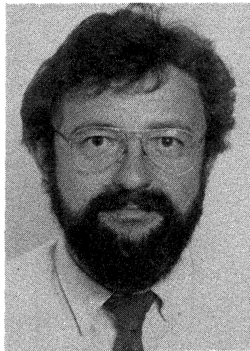

The authors: GARY BANKS (left) is an Assistant Commissioner at the Industries Assistance Commission, Canberra, Australia, and the late JAN TUMLIR (right) was Director of Economic Research and Analysis at the Secretariat of the General Agreement on Tariffs and Trade (GATT), Geneva (1967-85).

During the 1970s, especially after the oil shock, economic policy in industrial countries became preoccupied and their mutual relations disturbed, by the emerging 'problem' of adjustment to imports. In the face of rising protectionist sentiment, governments were encouraged to implement special 'adjustment policies'. With few exceptions, these measures have done little to promote adjustment; and protectionism has become even more entrenched.

According to the authors of this Thames Essay, the idea that new forms of government intervention were needed to 'improve' the adjustment process was fundamentally misconceived. They argue that the real adjustment problem — which goes beyond the imports issue — has more to do with political than economic market failure. It is a legacy of accumulated policies designed to redistribute income within society in ways which are best described as surreptitious. These redistributional measures have not only stalled adjustment in the crisis industries. They have also badly damaged the information-processing function of the price system on which the timely adjustment of all enterprises depends. New layers of intervention, even those called 'adjustment assistance', can be of little help. What is needed is some basic restructuring of the policy-making process itself.

GB £8.95 NET

ISBN 0-566-05332-2

00895

9 780566 053320

Gower

Gower House, Croft Road, Aldershot,
Hampshire GU11 3HR, England.

ECONOMIC POLICY AND THE ADJUSTMENT PROBLEM Gary Banks & Jan Tumlir

THAMES ESSAYS

Economic Policy and the Adjustment Problem

Gary Banks and Jan Tumlir

THE SOFT-WORD PUZZLE
Mr. Stanley Baldwin: "Can anybody think of another word for subsidy?"

TRADE POLICY RESEARCH CENTRE

The cartoon on the front cover, reproduced from *Punch*, London, 24 March 1926, depicts Stanley Baldwin, then Prime Minister of the United Kingdom, and his Cabinet colleagues grappling with 'the coal problem' by trying to find a way of playing down or concealing the extent of subsidies to the industry. In this Thames Essay the authors argue that the 'problem of adjustment' today is a legacy of accumulated government policies designed to assist discreetly various producer groups.

Thames Essay No. 45

Economic Policy and the Adjustment Problem

BY

Gary Banks

AND

Jan Tumlir

Gower
for the
TRADE POLICY RESEARCH CENTRE
London

Copyright ©1986 by
TRADE POLICY RESEARCH CENTRE
1 Gough Square
London EC4A 3DE

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without the prior permission of Gower Publishing Company Limited.

First published 1986 by

Gower Publishing Company Limited
Gower House, Croft Road
Aldershot, Hampshire GU11 3HR
United Kingdom

Gower Publishing Company
Old Post Road
Brookfield, Vermont 05036
United States of America

Gower Publishing Australia
85 Whiting Street
Artamon, New South Wales 2064
Australia

British Library Cataloguing in Publication Data
Banks, Gary
Economic policy and the adjustment problem.
(Thames essay, no. 45)
Bibliography: p. 92
1. Balance of payments — Political aspects
I. Title II. Tumlir, Jan
382.1'7 HG3882
ISBN 0-566-05332-2

Library of Congress Cataloging-in-Publication Data
Banks, Gary
Economic policy and the adjustment problem.
(Thames essay; no. 45)
Bibliography: p. 92
1. Trade adjustment assistance. 2. Economic policy.
3. Free trade and protection — protection. I. Tumlir, Jan. II. Title. III. Series.
HF1421.B36 1986 338.9 86-14934
ISBN 0-566-05332-2

ISSN 0306-6991
ISBN 0 566 05332 2

Printed in the United Kingdom by
Biddles Ltd, Guildford, Surrey

Contents

BIOGRAPHICAL NOTES vii

PREFACE ix

1 THE 'ADJUSTMENT PROBLEM' IN PUBLIC DISCUSSION 1
Alternatives to Adjustment 3
Rate of Adjustment 5
Historical Precedents 6

