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# FAIRNESS AND THE POLITICAL ECONOMY OF TRADE

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# **Fairness and the Political Economy of Trade**

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The language of fairness is extensively deployed in the politics of international trade virtually everywhere in the world. The legal structures providing protection through administered mechanisms are generally referred to as “fair trade laws”, the formula “free and fair” is widely used in the public politics of international trade, by both supporters and opponents of trade liberalization, as characterizing the ideal state of international commercial relations. As economists, we are justifiably skeptical of the rhetoric of fairness when applied to arguments for protection. On the one hand, again as economists, we are collectively strong supporters of liberalization and opponents of protection, so we find ourselves opposed to positions that appear to have their strongest support in fairness-based arguments; on the other hand, our most characteristic normative methods—based in straightforward individualistic utilitarian consequentialism—dismisses notions of rights, justice and fairness as, at best muddled, and more likely welfare worsening (Kaplow and Shavell, 2002). Unlike the archetypal two-handed economist, at least in this area, both of our hands are pushing in the same direction: rejection of fairness-based arguments for trade policy.

In this paper, and without prejudice to either of the predispositions of economists identified in the previous paragraph, we want to argue that, as a matter of positive political economy, fairness plays a non-trivial role in the politics of trade policy. In the next section, we want to argue that, as a matter fact, widely held notions of fairness, that are identifiable at the micro level, have macro effects not only in the social and political systems, but even in the economy. Furthermore, as we argue in the second section, these

notions systematically constrain public officials in the construction and pursuit of trade policy.<sup>1</sup>

## **I. Fairness in the Economy and Society**

George Stigler (1981, pg. 176), in his 1980 Tanner Lecture, asserted that “in situations where self interest and ethical values with wide verbal allegiance are in conflict. ... most of the time the self-interest-theory will win”. As a methodological assertion this has much to offer, as its overwhelming, and generally highly valuable, application throughout economics suggests. However, as an ontological statement, it is almost surely wrong.<sup>2</sup> It seems (at least to us) obvious, that relatively widely held notions of fairness have potentially powerful effects on political outcomes in general, and the outcomes of trade politics in particular. In particular, such notions increase the influence of people seeking to achieve “fair” outcomes and lower the influence of people seeking to achieve “unfair” outcomes. The result is that there is a genuine stake in attaching a policy goal to such widely held notions of fairness as well as to affecting those notions (usually by appeal to even more primitive notions of fairness). This obvious claim is affected not at all by the equally obvious fact that the people most aggressively asserting fairness claims expect to

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<sup>1</sup> This paper was presented at a conference on “Fairness and the Political Economy of Globalization, funded by the Murphy Institute (Tulane University) and the Leverhulme Centre for Research on Globalisation and Economic Policy (University of Nottingham), held in New Orleans on 1 and 2 April 2005. The organizers of the conference are grateful to both organizations for their generous support. In addition the organizers are grateful to all conference participants.

<sup>2</sup> It should be noted that many economists, who apply standard methods in much of their research, have long recognized the importance of extending that framework to include fairness considerations. See, e.g.: Akerlof (1979); Arrow (1979); Baumol (1986); Hirschman (1970); Kolm (2004); Okun (1981); and Varian (1974). Useful surveys can be found in Moulin (2003) and Zajac (1996). More generally, fairness considerations are obviously one of the types of “non-welfaristic” information that scholars such as Sen (e.g. 1979) have long argued are necessary to a welfare economics sufficiently rich to be useful in many applied situations.

benefit from general acceptance of those claims.<sup>3</sup> In this section we discuss the evidence that fairness considerations play a significant role in economics and politics generally, and then argue that these considerations merit more serious analysis in the specific case of trade policy.

Before considering more systematic evidence, it is worth noting that introspection should provide a first level of evidence. All of us have been children and many of us have been parents. A considerable part of the socialization process revolves precisely around the attempt to instill in children a sense of what the community considers fair behavior and fair outcomes. These lessons virtually never leave us. We respond strongly to perceived unfairness—not only against ourselves, but to others. Even Economics Departments consider fairness in the allocation of both unpleasant tasks and rewards. Fairness considerations are often not dispositive, but they constitute constraints that need to be taken into account. These considerations recognize an irreducibly social element even in the context of what is essentially a market relationship. Some of the most compelling evidence offered by Akerloff (1982, Akerloff and Yellen, 1990) in support of his fair wage variant of efficiency wage theory involves a survey of personnel texts. Those texts reflect an explicit understanding of fairness considerations in wage-setting. In recent years a sizable body of research has developed providing more systematic evidence that fairness considerations play a major role in the determination of even economic behavior.

