo) will as well. Iraq may soon split into three parts. Palestine will surely become a country. Northern Ireland may be next. Scotland and Wales will not, but debate about "devolution" of powers within Britain is alive and well.

Is this proliferation of countries new? And is it paradoxical, in the context of globalization? On the surface it is both. It is new because never before in human history have so many countries asserted their nationhood in so short a span of time, both benignly at the polls and in the United Nations and other global forums, and belligerently in wars of "liberation" as well as wars of aggression. And it is paradoxical because not only might globalization in its narrow economic sense of increased cross-border trade and investment seem bound to unite and homogenize, so too might the apparent philosophical convergence that came with the collapse of communism have been expected to put us all on the same page politically.[9]

However it did not put us on the same page. Both colonialism and communism discouraged nationhood, albeit in different ways. Tribal, ethnic, religious and cultural loyalties were all suppressed in the interests of ruling powers or in the interests of ruling ideologies. But capitalism and democracy does not suppress such loyalties. Neither necessarily does independent statehood even when it comes without capitalism or democracy. Hence some or all of these loyalties have flowered in newly independent countries that span the spectrum from capitalism and democracy to their antitheses: countries that span the spectrum from India to Malaysia to Macedonia to North Korea.

In short, part of the paradox of pervasive localism within a globalizing world is explained by two historic events that coincided with the rise of globalism: the demise of colonialism, and then the demise of communism. We could call this a *temporal* paradox, grounded in history and politics. It should not be surprising that a mere half-century of

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[9] As posited famously by Francis Fukuyama (2002) in *The End of History and the Last Man.*

accelerated globalization has not diminished longstanding sentiments of nationalism that were suppressed by colonialism and communism.

***Higher incomes but more inequality*[10]**

Perhaps more surprising, at least to economists, is a *spatial* paradox: by many measures, income gaps between rich and poor have widened, both within countries and between countries. Moreover *perceived* gaps in well-being often exaggerate these income gaps, because globalized information, television in particular, has made most poor people acutely aware of how the other half lives. The late 20th century bequeathed to the 21st century free markets and free politics for much of the world's population, but by the same token it bequeathed a paradoxical mix of equality and inequality, and of opportunity and frustrated opportunity, both disparities heightened by modern communications that have raised expectations everywhere.

Despite the undisputed fact that most people's incomes have increased much more rapidly than they would have in a localized world, many people believe that because of globalization, they are economically worse off. These beliefs are rarely true in terms of absolute income, but they are often true in terms of relative income. Economists are only beginning to come to terms with what social psychologists have known for a long time: people care at least as much about their incomes relative to their expectations, and about their incomes relative to their peers and cohorts, as they do about their absolute incomes.

Many people whose incomes are higher objectively as the result of globalization subjectively perceive themselves to be worse off economically, and in many cases they are wrong. Nevertheless the brutal reality is that objectively they are often right, particularly in terms of relative income. The facts are these: Average incomes have risen in virtually all countries that have opened themselves even partially to free trade in goods, services and financial flows. Moreover both the number and the percentage of people in poverty have declined. This is true even if we measure poverty relatively rather than absolutely: in other words, the *distribution* of income globally is more

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[10] The best single source on global income distribution, concisely covering measurement methodology, conceptual issues and actual data, is Campano and Salvatore (2006).

equitable. And beyond pecuniary income, broader measures of welfare – such as the UN's "Human Development Index" (which factors in education and longevity as well as income) - have improved both on average and in terms of disparity.

Nevertheless, average-income gaps between many countries have increased, as have income gaps within most countries (notably in the U.S. among major developed countries and in China among large developing countries).[11] This apparent contradiction with data showing that income distribution is more equitable globally leads to endless argument between those who claim globalization has made the rich richer and the poor poorer, and those who claim the opposite.

BOX 1

<u>Average income versus median income</u>

And why US average income is the highest in the world, but US median income is not.

By definition, half of any population is above the median, and half below. If the distribution of income is skewed toward the top, with a disproportionately small number of people earning very high incomes, the average will above the median, and vice versa.[1] Crudely put, countries with more equitable income distributions have average incomes closer to median incomes. Hence we have the paradox that although U.S. *average* income is and has been for over a century the highest in the world,* there are a dozen or more major countries where *median* incomes are higher.

*** This is true except for brief periods, such as the late 1980s, when the U.S. dollar was unusually low relative to other major currencies. The only persistent exception is the small country of Luxembourg, which is populated heavily by well-paid bankers and bureaucrats.**

[11] One simple measure of income inequality within countries is the difference between average income and median income. See Box 1.

