The Three Tailors

Ariel Rubinstein

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Translated from Hebrew by **Flora Gill**

I must confess that I'm somewhat embarrassed to address you. I am an economic-theoretician who hardly knows a thing about current economic affairs. I customarily dispose of the business section of the newspaper, along with the sports and health pages, as soon as I get the newspaper. I'm not at all certain that I know what a stock option is. I do not attempt to forecast the inflation rate, and neither do I try to predict the rate of productivity growth in the near future. Yet, I'm well aware of the fact that you've invited me to address you today because I'm a Professor of Economics. Well, why have I come? I came because I wish to make a number of comments on the public perception of the message of economic theory. In other words, I do not like the manner in which economic theory is exploited as an argument in debates on current economic affair. And this, may I add, is an understatement...

The major economic argument

I wish to start with a short exposition of the basic economic argument. Imagine an island with 400 residents, three of whom are tailors. It had been a time-honoured tradition that the islanders are evenly distributed among the three tailors; each of the residents employs the tailor who took care of the garments of their own fathers and forefathers. The fee for repairing an old garment had been set by custom (perhaps even by legal means) to 10 per cent of the price of a new garment. Each of the tailors could easily serve 200 hundred residents. There is a general sense in the community that although the tailoring industry does satisfy the island's clothing needs, it harbours disguised unemployment - the tailors are often seen yawning while reading the newspaper. Two tailors can meet all the clothing needs of the island. It would be absolutely harmless if one redundant tailor quit the tailoring industry to take up new, less redundant, employment. In economic terms, the current state of affairs is 'inefficient'.

This statement requires an explanation because the use of a natural language to professional ends is a bit misleading. The economist is saying that the situation in the island is inefficient because one can imagine an alternative distribution of economic resources, and an appropriate distribution of commodities that improve the lot of all. What could be worse than a situation where every single person is made better off?

One day the idea of a free-market reaches the island. Ordinances are abolished and traditions are broken to smithereens. Each of the tailors completes a short business administration course, embracing his assigned role in the new economic regime, requiring him to set the price that would maximise his profit at all costs. A price war erupts. The price of a new garment had been 100 and the fee for alterations 10. One of the tailors reaches the conclusion that it is preferable for him to reduce the price to 9 in the hope that all alterations will flow to his business. It is not long before the other two tailors follow suit. The price keeps falling till it reaches the level where one of the tailors decides to call it quits – he shuts down his business and goes out in search of a new employment. His shift to a new industry increases the size of the national pie. The new situation is more efficient. What a miracle – the invisible hand of the free-market has harnessed the selfish wants of each of the three tailors and all garment-wearers in the island, eliminating the inefficient state of affairs.

The problematic aspects of the central economic argument

Let's examine this argument. It contains a number of implicit assumptions that are not central to our discussion, but I'd nevertheless like to briefly discuss them.

1. Is it that certain that the tailors will bring the prices down? Perhaps they would take advantage of the situation to raise the price to 15% of the price of a new garment, in keeping with the pattern in other sectors of the economy. You might say 'but aren't they supposed to follow their own personal interests?' Let us assume that this indeed is what they all do, so that each tailor minds his

own profit interests. But it is precisely because of this interest that each of the tailors concludes that it is in his best interest not to cut the price, because any rise in profit he might experience would be short lived - it won't be long before the others follow suit. The temporary rise in profits, he surmises, would then pail into insignificance in comparison to the ultimate loss. This proposition does not even require that the tailor discusses matters with the others (it might be the case that an explicit act of collusion is forbidden on this island under the new competition legislation). This proposition is so elementary that it requires that the tailors study neither economics nor business administration.

2. Let us assume that the tailors are not so smart and they fall into the trap that competition sets up for them. Is it that obvious that the consumers would flow to the cheapest tailor? Until now they went to the tailor favoured by their father, from now on they must compare prices. Some of them might reckon that the saving they would get from a lower price is not worth the cost and effort of the search for the lowest price. Hence, it is not that obvious that the market will settle at a lower price.