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<sup>3</sup> This last fact does certainly mean that we cannot accept such claims at face value. It is, however, effective testimony to the potential importance of fairness claims to the final outcome of political conflict. Were this not the case, such language would long since have passed out of political use.

The evidence of fairness constraints in markets that is most closely linked to the evidence of introspection is given by surveys.<sup>4</sup> Important work has been done with respect to both markets for final goods and labor markets (e.g. Bewley, 1999). In the case of markets for final goods it has been argued that, in cases where firms are concerned with repeat business, firms adopt pricing strategies that reflect a concern with widely held notions of fairness among consumers (Okun, 1981). This can result in both excess demand when upward price adjustment is constrained by fairness considerations as well as excess supply when consumers are punishing firms. Kahneman, Knetsch and Thaler (1986b) carried out household surveys seeking to identify these widely held norms. Based on the results of those surveys, the authors proposed a number of implications for Okun-type “customer markets”:

*Proposition 1:* When excess demand in a customer market is unaccompanied by increases in suppliers’ costs, the market will fail to clear in the short run.

*Proposition 2:* When a single supplier provides a family of goods for which there is differential demand without corresponding variation of input costs, shortages of the most valued items will occur.

*Proposition 3:* Price changes will be more responsive to variations of costs than to variations of demand, and more responsive to cost increases than to cost decreases.

*Proposition 4:* Price decreases will often take the form of discounts rather than reductions in the list or posted price.

The authors find evidence supporting all of these propositions. Similar results are found in the much more extensive literature on fairness in the labor market context. Bewley (1999) reports extensive surveys of managers (246) and labor leaders (19) in the US in the early 1990s, when the US was in a recession. The core question was why wages were not cut during a recession. The answer had two parts, both interesting: first, the main source of resistance to wage cutting was management, not labor; and, more importantly,

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<sup>4</sup> For more detailed overviews of the empirical research on fairness constraints in markets, see Kahneman, Knetsch and Thaler (1986a) and Bewley (1999, 2005).

the main reason given by management for avoiding wage cutting was concern with morale. Furthermore, fairness considerations appear to play a major role in explaining the effect on morale. As Bewley's (2005) survey of this literature suggests, the great majority of work by economists is consistent with these conclusions.

An alternative source of evidence on the operation of fairness constraints comes from experimental economics.<sup>5</sup> From the earliest work on ultimatum games (Guth, Schmittberger, and Schwarze, 1982), experimental game theory has generated a steady flow of results that strongly suggest the operation of fairness constraints in economic environments. The ultimatum game involves a *proposer* making a take-it-or-leave-it offer of a division of some amount of money and a *responder* accepting or rejecting the offer. If the offer is accepted, the division is made; if the offer is rejected, neither player receives a positive payoff. The obvious Nash equilibrium in this game is for the proposer to offer the smallest positive payoff possible and for the responder to accept. As reported in Camerer (2003), in a wide range of treatments, proposers offer much larger shares (around 40% of the total) and responders tend to reject offers below a threshold well above the minimum (around 20%, with considerable variance). These experiments show that there are widely held and commonly understood notions of fairness that affect behavior both because they are internalized (altruism) and enforced (punishment).<sup>6</sup>

One particularly important set of experiments from the perspective of this paper are those that relate to labor markets. An important research programme, developed by

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<sup>5</sup> Excellent overviews of the experimental literature and its implications for economics and game theory can be found in: Camerer (2003, Chapter 2), Camerer and Thaler (1995); Fehr and Gächter (1998, 2000); Fehr and Schmidt (2003); and Rabin (1993, 2002).

<sup>6</sup> As Camerer notes, the power of internalized norms (altruism) without punishment is rather weak, though certainly not zero. This evidence comes from dictator games—i.e. games in which only the responder cannot reject offers. Closely related to the ultimatum games are both prisoners' dilemma and public good games, in which levels of cooperation are generally much higher than predicted by theory (Ledyard, 1995).