Superficially, the contradiction is fairly easy to resolve. Income distribution across the entire world's population has indeed become more equitable. But both between many countries and within most countries it has become less equitable. The reason is that China and India together account for one third of the world's population. Their average income relative to the rest of the world has risen sufficiently to make global income distribution more equitable. Nevertheless a large number of less populated countries – notably in sub-Saharan Africa but also in parts of Asia and Latin America – have become poorer relative to other countries. Not only that, income distribution *within* most countries has become less equitable: in developed countries, in developing countries, and in countries that underwent transition from communism to capitalism during the 1990s.

We have good made-in-Canada evidence of increased inequality within developed countries, especially the U.S. A carefully constructed "Index of Labour Market Well-being" for the OECD, constructed by Lars Osberg of Dalhousie University in Halifax and Andrew Sharpe of the Centre for the Study of Living Standards in Ottawa, shows that between 1980 and 2001, the "labour market equality" component of ILMW for the U.S. fell from .27 to .08. For Canada it started much higher and fell much less, from .46 to .42. Most of the 16 OECD countries that Osberg and Sharpe rank also fell, notably the U.K., from .71 to .60. But 6 countries actually rose on the equality index: Belgium, Finland, Germany (markedly, from .75 to .84), Japan, Norway and (very slightly) Switzerland.[12]

Osberg and Sharpe's evidence is for equality within labor income, but at least recently labor income seems also to have fallen behind relative to capital income. Since the bottom of the last U.S. recession in 2001, labor's share in income has risen by just 11%, versus 16% for capital. Canadian, European and Japanese data are similar. The conventional explanation of labor's falling share is competition from labor-intensive imports. Recent research for the U.S. by Ian Dew-Becker and Robert Gordon (2005) shows that although labor's share in GDP relative to capital's actually *rose* between 1966 and 2001, inequality *within* labor

[12] See Osberg and Sharp (2004).

income increased significantly: this is consistent with Osberg and Sharpe's index.

Logic for increased income inequality and income insecurity

We have noted thus far that the past half century has seen increased absolute income for the vast majority of the world's population, as well as increased relative income for a smaller majority. We have also noted that a substantial minority is relatively worse off. Some of that minority has fallen behind relative to average incomes in other countries; many have fallen behind relative to average incomes in their own countries. Globalization is part of the reason for this, but only part. The other part is technical advance. Technical advance interacts with free markets and globalization both to raise average incomes and to change the distribution of incomes around average incomes.

Moreover because that distribution is in rapid flux, many individual incomes have become less secure, and, more dramatically, income-security gaps between the U.S. and other rich countries have widened.[13] Particularly in the U.S., people whose absolute and even relative incomes have increased are nevertheless more insecure about their incomes in future. Can this too be attributed to globalization?

More generally, can we construct a theoretical logic that attributes both income inequality and income insecurity to globalization? If we can, then economists must on logical concede some ground to anti-globalists. And on moral grounds, they should offer policy alternatives that offer amelioration of inequality and insecurity, and estimate the costs of these policy alternatives.

Here is a plausible line of logic. Free[14] *domestic* markets, in goods, services, labor, natural resources and capital, act powerfully to allocate rewards *within* countries according to productivity – or, in the case of stock markets, expected productivity. Hence for example in the U.S.

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[13]The labor market security component of Osberg and Sharpe's ILMW actually rose in all but 3 of their 16 ranked OCED countries. But all 3 countries that fell started from high levels of security, and in 2001 all 3 still had security indices higher than the U.S.'s .26: Australia's is .30, Denmark's .37, and Sweden's .87.

[14] By "free" I mean, roughly, "unregulated, or at least lightly regulated".

during the late 1990s, a proliferation of so-called "dot com" entrepreneurs became millionaires because the markets expected them to be extraordinarily productive. They coexisted with unskilled workers earning stagnant or even declining wages because their productivity was going nowhere. Similarly, free *international* markets in goods, services, labor and capital – in other words "globalization" – act powerfully to allocate rewards *between* countries according to current and expected productivity.

Insecurity

It seems plausible to suggest that the modern world's combination of free markets, rapid technical advance, and their pervasive spread internationally has not only increased average incomes world-wide, but has also led to rapid movements both up and down the income scale for millions of individuals. These individuals sell their newly appreciated or depreciated assets, be they goods, services, labor, natural resources or capital, on markets that price those assets more precisely and more rapidly than ever before in human history, and that translate these assets into incomes more precisely and more rapidly than ever before. In short, it seems eminently plausible that freer markets, technical change and globalization have interacted not only to increase individual incomes worldwide, but also to make them less secure.