3. Suppose all the islanders deem price-search a national duty that will serve society exactly in the manner the economists describe. Also suppose that the tailors are not smart enough to foresee the dynamic consequences of price cuts. So they fiercely compete with each other sending price-competition out of control, and to the delight of the free market devotees, they force one of the tailors out of the industry. Is it that clear that he will succeed in finding another productive employment, or might he, alternatively, end up being an unemployed man wandering the streets of the city?

4. Now we reach the key question: was it all worth it?

The change in the competitive environment did increase the national pie, but in the absence of accompanying measures it had also altered the distribution of income – enhancing the income of some whilst undermining the income of others. In other words, the economic change is not what economists call a "Pareto improvement", because not everybody has been made better off. The tailors have been made worse off, whereas the rest of the residents have been made better off.

Let me, in addition, raise the following questions: (i) is the new distribution of income preferable to the old one, (ii) are the tailors receiving a fairer price now, and (iii) is the new price more reasonable. We are all entitled to express a view on each and every one of these questions. Economics itself has no analytical tool that can justify either the new or the old state of affairs in a manner that is not tautological.

Economics as a language

Economics is an academic domain that analyses phenomena associated with inter-person interaction in the process of exchange and production of goods. It investigates these issues by means of either deductive reasoning or empirical methods of analysis. Economics explores activities of individuals, firms and organisations, as well as the government. Like any other scientific field, economics has a language that restricts both the type of questions that can be asked, and the answers that can be reached, within its frame of debate. Economics, as we know it in the West, is characterised by the relative uniformity of its language. The grip of this uniform language is so strong, that I have the impression that a student completing the first year introductory course, or even graduate studies, is captivated by this language to the point of dismissing as illegitimate all arguments that are not articulated in the economists' lingo.

The fundamental concepts of economic-science

The fundamental textbooks of economics talk about prices, inflation, growth, fiscal deficit, interest rate, and some also discuss unemployment. Just a few speak a little, very little, on concepts that bystanders from other planets or even our own planet would consider very relevant to a major economic decision. I primarily have in mind the following four concepts:

1. Inequality: what is the level of inequality that we accept as 'reasonable'?

2. The origin of wealth: is the wealthy person rich because it befits him, and the poor person poor for reasons that we believe would justifiably render him poor?
3. Ownership of capital: how are capital-resources distributed and what non-economic, but rather political, dominance does capital ownership bring with it?
4. Culture: to what extent does the economic system influence (not just reflect) culture and the society in which we live?

Excuses

I wish to emphasise that there are many economists who raise many questions that are related to these issues. When I say that economics does not deal with these issues, I am referring to economics as the body of knowledge that is portrayed in the standard textbooks. I am also referring to the manner in which economic science is seen by the general public as well as in the eyes of economists themselves when they employ the coarse expression “economics says”. There exist a number of statements that are normally put forward to explain away the absence of the notions of *justice*, *fairness* and *inequality* in our economic models.

They say that a discussion of such issues involves subjective valuation; that is, what appears just to one person is not necessarily just in the eyes of another person. True, so what? The most important decisions we make in life are based on subjective valuations. This aside, the fact that certain decisions are not universally supported does not mean that all the questions that call for attention lack consensus. The fact that there is in the world a broad grey area does not imply that all areas lie under a grey veil.

Another excuse is that it is impossible to quantify inequality. This is true. By the way, neither is it that clear how to quantify the price level; and the consumer price index is a rather arbitrary measure. So what? Even if some things are unmeasurable they still demand attention; they have to be dealt with even if all we have is an imperfect index.

The central point I wish to make is this: I wish to stress that the fact that debates on economic issues regularly entail subjective judgement simply means that when it comes to these issues, a chief executive of a bank, professor of economics, financial wizard, an unemployed person, or a member of a labour council, all have an equal claim on the debate. None of them can be deemed superior by dint of their vocation.