Ernst Fehr, with a large number of co-workers has developed experimental labor markets with the express purpose of evaluating (among other things) the role of fairness considerations in wage-setting (Fehr and Gächter, 2000). These experiments construct a horserace between a standard moral hazard model in which expectation of minimum effort induces firms to pay a minimum wage and the Solow-Akerlof-Yellen efficiency wage model (Solow, 1979; Akerlof, 1982; Akerlof and Yellen, 1990) in which firms pay a premium and are rewarded by high effort. The results are strongly consistent with the Solow-Akerlof-Yellen model and, importantly, with the survey evidence reported by Bewley and others.

Overall then: in the surveys, people assert that they would take actions based on considerations of fairness that would have macroeconomic consequences; and in the experiments people appear to take economically costly actions based on fairness considerations of precisely this type. When considered along with the evidence of introspection, one needs to be a very well-trained economist indeed not to recognize the operation of fairness constraints even in the economy. It is important to note that this research does *not* suggest that fairness considerations are an alternative to self-interested behavior, but that they complement such explanations. In many cases little is lost by abstracting from fairness considerations. However, the presence of these effects, even where tightly constrained by competitive considerations, can have macroeconomic effects. When we turn to the political domain, where fairness considerations are less

tightly constrained, we should not be surprised to find both stronger evidence of their presence, nor should we expect their macro-political consequences to be smaller.<sup>7</sup>

In the specific case of preferences over policy it does seem that fairness considerations play an important role independent of (i.e. not reducible to) considerations of pure self-interest. Some considerable effort has been expended by political scientists in the attempt to identify the politically relevant components of fairness. With respect to economic (as opposed to racial or gender) issues, most of this research has focused on issues of equality, redistribution and support for the welfare state. While most of this research is based on public opinion surveys, it is interesting to note that there is also a body of experimental research on these issues which is both broadly consistent with the survey research noted here and the experimental research on markets noted above (Frolich and Oppenheimer, 1993).

Political science research on the economic foundations of political evaluation has struggled to disentangle two sorts of effects: retrospective v. prospective evaluation; and personal v. sociotropic evaluation. In all cases these refer to characterizations of the ways that rational individuals evaluate the performance of incumbent or potential

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<sup>7</sup> The notion that the economy and civil society are characterized by fundamentally different normative structures under capitalism is widely shared by political economists of virtually all sorts. The notion that these two normative systems are in fundamental conflict in the context of genuinely democratic politics (i.e. politics that enfranchise the relatively risk averse and relatively poor) has been argued by analysts as different in their political commitments as Joseph Schumpeter (1942) and Karl Polanyi (1944). For Schumpeter and Polanyi this conflict was seen to be fatal to capitalism, but for later scholars the success of capitalism in the wake of the Depression and the Second World War—both at avoiding further depression and securing widespread legitimacy in the context of democratic politics—became the core research question for macro political economy. This research has identified a central role for the state in mediating this relationship and, more recently, has focused particularly on the redistributive (i.e. ‘welfare’) state. Most recently, this research has sought to identify the ways in which welfare states have supported increased globalization. From the perspective of this paper, we are interested in the ways that claims about fairness emerge from civil society to underwrite claims for intervention in the economy.

governments.<sup>8</sup> It is the issue of personal versus sociotropic voting that interests us here. Starting with important research by Kinder and Kiewiet (1979, 1981) a body of research developed which challenged the consensus in research on economic voting, the same consensus that currently exists in research on the political economy of trade policy, that policies/candidates were evaluated based on their (expected or retrospective) impact on individual well-being. Kinder and Kiewiet, microlevel survey research showing that there was very little correlation between perceptions of individual well-being and voting behavior, developed the concept of *sociotropic voting*:

In reaching political preferences, the prototypic sociotropic voter is influenced most of all by the *nation's* economic condition. Purely sociotropic citizens vote according to the country's pocketbook, not their own. Citizens moved by sociotropic information support candidates that appear to have furthered the nation's economic well-being and oppose candidates and parties that seem to threaten it. Thus the party in power suffers at the polls during hard times because voters act on their negative assessments of national economic conditions—quite apart from the trials and tribulations of their own economic lives. (Kinder and Kiewiet, 1981, pg. 132)