Our reasoning thus far does not imply that *the spread of incomes around the average* has increased; it just implies that rapidity of movement around the average has increased. But dispersion of incomes has in fact increased, at least between many countries, and within most countries. Let's look first at inequality between countries.

Inequality between countries

Income dispersion has actually narrowed between some countries: notably between India, China and much of Southeast Asia on the one hand, and Western Europe, North America and Japan on the other. Partly because India and China are so populous, income dispersion has also narrowed across the world's entire population. But it has nevertheless widened between many countries, notably between sub-Saharan Africa and us.

A simple (though admittedly partial) explanation for this puzzle is that much of Asia globalized, but most of Africa did not. First China, and now India, have dramatically freed up their markets, both internally and externally. They and the East Asian so-called "dragons" and "tigers" have adopted modern technology, at first by opening up to investment and technology transfer from abroad, but increasingly via domestic research and development. Sub-Saharan Africa, by contrast, has neither freed up its internal and external markets, nor has it attracted foreign direct investment and the embodied technology. In short, globalization has been a force for narrowing income gaps between countries because it enables poor countries that globalize to "catch up" with richer ones that already have. But by the same token, poor countries that do not globalize fall behind.

Inequality within countries

But why has income dispersion *within* countries increased? The answer lies with much the same phenomena that explain increases in income insecurity. Free markets allow the returns on labor, capital and natural resources to be allocated "efficiently". By this, economists mean that income accrues or does not accrue to the owners of those "factors of production" – labor, natural resources and capital - according to their productivity or lack thereof.[15] For example it means that people with "productive human capital'' - that is, the kinds of education, skills and talents that other people value - will earn higher incomes than people with "unproductive human capital" - that is, people whose education, skills and talents do not equip them to produce services that people are prepared to buy. Simply put, this latter group of people do not meet the standards of the market, even though they may be immensely talented by other standards (for example the standards of an artistic, cultural or religious elite).

This state of affairs, which could be called "market meritocracy", has never existed anywhere in the real world. However, much of the world is closer to such a state than ever before in human history. The efficient allocation of factors to their most productive uses – most productive in the sense that they are used to deliver the products that people are most

[15] In an economist's dream world of perfect competition, zero restrictions on trade, and no 'shocks' (such as wars or sharp hikes in oil prices), a 'steady state' should rise wherein 'on the margin' all factors of production earn the same rate of return.

willing to pay for – is the reason that the market has been able to harness technology and bring the world a higher standard of living than ever before. Per capita incomes are indisputably higher, on average. But so too is income insecurity, both because technology and tastes change rapidly, and because free markets quickly reward those who can deliver the new products than people want, and punish those who cannot.

We still have not yet answered our question: why is income distribution *widening* within countries that have embraced free markets both internally and internationally? Our logic thus far, that technology and free trade raises incomes but increases income insecurity does not clearly imply that incomes concentrate at the top. Yet the evidence is that in many modern globalized countries they do. The process seems to be more pronounced in North America and the UK, where markets by many measures are less regulated than in continental Western Europe or most of Asia. But the process is pronounced there too. And it is more pronounced in countries that have only recently embraced free markets, notably ex-communist countries in Central and Eastern Europe, as well as Russia and the former Soviet Union.

Bearing in mind the perils of pulling too many disparate countries under one theoretical umbrella, let's advance a plausible extension of the "market meritocracy" thesis. During the past decade or two, developed countries have entered an epochal era of rapid technical change: what Alan Greenspan first sensed was a "New Economy", and what Richard Lipsey, much more systematically, attributes to four or five, "General Purpose Technologies" that, along with 19 others (beginning with "domestication of plants") have transformed economies between 9000 BC and the present.[16] In eras such as these, vast fortunes are rapidly made and lost.

Arguably, in the present era fortunes are often made and lost much more rapidly than in previous such eras: first, because technology evolves (and becomes obsolete) more rapidly; second, because finance is more efficient, and hence raising venture capital is easier, as is investing

[16] The five 'transforming General Purpose Technologies' that Lipsey *et al.* (2005), in their Table 5.1, identify for the late-20th century and 21st century are "Computer, Lean Production, Internet, Biotechnology and (potentially) Nanotechnology. It is notable that their GPTs are occurring with exponential frequency. Half of their 24 GPTs since 9000 BC were innovated since 1800, including almost one third in the 20th century.

in such ventures; third because capital moves more easily across borders; fourth because goods move more easily across borders allowing entrepreneurs who live and produce in small countries to achieve scale economies by selling to large markets; and finally because both people and ideas move more rapidly. It might seem reasonable to argue that these five phenomena have not only increased the volatility of incomes, they have also increased the upper the limits on incomes. Upper limits on incomes are increased by unprecedented technology, by the unprecedented availability of capital, and by unprecedented scale economies, both in terms of inputs to production and in terms of outputs. This is the case whether incomes derive from human capital, from physical capital, or from natural resources. For example since OPEC first felt its oats in 1973, the leverage of both countries and individuals who are well-endowed with oil has surely increased because the market for oil is so much bigger, not least because of demand from China.