Let me now turn to a number of issues that have been the subject of public debate during the last twelve months. I am doing so in order to demonstrate to you how the economic language blinds the ethical dimension of the phenomena it discusses.

The interest rate

We have been witnessing an animated debate on the desired level of the rate of interest in our economy. As you would recall, once a month the Governor of the Bank of Israel announces the level of the following month's rate of interest. The primary factors that dominate the central bank's deliberations are the impact of the rate of interest on the rate of inflation, and the negative impact of the interest rate on the rate of economic growth. However, in the deliberations on the level of the rate of interest, one element has been forgotten – what the rate of interest itself is. An annual rate of interest is the return you get for agreeing to postpone the consumption of one shekel (the Israeli currency) by one year. This is the reward for the fact that your grandfather has bequeathed you one shekel which you in turn have deposited in the bank indefinitely - you enjoy the return on your deposit *ad infinatum*. The rate of interest is also the fee paid today by the borrower who expects to earn one dollar only in the following year. An increase in the rate of interest means a transfer of income from those who borrow to those who save. Since in Israel the aggregate level of private sector savings exceeds the level of aggregate private sector borrowing, there exists one large borrower – the government. Therefore, a rise in the rate of interest means a massive transfer of resources from private borrowers, and the public chest, to the savers. In the public debate there were economists who expressed doubts about targeting a decline in the level of the inflation at the price of a significant decline in the rate of growth. Yet, … not a word was said about these massive income transfers.

The savers receive a windfall, a freebie, simply because the rate of interest happens to be the weapon used to battle inflation.

It is true that the issue is far more complicated. The impact on the distribution of income is a complex matter. A sound estimate of the influence of the rate of interest on the distribution of income requires detailed knowledge about the identity of borrowers and lenders. The research department of the Bank of Israel (Israel's central bank) has little information on the distribution of income between the business and private sectors.

By the way, there is an interesting psychological issue here – somebody must be saying 'why bother, what after all is the difference between 5% and 6%, we are talking about just one percentage point increase, so it does not really matter…' Not exactly so… a change from 5% to 6% is tantamount to a 20 per cent change in the wage level.

Employment of foreign workers

The public debate on foreign workers has centred on economic, social and moral issues. However, one specific question received far less attention. The level of foreign employment is affecting not only the number of Israelis who are unemployed, but also the wage level, at least for those who could have worked in jobs held by foreigners. If this argument is deemed false, then the scaffoldings of the free market idea collapse.

They say that there is a shortage of nurses, computer programmers and even professors of economics. In addition, they say, there is a shortage of agriculture, domestic services and construction workers. In all of these occupations there exists a whole ocean of foreign workers who would be delighted to come here and work for a wage much lower than that received by the local workers. So why have I not noticed any North American nurses and Indian programmers in the airport, whereas I did see the Thai labourers, the Philippine domestic helpers and the Rumanian construction workers. We know the answer, the state allows the import of foreign workers in the industries where the local workforce is lacking political muscle. The result is that the state does not attempt to bring in computer programmers even though they are likely to generously contribute to the country's value added.

So here we have an example where the public is focused on weighty economic and social questions, and yet one major issue has hardly received attention. Bringing in foreign workers does augment the national pie, but it also changes the distribution of income in a manner that enrages me. What is the moral basis for the good fortune being visited upon the lawyers who enjoy a pay increase whenever there is a shortage in their market, but when such good fortune befalls a woman who can do only domestic-care work, the opportunity to receive an improved pay is taken away from her by promptly importing foreign workers.