Kinder and Kiewiet presented preliminary survey research supporting this hypothesis, and while successive research has fairly consistently found evidence of personal voting, the current consensus would seem to support a strong role for sociotropic evaluation as well (Mutz and Mondak, 1997; Funk and Garcia-Monet, 1997; Gomez and Wilson, 2001).<sup>9</sup>

As a bridge to our discussion of fairness in the context of trade policy, it is worth noting that while there is little systematic work seeking to identify the microfoundations of sociotropic evaluation, there is some reason to believe that unemployment plays a particularly central role. A provocative paper by Conover, Feldman and Knight (1986),

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<sup>8</sup> While we are interested in the second of these pairs, it is interesting to note that in research on the political economy of trade policy, theoretical analysis tends to assume prospective evaluation while empirical research (usually implicitly) assumes retrospective evaluation.

<sup>9</sup> Some recent research has found quite strong evidence of other-regarding preferences in experimental settings in which agents vote on redistribution: Tyran and Sausgruber (forth.) and Bolton and Ockenfels (2002).

in addition to finding evidence consistent with both personal and sociotropic evaluation, found that the public responded more quickly to information about unemployment than to information about inflation. Specifically, the people in their sample (a panel survey from 1981-1983) generally had a more accurate perception of the state of unemployment than of inflation, furthermore even people without accurate knowledge of the unemployment rate were generally knowledgeable about its trend. By contrast, only those who had accurate knowledge of the inflation rate were also knowledgeable about the trend (although there was evidence of learning over time). The authors suggest that, at least in the early 1980s, the public appeared to be more responsive to unemployment than to inflation. This result finds more general support in the macroeconomic research on the relative effects of unemployment and inflation on reported happiness in the US and Europe (di Tella, MacCulloch and Oswald, 2001, 2003).

These results are consistent with recent work, also based on opinion surveys, on the foundations of “happiness”. There exists a substantial and growing empirical literature indicating that job loss generates a loss of utility or sense of well-being that goes beyond the loss attributed to the concurrent loss of income. The non-pecuniary value of employment appears to be quite large. Using panel survey data of German males aged 20-64, Winkelmann and Winkelmann (1998) find that the “non-pecuniary costs of unemployment by far exceed the pecuniary costs associated with loss of income while unemployed.” As the authors of this study suggest, “employment is not only a source of income but also a provider of social relationships, identity in society and individual self-esteem.” In a separate study using data from three waves of the World Values Survey covering more than 30 countries, Helliwell (2003) compares the effect of

job loss on individual well-being with a variety of other life events. For example, respondents were asked to evaluate their health on a scale of 1 to 5, with 1 representing very good health, and 5 representing very poor health. When including the health variable and employment status in the same regression (along with other control variables, including measures of income), Helliwell finds that unemployment reduces self-reported satisfaction by the same magnitude as a 1 point reduction in self-reported health. Other research has found that satisfaction levels are related to the overall level of unemployment.<sup>10</sup>

Our reading of the literatures sketched in this section suggests that the public politics of economic issues are likely to be strongly conditioned by broad fairness considerations that are closely linked to concerns about unemployment. In this paper we focus on the political economy of trade policy. Although there is quite compelling evidence that unemployment affects preferences over trade policy, there has been very little work to date seeking to make this link. At the same time, while the public rhetoric of trade policy often makes reference to fairness, there is literally no systematic research on the way fairness considerations affect the political economy of trade.

## **II. Fairness in the Domestic Political Economy of Trade Policy**

We noted in the introduction that the language of fairness is extensively used in the public politics of international trade policy. In this section we want to do three things: first, we want to briefly discuss the apparent foundations of fairness-related concerns

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<sup>10</sup> For example, Clark and Oswald (1994); Darity and Goldsmith (1996), Korpi (1997), Frey and Stutzer (2001); Di Tella, MacCulloch, and Oswald (2001, 2003), Clark, Georgellis, and Sanfey (2001), Clark (2003), and Blanchflower and Oswald (2004). A convenient, non-technical overview of this research can be found in Oswald (2003). A broad overview of research on ‘happiness’ can be found in Layard (2005).

with trade policy; second, we want to illustrate the way that individual level fairness concerns result in aggregate level policy outcomes; and third, we want to raise some broader issues in the positive analysis of fairness as applied to trade policy.