Yet this argument is readily turned on its head. Just as we argued that the fruits of technology are more easily harvested by means of modern finance and mobile factors of production, we could argue that the fruits are more widely distributed. Impoverished entrepreneurs and inventors can more readily raise physical capital; young people can more readily acquire human capital; goods and services can more easily be sold on world markets; ideas and technology move more easily around the globe. Is it really true that wealth and incomes are concentrating at the top more rapidly in this era than they did during and after the Industrial Revolution?

After a trend toward equality that began in the early 20th century, wealth and income distribution in the U.S., and to a lesser extent in most other industrialized countries, began to become less equal in the 1970s. The trend accelerated in the 1990s with the advent of the new information-technology economy. To be sure, wealth and incomes have not yet re-concentrated at the top to the extent that they had in America or Britain by the turn of the last century. This could be because the New Economy hasn't been in place long enough. Another reason may be that, in contrast to the period following the Industrial Revolution and right up until mid-20th century, virtually all industrialized countries

(except Canada) now impose progressive income taxes and estate taxes.[17]

> **BOX 2**
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> **The U.S. levies a federal tax of 55% on estates above $2 million, and in addition many states impose death duties, so that the total can be as high as 90%. Since 1994 wealthy American families have spent about $500 million to lobby for repeal of these taxes, and repeal is being considered seriously by the Republican administration as it prepares for mid-term elections in November 2006. Interestingly, their efforts have been given pause by America's two richest men, Bill Gates and Warren Buffet. Buffet's characteristically blunt comment is this: "Repealing the estate tax is equivalent to choosing the 2020 Olympic Team by picking the eldest sons of gold-medal winners in the 2000 Olympics."**

However it is not clear that punitive U.S. estate taxes have deterred recent trends toward increased inter-generational wealth concentration. America is no longer quite the legendary land of opportunity it once was: inter-generational mobility is now higher in Canada (despite Canada's abolishment of its estate tax in 1972), and in several European countries.[18]

"Star" incomes

The past few decades' gradual increase in wealth and income inequality may or may not persist. But one phenomenon does seem both new and puzzling. Over the past decade or two, "star" incomes have escalated. Movie stars, sports stars and corporate stars are the most evident. For example the average income of a Fortune 500 chief executive in the U.S. is now over 300 times that of the average U.S. hourly wage, whereas 10 years ago the multiple was less than 100. This is commonly attributed to flawed corporate governance: the interests of shareholders are distorted by the self-interests of managers. That explanation is plausible, partly

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[17] In 1972, Canada replaced its estate tax by a capital gains tax of up to 25% upon death or departure from the country.

[18] For a survey of recent evidence, see *The Economist* (2006a).

because CEO/worker wage ratios in the U.S. and to a lesser extent in Canada are substantially higher than in Europe or Asia. The 'governance' explanation has become more popular since the scandals that befell Arthur Anderson, Enron and WorldCom early in this century.

However Europe and Asia have had their share of corporate scandals too: they simply took different forms. Japan's were suppressed for so long that they turned the equity and real estate crash of 1989 into a 15 year recession. And in 1997, Southeast Asia's "crony capitalism" triggered a financial and macroeconomic crash that was much sharper though much less prolonged.[19]

A more fundamental explanation for "star" salaries may be the same one I have advanced for income insecurity and income inequality: "market meritocracy" that is leveraged by new technology, abundant capital and large markets. Rather than try to explain the uniqueness of U.S. corporate salaries by the dubious ascription of inferior corporate governance, we might instead start by observing that the U.S. economy enjoys labor, product and capital markets that are not only the world's most efficient and least regulated, but also the world's largest, richest and even most "adventurous".[20] In terms of product (though not labor) markets, Canada, which enjoys virtually free trade with the U.S., is not far behind. On balance, pan-European markets remain much more regulated: despite the EU they are still *de facto* relatively segmented. So are markets both within and between Asian countries.

The mobility of the U.S. labor market means that CEOs readily move between firms; but more importantly, the efficiently and size of the U.S. product and capital markets means that an even slightly more productive or suitable manager can leverage his or her salary into huge increases in revenues and profits. A $10 million bonus is only one percent of the billion dollar profit increase that could come from hiring just the right CEO.

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[19] For an analysis of the "crony capitalism" and competing theses of Asia's financial crisis, see Dean (2000, 2001).