2 HISTORY OF ADJUSTMENT ASSISTANCE POLICY 11
Rise of Adjustment Assistance 12
Administrative Explosion 15
Fall from Grace 17
Enter 'Positive' Adjustment Policy 18

3 IS THERE A CASE FOR ADJUSTMENT ASSISTANCE? 24
'Costs' of Adjustment 24
Declines in Wealth 25
Transitional Unemployment 28
The Second Best 30
Equity Considerations 31
Political Expediency 35

4	PUBLIC ASSISTANCE AND PRIVATE INCENTIVES	44
	Moral Hazard	45
	Rent Seeking	47
5	IMPEDIMENTS TO THE ADJUSTMENT PROCESS OF THE MARKET	52
	Labour Markets	53
	Restrictive Practices	54
	Minimum-wage Legislation	56
	Job 'Security' Requirements	57
	The Social Security and Taxation Trap	58
	Capital Markets	59
	Taxation	60
	Regulation	61
	Inflation	62
	Product Markets	63
	Monopoly Power	64
	Protectionism	66
	Conventional Fallacies about Trade Liberalisation	68
6	THE POLITICAL PROBLEM OF ADJUSTMENT	75
	Economic Policy as Income Redistribution	76
	Political Market	77
	Administrative Discretion	79
	'Political Failure': the 'Constitutional' Approach	82
	Revival of the 'Delegation Doctrine'	83
	A 'Transparency Institution'	84
	A Non-discrimination Trade Treaty	86
	LIST OF REFERENCES	92
	LIST OF THAMES ESSAYS	98

Biographical Notes

GARY BANKS has been an Assistant Commissioner at the Industries Assistance Commission (IAC) in Canberra, Australia, since late 1985, having some years earlier served as a Principal Research Economist at the Commission (1972-76). (The IAC's functions are to advise the Government of Australia on, and facilitate public scrutiny of, assistance to industry and its effects on the Australian economy.)

For most of the time between leaving and returning to the IAC, Mr Banks was an economist with the Secretariat of the General Agreement on Tariffs and Trade (GATT), in the Economic Research and Analysis Division (1976-84). Between then and his present appointment, he was a Senior Economist in the Office of National Assessments, Government of Australia.

Mr Banks graduated from Monash University, Melbourne, in 1972 and from the Australian National University, Canberra, in 1974. In 1975, he was a Lecturer in Economics in the Faculty of Military Studies, University of New South Wales. He has contributed articles on aspects of international trade and industrial policy to *The World Economy*, *Kyklos* and *Intereconomics*.

JAN TUMLIR was Director of Economic Research and Analysis at the Secretariat of the General Agreement on Tariffs and Trade (GATT) in Geneva from 1967 until early 1985. In June 1985 he was about to return to a senior teaching

appointment at the University of California at Los Angeles, where he was a Visiting Professor in 1983-84, when he died suddenly at the age of 58 years. Tumlir had been a Professor of Economics at the Institut Universitaire de Hautes Etudes Internationales, University of Geneva, a member of the Council of the Trade Policy Research Centre, London, and a member of the European board of economists on *Time* magazine.

Tumlir joined the GATT Secretariat in 1964 to work in the Trade and Development Division, having previously taught economics at Yale University, New Haven, in the United States of America, where he obtained his doctorate. He studied law at Charles University, Prague, leaving Czechoslovakia in 1949 to work in the Federal Republic of Germany as a journalist before eventually going to the United States.

Besides many articles and contributions to volumes of essays, Tumlir was the author of *Protectionism: Trade Policy and Democratic Societies* (1985) and co-author of *Trade Liberalization, Protectionism and Interdependence* (1977), *Adjustment, Trade and Growth in Developed and Developing Countries* (1978) and *Trade Relations under Flexible Exchange Rates* (1980).

Preface

THE PURPOSE of this Thames Essay is to clarify thinking on the adjustment process of the market and the role of economic policy. Governments have been making heavy weather of the 'adjustment problem'. They usually see it in terms of the inherent economic difficulties posed by changes in international trade, necessitating special forms of government intervention. It is shown here though that the adjustment difficulties of contemporary economies are largely a consequence of economic policy decisions of the past. The authors argue that the real adjustment problem is a political one, calling for a restructuring of the policy-making process, which they discuss in their concluding chapter.