Among the many things that surely are relatively widely held components of a public notion of fairness, we focus on three here: exogeneity; unemployment, and inequality.<sup>11</sup> Unlike outcomes that are the result of poor, or even unfortunate, choices by individuals, trade shocks appear to be essentially exogenous to those choices. Like epidemics, earthquakes, and hurricanes, a trade shock has widespread effects that produce a sympathetic response from unaffected citizens. In all of these cases, claims in fairness to a positive response meet with considerable support from such citizens. This is precisely the basis of arguments for trade adjustment assistance (Lawrence and Litan, 1986).<sup>12</sup> Also like epidemics, earthquakes and hurricanes, the exogeneity of trade shocks also carries a strong implication of unpredictability. There is a sizable literature that seeks to account for trade policy activism in terms of insurance motives and, while the insurance motive for trade policy can be rooted in purely self oriented preferences,

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<sup>11</sup> Suranovic (2000) presents a catalogue of arguments that might be used to justify various trade policy positions as fair or unfair; and Risse (2005) provides an analysis of fairness claims in protection policy. Neither of these is a positive analysis in the sense suggested here—i.e. an attempt to understand the implications of widely held notions of fairness for equilibrium trade policy.

<sup>12</sup> The “foreignness” of the shock is also clearly relevant. The current consensus among economists (if not among the public at large) is that technological change is at least as significant as trade/globalization in producing income redistribution and insecurity, but, except for hardcore Luddites, there is very little resistance to technological change. I do not mean to suggest that there is no resistance to technological change. We can see a sort of diffuse Luddism in response to new retail technologies. In the middle of the twentieth century this showed up in attempts to regulate the activities of chain stores (e.g. resale price maintenance) and currently we see this in resistance to Walmart. Nonetheless, these concerns seem considerably less potent than anti-globalization concerns.

general support for social insurance surely contains an element of concern for fairness as well.<sup>13</sup>

The role of unemployment in public evaluations of trade policy is well-documented. A standard finding in the public opinion literature on trade policy is that questions linking trade to unemployment systematically induce stronger support for protection than questions which make no such link (Scheve and Slaughter, 2001; Mayda and Rodrik, 2005; Hiscox, 2004). This link is sufficiently strong that Michael Hiscox (2004) characterizes questions which make the link as an “anti-trade” framing. Our discussion of unemployment in the previous section suggests why this effect is so strong: we all understand that (involuntary) unemployment has large pecuniary and psychic effects. When linked to the claim that trade-related unemployment is unfair due to the generally unfair nature of trade shocks, it is clear why even people with little risk of unemployment still respond strongly to a framing in terms of unemployment. Hiscox presentation of his results in terms of framing suggests that people have no fixed preference over trade policy, but rather can be manipulated due to framing effects. An alternative interpretation is that, if the politics of trade policy come to be seen as about unemployment, the general support for trade intervention will be high.<sup>14</sup>

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<sup>13</sup> The classic paper on insurance motives in trade is Newberry and Stiglitz (1984). Eaton and Grossman (1985), Cassing, et al. (1986), and Dixit (1987, 1989), among others extend that analysis. In addition, there is an interesting body of work that seeks to understand the link between support for openness and the presence of a redistributive state in terms of insurance motives (e.g. Cameron, 1978; Bates, et al., 1991; Rodrik, 1996; Alesina and Wacziarg, 1999; Iverson and Cusak, 2000; Adserà, and Boix, 2002; Mares, 2005).

<sup>14</sup> It is hard not to see some of the hysteria among trade economists on trade and wages, and trade and unemployment, as being driven by precisely this concern.

Finally, one of the most fundamental foundations for public claims about fairness in Liberal society is (in)equality.<sup>15</sup> Conditional on a wide variety of contextual information, there is considerable evidence that people possess some preference for equality.<sup>16</sup> With specific reference to trade policy, Robert Baldwin (1985; Anderson and Baldwin, 1987), among others, has long noted that trade policy seems to protect relatively unskilled workers.<sup>17</sup> Since this result continues to hold even when the analysis controls for factors that might make such workers politically effective (e.g. unionization), this seems strongly consistent with the operation of some kind of equality norm and this is precisely the interpretation given by Baldwin.