[20] It can be argued that the willingness of American consumers to try new products (and also to buy on credit and save so little) is a crucial spur to American innovation and entrepreneurship.

Of course this argument must be tempered by the reality that in a globalized world of free trade and cheap transportation, CEOs from small-market countries like Sweden or the Netherlands should in principle be able to leverage their salaries similarly. And also, isn't it true that China, not America, is now the world's workshop? Why doesn't access to the world's markets make China's CEOs as rich as America's?

The answer is that America is no longer just the world's workshop for manufactured goods; rather it is also the world's workshop for products that embody much more human capital. America, more than any other country, now exports what accountants call "invisibles": legal, financial, accounting and consulting services. America also dominates the world's entertainment services, notably, in film, television and music. Despite its huge current account deficit in merchandise, the U.S. runs a substantial surplus in services. Hence "star" salaries apply not only to CEOs, but also to investment bankers and lawyers, not to mention movie stars. And their markets are not just America's (which is already the world's largest and richest), they are truly global. American investment bankers manage the mergers and acquisitions that are prompted by Europe's rapidly-unifying product and capital markets; American law firms have long since set up shop in the business capitals of the world; and American movie stars and musicians command a global audience. The leveraging this global market makes possible means that extravagant 'star' salaries make sense for purely profit motives.

Cultural catharsis

Of course American dominance of the global entertainment industry is also one reason for much of the world's ambivalence about "globalization". Consuming Japanese cars does not challenge foreign cultures, but watching American movies does. Over the past century, Americans for their part have felt threatened by foreign cultures only rarely and briefly, for example in the late 1980s when a wave of Japanese investment culminated in the purchase of Universal Studios, the ultimate American cultural icon. But the rest of the world feels seriously threatened by American culture, because the American media, and American movies in particular, are at once so seductive and so surreptitiously erosive of local and traditional values. Paradoxically,

Canada is at once the most Americanized of cultures and the most paranoid about it.[21]

Economists discover "happiness"

Thus far we have observed that widespread popular ambivalence about free trade and "globalization" is in good part grounded in the suspicion that it has led to greater income disparities. By many measures this is in fact true. But it is also true that in countries open to free trade, most people at the bottom of the income distribution, though relatively worse off, are absolutely better off. But this may not make them happier. Popular unease about globalization is compounded by its cultural baggage: many, not just the relatively poor, are worried about homogenization, or, worse, Americanization. To delve deeper into the disquiet that surrounds globalization, economists must consult other disciplines such as history, philosophy, theology and psychology.

Over the past two decades, collaboration with psychology has proved particularly fruitful. Economists have discovered for themselves behavioral patterns that psychologists claim they knew all along, but have recast them in economic terms. Economists have confirmed for themselves that relative incomes among peers and within communities typically mean more than absolute incomes; that people value what they already have at more than market value (the so-called 'endowment effect'); that people would forgo substantial income for closer familial and community ties; and much more.

Moreover, economists are finally conceding that "happiness" is culturally conditioned. Consider preferences for more income versus more free choice versus more leisure. We have all heard people say something like this: *"I would be happier if I had more money, more choices, and more time."* It's an assertion that's hard to dispute. It underlies the credo of modern, free market, democratic societies. But some people – notably North Americans - give relatively more weight to money and free choice and than to leisure, whereas others – such as our lazier and more statist cousins in Western Europe – give relatively more weight to leisure. Other rich countries – notably Japan, Korea and Singapore – put somewhat less weight on free choice. But few in any

[21] See Dean and Dehejia (2006).

country or culture would refuse money, choice or leisure if they could have more of one without sacrificing any of the other two. Of course economists, dismal scientists that they are, are quick to point out that to get more of any one requires sacrificing some of the other two: in a world of fixed resources, particularly time, there's always a "tradeoff" between desirable pursuits.[22]

Recently, however, some economists have moved beyond simply enunciating tradeoffs to question the sanctity of preferences themselves. Tradeoffs notwithstanding, three traditional starting assumptions of economic theory – we call them 'axioms' -- are that people are made unambiguously happier by more consumption, by more choice, and by more leisure. Yet over the past decade, many economists, even "mainstream" economists, have begun to question these axioms. The burgeoning new field of "happiness research" marries economics to psychology and finds, *inter alia,* that more is *not* always better than less. For example people in ex-communist countries often complain about the overwhelming career and consumer choices they must cope with under capitalism. As another example, retired 55-year-olds sometimes chaff under their new regimen of unbounded leisure. In this and a myriad of other ways, economists to their credit are now pushing the limits of their own logic to accommodate, if ever so slightly, the yawning gap between what economic theory says should make people happy, and how people actually behave.