Gary Banks and Jan Tumlir began work on the careful presentation of the ideas in this essay when both were on the staff of the Secretariat, in Geneva, of the General Agreement on Tariffs and Trade (GATT), but much of it was written when the latter was on sabbatical leave at the University of California at Los Angeles in 1983-84 and when, soon after, the former returned to Australia. The essay was nearly finished when Tumlir, having retired early from the GATT Secretariat to return to the United States to teach and write, died suddenly at his home in Versoix on 22 June 1985. Mr Banks put the finishing touches to the essay before he joined the Industries Assistance Commission in Canberra later in the year.

Tumlir was only 58 years old when he died. Although a prolific writer, whose articles, lectures and papers for conferences had made him an influential figure in policy debates on the state of the international system of trade and

payments, Tumlir had hardly begun to write what he had to offer. Some inkling of what was in store can be got from this essay.

The authors acknowledge that successive drafts of, and exerpts from, the essay have benefited from discussions with a wide range of people, including academics and officials in governments and international organizations. Among the latter, Richard Blackhurst, of the GATT Secretariat, deserves special mention.

It has to be stressed, however, that the views expressed in the essay are the personal responsibility of the authors; and they do not necessarily represent the views of members of the Council or those of the staff and associates of the Trade Policy Research Centre which, having general terms of reference, does not represent a consensus of opinion on any particular issue. The purpose of the Centre is to promote independent analysis and public discussion of international economic policy issues.

HUGH CORBET
Director
Trade Policy Research Centre

London
February 1986

Chapter 1

The 'Adjustment Problem' in Public Discussion

'Aging economies have no choice but to carry on, without contemplation of any terminal stage'

— Charles P. Kindleberger, 'The Aging Economy', *Weltwirtschaftliches Archiv*, Kiel (1978)

FOR A decade and a half, the governments of industrial countries have been grappling with a new policy problem, the 'problem of adjustment'. In public discussion, the problem has generally been identified with import competition, especially that from developing countries. Much has been written on the subject, numerous conferences have been held, many committees have been established and diverse policy measures have been implemented to deal with the problem, but no government could be said to have found a solution. On the contrary, the present crisis in international trade relations suggests that things have been getting worse.

That the focus of economic policy has been on adjustment to imports would seem at first sight to be misplaced. Imports represent only a small part of the general change that must be allowed to proceed if an economy is to grow.[1] In the normal course of economic development, import flows change slowly enough for adjustment to take place; not always smoothly perhaps, but seldom in the form of 'crises'. To appreciate why adjustment to imports has nevertheless become a major preoccupation of policy-makers, it is necessary to begin by considering the nature of the adjustment process itself.

Much of the discussion about government's role in 'structural' adjustment or the 'restructuring' of industry has fostered a misleading view of the adjustment process and structural change, as if they were able to be purposefully managed.[2] The reality is that structural adjustment is a diffuse process that begins within individual enterprises. Whole industries or sectors do not 'adjust'. It is the normal business of managers to devise strategies for dealing with changes in the market place; in fact, it is what they are paid to do. Sometimes this will involve new investment, sometimes disinvestment — the abandonment of once profitable activities — and sometimes a mixture of the two. It is the sum total of these numerous individual reactions that is perceived *ex post* as changes in the statistical aggregates used to measure structural change.

Seen in this way, structural change proceeds continuously, in response to other changes which can be most conveniently classified under the headings of supply and demand. Those on the supply side include technological innovation, both at home and abroad, and the emergence of new suppliers to the world market, together with the consequent changes in trade patterns.

Changes in the pattern of demand may either occur spontaneously (for example, as a result of changes in income which affect the demand for products in different ways) or in response to relative price changes. These antecedent changes *cause* structural change; alternatively, it may be said that structural change represents an adjustment to them. As a term of economic analysis, therefore, the word *adjustment* has a very broad meaning. It could stand, as a generic term, for all the particular changes and processes, the totality of which constitutes economic growth.