We now turn to a simple illustration of the impact of such preferences on equilibrium trade policy. Specifically, we will abstract from exogeneity and unemployment to illustrate this effect in the simplest environment—one in which the only issue is the presence or absence of a preference for equality. To do this we will draw on recent research suggesting that a simple form of preference for fairness as equality rationalizes many of the experimental results on this topic. Specifically, we will introduce Fehr/Schmidt preferences (Fehr and Schmidt, 1999, hereafter F/S) into Mayer's

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<sup>15</sup> The literature here is vast. An excellent discussion of many relevant issues is Nagel (1991) and Clayton and Williamson (2002) collect a number of fundamental contributions that provide an excellent overview of the main positions. Miller (1992) provides an interesting overview that seeks to relate the empirical research on the actual beliefs of people about distributive justice to the philosophical literature. Philosophers often abstract from empirically relevant, but philosophically tangential issues and focus directly on equality, while empirical political scientists find the costs of such simplification too high, and thus focus on equity.

<sup>16</sup> Scholars like Hochschild (1981), McCloskey and Zaller (1984), Chong (1993), Feldman (1999), Berinsky (2002), Fong (2002), and Corneo and Grüner (2002) have pursued the positive analysis of public values of distributive equity and their implications for political behavior.

<sup>17</sup> Standard surveys of the empirical political economy of trade by Baldwin (1984) and Rodrik (1995) both document the fact that most studies that, controlling for a variety of other factors, sectors which are characterized by low skill-intensity/low wages/labor intensity are relatively highly protected.



model of endogenous tariff formation (Mayer, 1984). We then discuss some extensions and implications.

Mayer (1984) considers a small open economy which produces two goods, from two factors, under standard Heckscher-Ohlin-Samuelson conditions. That is, production functions in each sector are characterized by constant returns to scale, with both factors essential in the production of both goods.<sup>18</sup> If we take the two factors of production to be skilled and unskilled labor, the standard no factor-intensity reversal assumption means that we can refer to one of the goods as the skill-intensive good and one as the (basic) labor-intensive good. These assumptions (along with differentiability and strict concavity of the production functions) ensure that there is a one-to-one relationship between relative commodity prices and relative factor prices and, more importantly, that the Stolper-Samuelson theorem holds:

*Stolper-Samuelson theorem:* Under the assumptions of the Heckscher-Ohlin-Samuelson model, a fall in the price of one of the goods lowers the return to the factor used intensively in the production of that good, relative to all other prices, and raises the return to the other factor, relative to all other prices.

To generate heterogeneity among agents, although all agents share identical, homothetic preferences, Mayer assumes that every agent is endowed with one unit of unskilled labor and some non-negative endowment of skilled labor.

The key to Mayer's analysis is that, under the assumptions of the model, every agent has an optimal self-interested tariff dependent only on her endowment. Under the assumptions that tariff revenues are redistributed according in proportion to agent's income as a share of national income and that utility functions are strictly concave in the

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<sup>18</sup> A bit more technically, in addition to linear homogeneity, we take both production functions to be twice differentiable and strictly concave.

tariff, Mayer shows (pg. 974): 1) any agent whose endowment is identical to that of the economy as a whole prefers the economy's optimal tariff (zero for the small economy case assumed here and in Mayer); 2) that the agent's optimal tariff is positive (negative) for agents well-endowed with the scarce (abundant) factor relative to the economy's endowment; and 3) this preference is increasing in the distance between the agent's endowment and the economy's endowment. Black's (1948) theorem is then used to identify the equilibrium tariff:

*Black's theorem:* In a majority rule contest in which preferences are single-peaked over a one-dimensional issue, the most preferred policy of the median voter cannot be defeated.<sup>19</sup>

Once the median voter has been identified, we know from Mayer's result and Black's theorem that the optimal tariff of the median voter will be the equilibrium tariff for the economy. For our purposes, Mayer's essential result is that, as long as the median voter's proportional endowment of skilled to unskilled labor differs from that of the economy as a whole, the equilibrium policy will not be free trade.<sup>20</sup> Furthermore, to the extent that ownership of skill is skewed toward the right, the equilibrium will involve a positive tariff.