Democracy and optimal government

I want now to talk briefly about two other issues from my original laundry list. In our globalized 21st century, we have:

No consensus about the universal feasibility or even desirability of democracy.

No consensus even among democratic, capitalist countries about optimal government involvement in their economies.

[22] I am reminded of a lecture by H. Scott Gordon, my first (and only) undergraduate economics professor, who remained my favorite even after dozens of professors in graduate school. Professor Gordon pointed out that the French revolutionary ideal of *Liberte, Egalite et Fraternite, as* well as the American *Life, Liberty and Happiness* involve immutable tradeoffs in practice.

Perhaps these issues are not puzzles or paradoxes, but they are issues that for most of the 20th century were relatively consensual, at least among the mainstream intelligentsia in free market democracies. In the 21st century they have become decidedly controversial.

The chattering classes of Western Europe and North America no longer universally support the rapid export of democracy to all and sundry. One set of epochal events that put pause to such idealism was the chaotic democratization of Russia. This occurred before property rights and other capitalist rules of law had been institutionalized, and led to wanton plundering of economic assets. It contrasted sharply with the much more benign evolution of China, which has made little pretense of democracy.[23] Another disillusioning experience has been the failure of democracies to take root in much of post-colonial Africa. The most vivid disillusionments of all have been the twin tragedies of Afghanistan and Iraq.[24] George W. Bush's pledge in his 2004 state of the union address to put the full force of America's military behind global democratization seemed oxymoronic at the time and by now seems decidedly counterproductive.

But even those countries and commentators that are firmly committed to democracy debate about something more subtle: the optimal size and role of government. This debate seems to have revived recently among economists with their re-discovery of the Swedish miracle.

Economists since Adam Smith have instinctively put the onus of proof on those who advocate a government role beyond rule of law, in particular protection of personal safety and property rights. Most economists also endorse a government role wherever actions by individual persons or firms might impose costs on others – what we call "negative externalities".

From roughly 1950 to 1975, most economists also subscribed to the "Keynesian Consensus", which went beyond rule of law and

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[23] See Dean (2000a) for description of this contrast.

[24] For a profoundly disturbing insider's report of the incompetence of the coalition's post-invasion government of Iraq, see Stewart (2006). Rory Stewart was deputy governor and then governor under Paul Bremer's U.S. administration of the southern Iraqi provinces of Mayson and then Dhi Qar from September 2003 to the "handover" in June 2004.

compensation for negative externalities to advocate macroeconomic intervention to combat unemployment, on the theoretical grounds that collective behavior did not necessarily correspond to the aggregation of rational individual actions. More broadly, governments and bureaucrats were seen to act in the "public interest". At the level of theory, bureaucrats were deemed capable of divining "social welfare functions".

By the late 1970s, the "Keynesian Consensus" had given way to "New Classical" theory, which models macroeconomic behavior as the simple aggregation of rational, self-interested micro-behavior.[25] Also by the late 1970s, "Pubic Interest" theories of government had given way to "Public Choice" theory, which sees governments' choices as products of self-interested private interest groups and self-interested bureaucrats and politicians.[26] Hence all government activity is suspect, since none of it was conceived altruistically, in the public interest.

Although "New Keynesianism" supplanted "New Classicism" in the 1980s, the enduring impact of New Classicism has been to put the onus on economic theorists to rationalize any macroeconomic departures from self-interest. For example, New Keynesians would prefer to rationalize sticky wages and prices as the result of the failure of aggregated behavior that may have been rational at micro levels to result in rational behavior at macro levels. This translates into a prescription of government policies to reduce unemployment and transfer income to those who remain unemployed. But New Classicists would prefer to rationalize downward-sticky wages either as the result of non-market intervention by unions and the like, or as behavior that is actually in the perceived self-interests of workers or firms at the micro-level. This translates into a prescription of minimal government intervention. The continued popularity of Public Choice theories of government reinforces the persistent influence of New Classical theory, so that on balance, current conventional wisdom among economists in the Anglo-American tradition is that government's optimal role is a minimal one.

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[25] See Dean (1980, 1982) on breakdown of the Keynesian Consensus.

[26] See Dean (1984) for an analysis of Public Choice theory.

The conventional theoretical wisdom that optimal government is minimal got a big boost during and since the mid-1990s, with the excellent economic performance of Britain, Ireland and the U.S. Among developed countries, these three have been in the forefront of deregulation, particularly in their capital and labor markets. All three have enjoyed higher growth of both output and productivity, as well as lower unemployment rates, than several large and more regulated countries of Western Europe, particularly France, Italy and Germany.