Then what is the problem? In most cases, firms should have been capable of adjusting to change, whether originating in trade or in the domestic economy — and economies should have been capable of absorbing their adjustments — without the need for government intervention. Nevertheless, in the

'crisis' industries (including agriculture), the main difficulty has arisen precisely from the failure of the normal, cumulative process of individual adjustments to take place. How did this come about? No individual firm or group of firms has the power to resist change. Failure to adjust, or responding in the wrong way, would normally result in the eventual takeover or liquidation of the enterprises concerned. But this, too, is merely another form of adjustment. It is obvious that a backlog of adjustment could not have occurred without government assistance.

The truth is that most governments have only been paying lip-service to the need to maintain adaptable economies. In practice, they have acted as if adjustment were a burden, something to be deferred until better economic (and, it is assumed, political) times. Internationally, tensions have increased and time for reform has been wasted by the three major trading powers — the United States, Japan and the European Community — accusing each other, and the developing countries accusing all three, of trying to shift the 'burden of adjustment' on to others. It is sad to contemplate the period since the early 1970s and to recognize that the burden of adjustment which nobody wanted to bear *was* the economic growth that everybody wanted.

Alternatives to Adjustment

The overriding objective of government policy in economic affairs is to maintain stable progress over the long run. Another way of expressing this, and one more closely connected with the current discussion of trade policy, is to say that the overriding objective of all governments should be to maintain and improve the economic order.

The very notion of order — a stable framework of cooperation among free men and sovereign nations — is predicated on unobstructed adjustment to changing economic circumstances. Individuals and societies seek to improve their position by reacting — more or less alertly, more or less creatively — to their perceived opportunities. From this effort,

novelty is continuously generated. The laws which protect individual freedom and national sovereignty ensure that this continuous and ubiquitous effort combines to produce a massive global flow of innovation in economic activity which no government or group of governments can control.

If the global flow of change cannot be arrested, societies must adapt to it; there is no other way to maintain order. What can a refusal to adapt mean? Two different cases should be distinguished. Imagine a world in which only one country — a Himalayan kingdom or a small and quaint Old World country — refuses to accept the economic and social change proceeding abroad.

First, either its citizens must be unanimous in refusing the change, or the refusal must be enforced on an unwilling minority.

Second, the refusal implies a growing discrepancy between the country's actual and potential income as more efficient methods of production are foregone and an increasing part of the country's foreign trade is subjected to controls.

This is bound to increase the proportion of population which resents the growing social cost and is prepared to adjust to change. Thus persistence in the refusal to adjust necessitates an increase in coercion. And it is not difficult to imagine a degree of pressure or tension which the social fabric can eventually no longer bear.

This was the relatively favourable case. Imagine, instead, that a number of large industrial countries find it difficult, for political reasons, to adjust to economic change generated abroad. Since in each, the attained level of prosperity and, to an even greater extent, future growth depend significantly on foreign trade, there would immediately arise two kinds of friction or tension, internal and external, each exacerbating the other.

Internally, there would be distributional problems as economic growth at the rate to which these societies have grown accustomed slowed down. (It would have to be decided politically, in other words, who could benefit from foreign trade and who could not.)

Externally, the countries might agree that somewhat more organized trade would be a good idea; frictions would be bound to arise, however, on the questions of who should do the organizing and which products would be organized.

These illustrations announce two themes which will be important in subsequent analysis. One concerns the optimal rate of adjustment; the other, the secondary effects of adjustment assistance policies.

Rate of Adjustment

It is widely assumed in economic policy making that prolonging the process of adjustment reduces its 'cost'. This assumption is seldom examined in any detail. Logically, for example, it would lead to the economically absurd conclusion that an infinitely prolonged adjustment, that is, no adjustment at all, should be optimal and indeed costless.

One may surmise that one of the reasons for the prevalence of this assumption is the standard procedure of theoretical economic analysis itself. To understand any economic process it must first be studied in isolation. Thus an equilibrium is assumed, a particular disturbance posited and the process of adjustment to it traced, step by step. In such theoretical analysis of an isolated case, a prolonged adjustment might well appear preferable to a rapid one. But if it is to be relevant for policy purposes, economic analysis must not stop at the isolated case. In the real world, disturbances follow on each other's heels and the policy measures adopted to control the present one influence the form in which the following ones will appear.