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<sup>19</sup> In political economy applications the usual mechanism is given by two-party competition over the issue space and Hotelling's (1929) result that the Nash equilibrium of that game is for both parties to offer the most preferred point of the median voter. The classic development of spatial political competition is Downs (1957), and an admirably clear pedagogical treatment can be found in Enelow and Hinich (1984).

<sup>20</sup> It is one of the striking facts of this analysis, in this general case, the optimal choice of a social choice function (majority rule) which is Arrovian differs from the optimal choice of a Kaldor-Hicks social welfare function (i.e. free trade).

Now we suppose that, instead of strictly selfish preferences, all agents possess a preference for a fair distribution of income. Following Fehr and Schmidt (F/S, 1999) we assume that all agents have preferences of the following form:<sup>21</sup>

$$U^k(\mathbf{x}_k; \mathbf{x}_{-k}) = u^k(\mathbf{x}_k) - \alpha_k \int_{e_k}^1 [u^h(\mathbf{x}_h) - u^k(\mathbf{x}_k)] f(k(e)) de - \beta_k \int_0^{e_k} [u^k(\mathbf{x}_k) - u^h(\mathbf{x}_h)] f(k(e)) de, \quad (1)$$

where  $k, h \in H$  denote agents,  $\mathbf{x}_k$  is the consumption vector of agent  $k$ ,  $\mathbf{x}_{-k}$  is a matrix of consumption bundles of all other agents,  $e_k$  is the endowment index for agent's with a given endowment, and  $f(k(e_k))$  is the proportion of agents with that endowment. Thus, in addition to the standard utility function, defined over own consumption, F/S preferences reflect a general distaste for inequality composed of both a dislike for others being better off than oneself (the term preceded by  $\alpha_k$ ) and for oneself being better off than others (the term preceded by  $\beta_k$ ).<sup>22</sup> That is, for a given level of own utility from consumption, total individual utility is maximized if income could be redistributed such that everyone has

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<sup>21</sup> We are grateful to Simon Gächter for suggesting that we consider these preferences. F/S are concerned with accounting for experimental results in which some good is simply divided, so their utility function is defined over a scalar quantity allocated to the individual, say  $x_k$  and its allocation to others  $x_h$ . Because we assume identical preferences, agents are assumed able to make the relevant comparisons in utilities. In addition, we have taken advantage of the natural ordering of incomes, and utilities, induced by our assumptions on agent endowments and identical preferences. That is, since all agents have the same preferences, the self-regarding utilities  $u^k(\mathbf{x}_k)$  differ only as a function of incomes and incomes rise with the size of the skill endowment. Under free trade and no redistributive policy, an agent's position in the income distribution and the utility distribution is given by her endowment ratio. Given this, we can associate every agent with their endowment ratio and, following Mayer, associate this ratio with an index,  $e$ , such that  $k(e) = k(0) = 0$ ,  $k(e) = k(1) = k^{\max}$ , and  $\partial k / \partial e > 0$ .

<sup>22</sup> While it is not essential for our purposes, F/S assume that  $\beta_k \leq \alpha_k$  and  $0 \leq \beta_k < 1$ . That is: agents dislike being worse off than others more than they dislike being better off than others; and that no agents like to be better off than others. The first of these seems sensible given the general concern with fairness, the latter is surely counterfactual, but is a useful simplification in an attempt to evaluate the impact of preferences for fairness at the aggregate level.

the same utility from consumption (i.e. the second and third rhs terms in (1) are zero) without reducing the economy's total income.

We have already noted that, in the Mayer (strictly self-regarding preferences) model, free trade will only obtain for a small economy if the median voter happens to have the same endowment ratio as the economy. Under the assumption that the median voter is unskilled relative to the aggregate endowment (i.e. the skill endowment is skewed to the right) in a skill-abundant economy, this implies that the equilibrium tariff will be positive. We now argue that an economy with F/S preferences will have a higher endogenous tariff than the Mayer economy. Note that the identity of the median voter will not change—this is determined by the natural ordering of agent endowments. Since all agents possess one unit of unskilled labor and some non-negative endowment of skilled labor, all agents to the left of the median voter are poorer than the median voter and all agents to the right are richer. Furthermore, since, via the Stolper-Samuelson theorem, an increase in the tariff transfers income from skilled to unskilled labor, the welfare of the median voter is raised both because the income of all agent's to her right are reduced and because the income of all agents to her left are raised. Thus a small increase in the tariff from the self-regarding optimum will reduce aggregate inequality and raise the welfare of the median voter, so the equilibrium tariff must be higher under F/S preferences than under self-regarding preferences. There is also, of course, an aggregate efficiency cost that will work against increasing the tariff, however it is notable

that experimental work by Bolton and Ockenfels (2002) suggests that agents may generally have a rather strong preference for equity relative to efficiency.<sup>23</sup>