The US is an outlier among rich countries: its per capita income and human capital ranks at the top, but its income equality and security at the bottom.[27] Perhaps Americans are willing to tolerate more inequality and insecurity in return for higher productivity growth and a promise of upward mobility. Certainly the US allocates both labor and capital income efficiently according to productivity, except perhaps for CEO incomes. And the US has taken full advantage of globalization.

However, Norway, Sweden, Denmark, Finland and the Netherlands manage to realize high productivity growth without sacrificing equality and security. These countries also have low unemployment. Germany, France and Belgium also boast high equality and security, but their unemployment rates are high. Why?

In short, a puzzle arises when we look at northern Europe: Norway, Sweden, Denmark, Finland and the Netherlands seem to have it both ways: high productivity growth and low unemployment, like the U.S. and the U.K., but in contrast to them, high income equality and security as well. A related puzzle is that in the Nordic countries taxes as a percentage of GDP are the world's highest: conventional wisdom is that both retard growth. So too their social security nets - unemployment insurance and welfare payments - are the world's highest. Redistribution from high to low earners is also generous, via progressive taxes and subsidies in cash and in kind to low earners. To repeat: these northern European countries seem to enjoy the best of both worlds: high growth, low unemployment *and* relative income equity.[28] By contrast, the UK and the US pay a severe price for their

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[27] See again Osburn and Sharpe (2005).

[28] However official data do not always tell the truth. For example Sweden counts people as employed if they are in government make-work programs, on long-term sick leave, forced into early

high growth and low unemployment in terms of high and growing income inequity. They also pay a high price in terms of income insecurity.

None of this is to suggest that Anglo-American insecurity is without its rewards. Just financial investors understand full well that high risk promises high rewards, so too do most people understand, at least intuitively, that high income insecurity offers opportunities to become rich. People in the US are not lining up to immigrate to Sweden, nor are people in Sweden lining up to immigrate to the US. But the US still attracts "A-type personalities" who savor the opportunity to become much more successful than they could in Sweden.

Summary and conclusion

I began with a long list of "paradoxes and puzzles". Many of them emanate from people's perceptions that globalization threatens their uniqueness as embodied in their historic nationalities and cultures. Similarly, many people are uncomfortable with change: the modern era of rapid technological advance coupled to globalized goods and ideas has brought rapid change to remote corners of the world. Many paradoxes and puzzles emanate also from socio-psychological tension between rising average incomes and rising inequality and insecurity.[29]

I believe that economists have begun to grapple with these puzzles more systematically than in the recent past. "Behavioral" economists have convinced most of the profession that "endowment" effects are pervasive: people value what they have owned for some time more than the market does. This phenomenon is easily extended to cover attachment to nationality and culture. Economists since Harvey Leibenstein have recognized "inertial" behavior, that persists beyond

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retirement, or studying when they would prefer to be working. Sweden's official unemployment rate is only 6%, but a recent study by the McKinsey Global Institute estimates put it at 15-17%. See *The Economist* (2006b) for an excellent and appropriately skeptical analysis of the extent to which the Nordic economies truly transcend typical macroeconomic tradeoffs.

[29] Vivek Dehejia and I have written about the policy challenge inherent in these and other tensions, and tried to formulate a concept we call "optimal globalization". See Dean and Dehejia (2004).

what standard microeconomic theory would suggest is rational. Harvey Leibenstein back in the 1970s called "Oblomovian" behavior.[30]

Economists are also now beginning to see, however dimly, that economies and the people who populate them may choose different combinations of consumption, leisure and even free choice. Most Indians would not trade their democracy for the higher incomes offered under China's quasi-dictatorship, just as most Swedes would not trade their security for the promise of higher income in the U.S. The message to ideologues who preach the virtues of one or two of these three human wants over the others is to recognize that tastes differ. Both the political left and the political right would do well to head this message.

A final and laudable breakthrough in economists' mindset is that they are beginning to recognize that their convenient assumption of "non-satiability" – fundamental to conventional economic theory since 1949 when it was codified in Paul Samuelson's *Foundations of Economic Analysis* – does not necessarily correspond to human behavior. Many people do not necessarily want unlimited quantities of consumption, or of leisure, or of free choice, even if they were no tradeoffs between them: that is even if they didn't have to sacrifice one of these wants to get more of the other.

Similarly, some economists have at last begun to repudiate the doctrine that "greed is good" – a serious distortion of what Adam Smith really wrote. Notably, Deidre McCloskey has recently published a lengthy tome called *The Bourgeois Virtues: Ethics for a Capitalist Age*[31] that enumerates seven "virtues": hope, faith, love, justice, courage, temperance and prudence. Drawing in detail from centuries of philosophical and theological thought, she argues that each of these virtues is necessary for capitalism to be successful and sustained. She then turns the argument around and argues something more startling: that capitalism and only capitalism can foster these virtues.