The notion of a continuous change, of a flow of disturbances, thus shows the 'problem' of an optimal rate of adjustment to be an artificial one. Adjustment must simply match the rate of change; if it falls below it, maladjustment will begin to cumulate, whereas a rate of adjustment exceeding

the rate of change is a contradiction in terms. In short, it is as illusory to think that a relatively affluent society has a choice between more efficiency and growth, on the one hand, and greater stability and comfort from dampening down change, on the other, as it was to think of choosing between more inflation and somewhat less unemployment. In both cases the choice is solely between less discomfort now and much more of it later.

As mentioned, the measures chosen to deal with a particular disturbance influence the form of future disturbances. They do so mainly by modifying economic incentives, not only of the groups at which the policy is aimed but also those of other groups which learn from the precedent established by the policy in question. Sooner or later even these secondary effects will be felt in foreign trade and other governments may be forced to react to them. To ascertain the effects of a particular policy has been, for these reasons, perhaps the most difficult task of applied economic analysis and also the least successful.

Historical Precedents

Much of the discussion about the 'adjustment problem' has assumed or implied that the adjustment pressures since the early 1970s have been of an exceptional nature. The market, according to this view, has been overloaded by these developments, unable to 'cope'.[3] But history is full of examples of the market absorbing major structural changes without government intervention. In *The Wealth of Nations*, Adam Smith gave us the following, rather picturesque, example:

> 'By the reduction of the army and navy at the end of the late war, more than a hundred thousand soldiers and seamen, a number equal to what is employed in the greatest manufactures, were all at once thrown out of their ordinary employment; but, though they no doubt suffered some inconvenience, they were not thereby deprived of all employment and subsistence. The greater part of the seamen, it is probable, gradually betook themselves to the merchant-service as they could find occasion, and in the meantime both they and the soldiers were absorbed in the great mass of the people, and employed in a great variety of occupations. Not only no great convulsion, but no sensible disorder arose from so great a change in the situation of more than a hundred thousand men, all accustomed to the use of arms, and many of them to rapine and plunder. The number of vagrants was scarce anywhere sensibly increased by it, even the wages of labour were not reduced by it in any occupation, so far as I have been able to learn, except in that of seamen in the merchant-service.'[4]

It is not necessary to go back this far in history to find examples of relatively rapid and smooth adjustment to major changes. Consider the adjustment facing the economy of the United States at the end of World War II. The following two passages show the concern of economic experts at the time:

> 'Provision will have to be made for a minimum of 5 million soldiers returning from war; and the figure is likely to be considerably larger. A fair estimate would probably be in the vicinity of 9 million. Of these the youngest age groups will be persons who never held jobs before their entry into the army. In addition, under present forecasts, perhaps 25 million workers will have been absorbed into war industry. These will have to be replaced in peacetime industry. Included in this figure will be not less than 5 million individuals not heretofore engaged in regular labor... In the aggregate, therefore, immediate post-war readjustment will have to take care of the enormous total of perhaps 34 million individuals.'[5]

The second passage follows:

> 'The bill of goods our people would like to buy in peace ... differs greatly in make-up from what we are producing for war. In some lines, ships and aircraft notably, production would have to be much smaller. In metal fabricating as a whole, we would need only about one-third as much as we were producing in the middle of

1944. In consumer goods like clothing, textiles, lumber, paper, printing, and miscellaneous small industries, expansions in output of one-fourth or one-third over peak war production might be needed. In construction, trade, and service industries, the expansion above wartime levels would be still larger...That involves something more than a process of factory conversion.'[6]

By the close of hostilities, the war was estimated to be consuming some 50 per cent of the gross national product (GNP) of the United States.[7] The change was sudden. Between 1945 and 1946, Federal purchases as a proportion of GNP dropped from 42 to 12 per cent; and in 1947 they were down to 8 per cent, a level maintained in subsequent years.[8] In spite of this decline in public spending, and contrary to the pessimistic forecasts of many eminent economists, the post-war growth in GNP suffered only a temporary setback. Real GNP fell by 15 per cent in 1946, stabilized in 1947 and in 1948 grew by 4 per cent. (The initial drop in GNP undoubtedly coincided with a rise in living standards, as more production became available for domestic consumption.) Given the large stock of household savings which had been accumulated during the war, coupled with the removal of price controls, inflation was relatively high throughout this period: 9 per cent in 1946, 14 per cent in 1947 and 8 per cent in 1948; in 1949, however, consumer prices fell by 1 per cent and in 1950 there was only a 1 per cent increase.