Unemployment

The term unemployment does appear in the economist's lexicon. Why it is that unemployment does make an appearance. I think that this is the case because unemployment inspires dread not only at the sight of the victims' misery, but also because it threatens our very own selves. It conjures up in our mind social upheavals and political revolutions - a mayhem that would greatly upset orderly life. It is not a good idea to have lots of unemployed people; neither is it worth our while to have in our midst people who have very little to loose. Yet another reason is the fact that unemployment is relatively easy to measure.

Thus, when we contemplate a rise in the minimum wage, the economists tend to oppose it because it would raise the level of unemployment. Let me mention in passing that there actually is a debate among academic economists about the empirical validity of the proposition that a rise in the minimum wage exacerbates unemployment. But let us set aside the quandary about the link between the level of the minimum wage and unemployment. A rise in the minimum wage actually affects the large population of workers whose wage is in the immediate neighbourhood of the minimum. An addition of 260 shekel represents a 10 per cent increase in their wage. The case for a rise in the minimum wage rests on the principle of granting a less unequal pay to people who make their contribution to society. Moreover, in the Israeli reality it is not at all clear that reducing the inequality is not worth the price of a rise in the number of the unemployed. The rise in unemployment must be weighed against the significant improvement in the lot of workers whose earnings are in the immediate vicinity of the minimum wage.

Privatisation

In the West the excitement about privatisation stems from two profit interests. One is the economic instinct that claims that private institutions work better, that they are more efficient and less wasteful than government bodies. Economists would cite an endless number of studies that point to facts such as that when telephone services are managed by the government the prices are higher and the service is poorer; and once they had been privatised, the service improved and their price declined. The second is the democratic instinct; it says that the government is a too powerful body that can unduly dominate our life. Private enterprise is a counter to dark totalitarian regimes.

At this point I would like to point to yet another element that fails to enter economic discussions. I'm referring to the influence of economic measures on the distribution of capital and political power within the country. Ownership of capital is accompanied with significant degree of political power; this is so unless well-defined legislative breaks are established firmly in place. In Israel, it appears that it is already difficult to discuss the political impact of the privatisation because we already have a significant segment of politicians with their umbilicus attached to owners of capital. But take notice of two additional points.

There is a common belief that a replacement of Pinchas Sapir (the minister who oversaw the fast industrial development of Israel in the late '50s and early 1960s) with the giants of private capital would have rendered the system less corrupt. I wonder. The opposite might be true. Pinchas Sapir would have found it very hard to appoint his own son as the CEO of a publicly owned business enterprise. The giants of industry, in contrast, are allowed to do this regardless of the offspring's capabilities and without any scrutiny by appointment committee of any kind. Indeed, in the corporate sector, the appointment of one's own progeny is a common and legally permissible phenomenon. Under both systems we have high level positions being held by people who should have never been placed there in the first place. Sapir could have at least been replaced by the democratic process, whereas owners of capital cannot be replaced without a real revolution in property rights. As an example consider earmarked public expenditure. The government allocates special sums of money according to some political criterion. Owners of capital allocate earmarked resources that bear the name of 'donations'. Is it that obvious that these donations are better targeted than the public resources? Look at the settlements east of Jerusalem most of which are being funded by donations. Look closely at the political donations that do not reflect actual political reality, but rather determine it. Look at other donations that determine the very essence of our society: for instance, consider the case of donations to universities. A large part of the development budgets of universities has been transferred away from the public sector having been turned into a "private responsibility." This has created a situation where private capital owners have a major say in the direction of academic research activity. It is the capital owners who, for example, have decided that business and law schools are more important than the schools of physics and philosophy.

A global economy

There is a great deal of talk about the global economy reaching our shores, about opening markets, and about the removal of various restrictions. The conditions are almost ripe for virtually free two-way capital flows. The narrow economic argument posits that opening of the capital markets is a good thing because it allows for a better use of their potential. If in Kenya the dollar yields of 30 per cent, and in Israel it yields only 10 per cent, why shouldn't the dollar be allowed flow to wherever its return is highest?