A similar argument applies to the case of a trade shock. That is, suppose that our initial state is an equilibrium with a tariff and F/S preferences. For some reason, say China liberalizes its trade regime, the world price of the unskilled good falls. Now the Stolper-Samuelson effects redistribute income generally from unskilled labor to skilled labor and specifically from agents to the left of the median voter ('poor' agents) to agents to the right of the median voter ('rich' agents). By the same argument as in the previous paragraph, a small increase in the tariff will undo some of the negative distributional effect. This is just a specific version of what Corden (1974, 1986) called the conservative social welfare function argument for protection.<sup>24</sup>

It is particularly easy to illustrate the effect of a preference for a fair income distribution, or a fairness-based insurance motive as with the above version of the conservative social welfare function, but it should be clear that a similar sort of analysis could be generated for a social concern with unemployment in a model with equilibrium unemployment. However, this approach simply illustrates an effect in a simple, reduced form model of a political economy. The great virtue of the referendum model is its simplicity, but if we are trying to understand the role of fairness it has the fundamental weakness of portraying the politics as essentially public. However, one of the most distinctive attributes of the politics of trade policy in the GATT/WTO era is precisely that

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<sup>23</sup> This is also the opening wedge of the argument for the superiority of using an alternative instrument to secure the welfare optimum—i.e. some combination of free trade and a less distorting means of transferring income. As a practical matter, it is probably the case that stably low tariffs in the post-Second World War era are associated with the presence of a redistributive welfare state for more-or-less this reason. See, among others, for an argument of this sort, in addition to the work cited in footnote 12, Bordo, Eichengreen and Irwin (1999).

<sup>24</sup> Also see Deardorff (1993) for a development of the logic of a conservative social welfare function.

those politics are not public. Unlike the politics of the tariff during the era of classic tariff politics (essentially from the end of Reconstruction until the Reciprocal Trade Agreements Act of 1934), trade policy is an “inside the beltway” issue. This provides much less opportunity for trade politics to be *about* fairness. Inside the beltway, the politics of trade is about balancing interests with very little rhetoric about fairness. In a sense, public deployment of the language of fairness in this context (e.g. fair trade laws, rhetoric of ‘level playing fields’, and trade adjustment assistance) is more about keeping the public out of the politics of trade than delivering anything that is identifiably about fairness.<sup>25</sup>

If, and as, the politics of trade policy become public politics, the role of fairness language will become much more important. In the context of essentially technical politics like those related to trade policy, public fairness claims constitute a first step in the process of making those politics more public, more democratic, and less predictable. The purpose of a fairness claim in the public political discourse is to increase the political weight of agents who are, in some sense, losing the political struggle (either as direct participants or as a result of being marginalized).<sup>26</sup> In an era of striking Liberality and relatively rapid globalization, it is not surprising that it is opponents of globalization that seek to use the language of fairness to increase their influence. We are only at the very beginning of a systematic understanding of the public politics of trade policy, but it

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<sup>25</sup> It is interesting, and essential to note, that the reason for keeping the public out is to support a more Liberal trade policy than could be sustained under public determination of trade policy. Thus, as Pastor (1981) and Destler (2005), among others, have argued, when the politics of protection threaten to become public, political elites can point to these institutional commitments to fairness, thus deflecting that pressure. This particular subtlety is usually lost on us as economists. We tend to see fairness language as empowering protection seekers even inside the beltway.

<sup>26</sup> This is a specific instance of Schattschneider’s (1960) classic account of the unpredictability of democratic political struggle—as opposed to the much greater predictability of what he called “group politics”.

seems likely that an understanding of the politics of fairness will be central to any advance in this area.

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