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[30] Oblomov, the central character in Ivan Goncharev's classic 1858 novel, *Oblomov,* spends the first half of the book in bed. Harvey Leibenstein was the inventor of "X-Inefficiency" (a reference from Tolstoy's *War and Peace* to an unquantifiable "X-Factor" that makes the difference between one army's winning a war and another army's losing it). Leibenstein was also a pioneer of what is now called "behavioral" economics: see Dean and Perlman (1998a).

[31] McClosky (2006).

In a somewhat similar vein, Benjamin Friedman last year also published lengthy tome, called *The Moral Consequences of Economic Growth.*[32] Friedman argues that macroeconomic growth – not greed but growth – enables nations to pursue morally uplifting ends, whereas stagnation fosters futility and worse. Like McCloskey, he draws from centuries of philosophical and theological thought, particularly in his case from the Protestant Reformation, the Renaissance and the Enlightenment. He also draws from American, British, French and German history, to document that periods of slow or negative macroeconomic growth were periods when interest groups preyed upon each other. For example the Ku Klux Clan was spawned during the U.S. depression of the 1890s, not during the prosperous two decades after the Civil War that ended with emancipation of black slaves.

Globalization has brought macroeconomic prosperity and growth to every country that has embraced it. It has also brought puzzles and paradoxes. Many of these paradoxes arise because within the macro-economy, some benefit more than others. Other paradoxes arise because a society that abruptly elevates material greed to the top of its moral sentiments begins to fear it will lose its religion, or its culture or its identity.

If we are to harness the power of globalization for good, it is crucial that we understand these paradoxes. It is crucial we think hard and creatively about how to mobilize our unprecedented prosperity toward those who are left behind, or toward those who believe their cultures are jeopardized. As Joseph Stiglitz put it recently, "…what makes the market economy work is that we've learned how to temper capitalism, and to ensure that the benefits are brought to a wider span of people. The problem of globalization is that these democratic processes are not in place. Globalization is undermining the ability of the nation state to deal with problems: workers are told you're going to have to have weaker job protection and lower taxes in order to compete." Stiglitz describes this process as a "race to the bottom".

Stiglitz is regarded by many hard-core economists as a maverick. He lays blame at the feet of developed nations and the institutions they dominate, like the WTO and the IMF, when developing countries are often not just self-serving but

[32] Friedman (2005).

corrupt, permitting their elites to appropriate the fruits of globalization at the expense of the larger population.

But in practice globalization's imperfections are substantial and very real, no matter how perfect its promises in theory. Stiglitz won the Nobel Prize for formalizing systemic imperfections in markets that had conventionally been modeled otherwise. All economists, not Stiglitz, are well trained to analyze the shortfalls of globalization if they can break even marginally "out of the box".[33] In fact over the four decades that I personally have practiced the dismal science, I believe the last decade has been the most promising. Economists have indeed begun to break out of their box, both theoretically and empirically. I am optimistic that they will continue to do so.

One last word of caution: no one should walk away this evening believing they've heard a tirade against globalization. On the contrary, the greatest danger we face after half a century of successful multilateral tariff reductions is that they will stall, devolve into a "spaghetti bowl" of trade-diverting regional trade agreements, or worst of all, go into reverse. If, for example, the US economy slows down significantly, protectionist sentiment will grow. Millions of Americans believe that the goose is laying golden eggs for others but not themselves. Indeed, median real wages of American workers have *declined* by 4% since 2001, while total factor productivity has risen 15%. Even more dramatically, the median wage of first-degree university graduates has fallen by 6% since 2001.[34] Correctly or incorrectly, these "median" people typically believe that free trade is to blame.

As *The Economist* magazine, no bleeding heart socialist rag, put it last week, "…unless ordinary folk are seen to share in the gains from globalization, there will be growing demands for import barriers or much higher taxes on corporate profits … The challenge for governments is to find ways to share out the fruits of globalization more fairly without undermining the economy's ability to reap the benefits."[35] Unless we share the eggs, those left out could kill the golden goose.

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[33] Deidre McClosky is fond of teasing that most academic economists are like "boys playing in a sandbox".

[34] This startling statistic is due to Alan Blinder at Princeton. Apparently, the fact that the overall wage has declined by only 4% is because high school graduates' wages actually rose slightly. A plausible explanation is that routine jobs done by college graduates – computer programming, conventional accounting and even medical diagnoses – can be outsourced to Bangalore, whereas construction work, taxi driving and 'hosptality services' cannot.

[35] *The Economist* (2006c).

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