First comment. We are not in a global village. Nationalism and barriers to trade between countries have not been eliminated. We are really talking about removal of barriers of one and only type: the freeing of inter-country capital movements. The movement of labour remains severely restricted. The fact that financial capital can move freely whereas human capital is not free to move has of course an impact on the distribution of the national pie, whatever its size may be. The worker who can gain a higher salary in Silicon Valley, but is resolved to stay in Israel cannot take advantage of this opportunity. The capital owner, in contrast, can readily send his capital to another country in search of higher return. If Delta shuts down its textile mill in Israel transferring it to Jordan in search of lower wages, the national pie would increase in size only if alternative jobs are awaiting the workers who had been laid-off. But even if the opening of national borders to capital movements increases the national pie, the increment is divided among a very small number of people.

The opening up of the Israeli economy has yet another aspect. One of the most precious assets of the Israeli society is the existence of many entrepreneurs who are both daring and well-connected. These entrepreneurs, by the way, play a critical role in the marketplace – they are said to be the "market-makers". They are behind the market's *invisible-hand*. They can play their role either here or somewhere else. Having the Jewish-Israeli connection, many of them prefer to channel their energy outside of Israel. You might say 'well, this is good'. The trouble is that entrepreneurial energy is a dear and rare resource, and there a reasonable suspicion that construction enterprises in Rumania are done at the expense of construction in Israel.

Another point, how come an Israeli finds it more attractive to invest overseas whereas foreigners find it more attractive to invest here in Israel? It must be that this is not a consequence of economic considerations alone. Here we might warn about yet another phenomenon - the influx of foreign capital into Israel does not have an altogether positive value. Investing foreigners collect not merely financial rewards – they also gain power in both the economic and the political domains in Israel. A person who is willing to invest in Israel, in spite of the fact that he can invest in Zurich and Rumania must have good reasons, and these reasons are not necessarily purely economic. I would not recommend dismissing this proposition off hand. We had not paid attention, and suddenly we discovered that under the protective umbrella of the determination to replace the workers from the occupied territories, we have created a new problem – the presence of a large number the foreign workers. I'm certain that the absolute commitment to economic growth and the large volume of foreign capital that will eventuate from this commitment, will saddle us with a gamut of undesirable constraints for the Israeli society.

Conclusion

On the face of it, all the current issues I have mentioned above have an economic solution. However, these issues are not merely economic; they are also political and moral by their very essence. They cannot be resolved by scientific or academic means. The positions we take on these issues stem from the same psychological motives that lead us to adopt our positions on many other issues. The idea of a free-market has a seductive property. The zeal of the free-market devotees surpasses the zeal of the engineer that has solved the technical problem of constructing an efficient mechanism for the economic system. The idea that things that appear to require planning, maintenance and a strong state can in fact be generated of their own accord without planning or a strong government is very seductive, especially to a person who believes that he himself is more powerful than other individuals. The competitive idea appeals to many of us also because we are wary of a strong government that restricts liberty. Yet, on the other hand, many of us care for the weak, and lack sympathy for the very rich, dreading the clout of their power.

The question of the implications of economic theory for current real world issues is a fundamental methodological question within economics itself, and it legitimately remains a disputed one. Of course, other economists hold different positions to mine. I'm here because I have been watching with much concern the use being made of arguments taken from economic theory in the context of current real world issues. I believe that this is a misguided use of science in matters that are not at all scientific. It behoves us economists to point out instances of failure to properly apply analytical arguments. This is what I've endeavoured to do here today.

Economics is an interesting occupation, and there are very wise, smart and nice economists, but major socio-economic questions are normative questions about which we all must have a stand; the position held by a professional economist can claim no superiority over the position held by another person, even if he is a layman. The saying “I am not an economist” does not absolve you from the responsibility of having a position on issues that are supposedly “economic”, and the statement “I’m an economist” does not endow the economist with a greater authority over a matter that involves much more than sheer technical economic questions.