The demobilization of labour was even greater than predicted. The armed forces declined from 11 million in 1945 to 1 million in 1947. But, in spite of this large and sudden increase in the labour force, and the need for a still larger number of workers in defence industries to switch to civilian production, the level of unemployment rose from 1 million in 1945 to only 2.3 million in 1947 and 1948 (less than 5 per cent of the total labour force and roughly one quarter of what it had been in 1939). The average duration of unemployment

in this period was eight weeks. In the recession of 1949-50 unemployment rose to 3 million.

Compared with this immediate post-war structural adjustment, the adjustment demands placed on contemporary economies pale to insignificance. The conditions in which this massive structural adjustment took place are worth recounting. The government's role was, if anything, a passive one. Assets were sold to private industry on attractive terms. Price controls were removed; subsidies for food production reduced. And, as already mentioned, public expenditure was cut together with the tax burden. These changes enabled the high, post-war consumer demand to be rapidly reflected in supply. Industrial production recovered from a 14 per cent drop in 1946 to grow at an annual average rate of more than 6 cent over the next four years. Real gross private investment expenditure in 1947 was more than twice, and in 1950 nearly three times, its level in 1945.

The rapid reconversion of the American economy to peacetime production points to the two necessary conditions which must be satisfied if adjustment is to proceed rapidly and relatively smoothly.

First, the macro-economic framework must be right. This condition comprises not only adequate consumption demand but also, even more importantly, sufficiently strong investment incentives. It therefore points to the crucial policy task of maintaining economic confidence.

Second, the price system must be allowed to perform its allocative functions properly. This second condition is even more fundamental, for without it, macro-economic policy cannot function effectively.

NOTES AND REFERENCES

1. Richard Blackhurst, Nicolas Marian and Jan Tumlir, *Adjustment, Trade and Growth in Developed and Developing Countries*, GATT Studies in International Trade No. 6 (Geneva: GATT Secretariat, 1978).

2. On the abuse of the word 'structural' in economic discourse, see Fritz Machlup, 'Structure and Structural Change: Weasel Words and Jargon', *Zeitschrift für Nationalökonomie*, Vienna, Vol. 18, No. 3, 1958.

3. Note that, while Alan Powell and Peter Dixon, *Structural Adaptation in an Ailing Macroeconomy* (Melbourne: Melbourne University Press, 1979), define a 'structural adjustment *problem* ... to exist when the rate at which resources are required to be transferred patently exceeds the ability to cope of those who own and/or control the resources in question' (p. 2), this is *individual* failure and is not the same as the inability of the *market* to cope (for instance, bankruptcy does not constitute market failure).

4. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Indianapolis: Liberty Press, 1981) p. 436.

5. Adolf A. Berle, 'Government Function in a Stabilized National Economy', *American Economic Review*, Menasha, Wisconsin, Supplement, March 1943, p. 27.

6. Mordecai Ezekiel, 'Agriculture and Industrial Problems in Conversion from War to Peace', in Seymour E. Harris (ed.), *Economic Reconstruction* (New York: McGraw-Hill, 1945) pp. 25-26.

7. William Haber, 'Manpower and Reconversion', in Harris (ed.), *op. cit.*, p. 96.

8. This and subsequent data taken from *Economic Statistics 1900-1983* (London: The Economist Publications, 1985).

Chapter 2

History of Adjustment Assistance Policy

'The bounty to the white-herring fishery is a tonnage bounty; and is proportioned to the burden of the ship, not to her diligence or success in the fishery; and it has, I am afraid, been too common for vessels to fit out for the sole purpose of catching, not the fish, but the bounty'

— Adam Smith, *The Wealth of Nations* (1776)

'ADJUSTMENT POLICY', as a major government activity, is a creation of the 1970s. Its roots can be found, however, in a number of 'adjustment assistance' schemes devised in the two preceding decades.[1] The first of these arose as part of the Treaty of Paris, establishing in 1951 the European Coal and Steel Community, to facilitate the integration of coal and steel production in what was to become the European Community. This was followed by the establishment in 1957, under the Treaty of Rome, of the European Social Fund which provided assistance to workers (re-training, income maintenance, re-settlement subsidies) for the purpose of adjustment.[2]

Then, in the 1960s, there were two major adjustment assistance programmes established to compensate domestic interests injured by import growth resulting from the Kennedy Round of multilateral trade negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT), one in the United States, which has continued in one form or another to the present time, the other in Canada.[3] In the United States the Trade Adjustment Assistance (TAA) programme began under President Kennedy's Trade

Expansion Act of 1962. It provided benefits to workers consisting of a supplementary unemployment allowance, vocational training and a grant to cover household removal expenses. Assistance to firms, following the approval of an adjustment plan, consisted of loans and loan guarantees, technical assistance, consultancy grants and special taxation provisions. In Canada, the General Adjustment Assistance Programme (GAAP), which began in 1968, was modelled on the American one. It applied to firms only, workers being covered by other more general measures.

The 1960s also saw some adjustment assistance schemes which were specific to particular sectors. The United Kingdom's Cotton Industry Scheme is one example. Its main objective was to restore the industry's competitiveness through a programme of modernization. To this end, it provided capital-scrapping compensation and investment subsidies.[4] Japan also gave similar assistance to her textiles industry under the Textile Structural Adjustment Law.[5] And, in Canada, adjustment assistance was provided to firms and workers who could demonstrate injury resulting from the liberalization conducted under the Canadian-American Automotive Agreement of 1965.[6]

Rise of Adjustment Assistance

But the main thrust of activity occurred in the early 1970s. There were two main forces responsible. On the international plane, the North-South issue began in earnest in 1970 when the idea of a 'new international economic order' (NIEO) was formally adopted by the United Nations. A central concern of the NIEO proposals was the planned displacement of labour-intensive manufacturing production in industrial countries by imports from developing countries. Adjustment policy was seized upon as a means to that end.

> 'Developed countries, having in mind the importance of facilitating the expansion of their imports from developing countries, will consider adopting measures and where possible evolving a programme early in the decade for assisting the adaptation and adjustment of industries and workers in situations where they are adversely affected or may be threatened to be adversely affected by increased imports of manufactures and semi-manufactures from developing countries.'[7]

This theme was echoed repeatedly in different fora of the United Nations throughout the 'Development Decade', especially in the United Nations Conference on Trade and Development (UNCTAD) and in the United Nations Industrial Development Organization (UNIDO).[8] It was also taken up by the Development Centre of the Organization for Economic Cooperation and Development (OECD) in a widely-cited collection of essays on the subject,[9] by the International Labour Organization (ILO) which, at its Tripartite World Conference in 1976 passed a Declaration of Principles and Programme of Action, by the GATT, in the work of the Committee on Trade and Development and as part of the Multi-fibre Arrangement (MFA) and by the International Chamber of Commerce.[10]

A second reason for the increased focus on the adjustment issue was the recession, which exposed the weakened state of certain industries in developed countries that were already receiving considerable support and led to new claims for assistance. The phenomenon of absolute shrinkages in particular industries was an unaccustomed one in the post-war period and was felt to be overloading the ability of the market to cope. The quadrupling of oil prices in 1974 created a major additional need for adjustment, rendering uneconomic, in a single blow, a significant proportion of each country's capital stock. The pressure on governments to 'do something' intensified.

The natural resistance of those under pressure to adjust was manifested in a more widespread protectionist sentiment than had hitherto existed. This not only alarmed the North-South interest groups and lent additional urgency to their demands for improved market access for developing countries, it also

alarmed others in developed countries who had fought for liberal trade on its own merits and were anxious to avert a retrogression. Adjustment assistance became the *cause celèbre* of the liberal trade movement in the early 1970s.

The following quotes capture some of the spirit of the literature at this time:

'The first step in a logical attack on non-tariff barriers, therefore, would be the adoption of an international Adjustment Assistance Code which would [*inter alia*] commit countries to setting up domestic adjustment assistance programmes.'[11]

'Adjustment assistance programmes should include an appropriate mechanism for anticipatory resource displacement in particularly vulnerable industries ... The criteria governing eligibility for adjustment assistance should be explicit and liberal...'[12]

'It is a preferable method than protection, since it protects, or at least supplements, real incomes without embalming or protecting patterns of production.'[13]

'Any form of adjustment assistance helps the private sector to adapt to changes, whether in government policy, the pattern of demand or the advance of technology... Adjustment assistance on a multilateral basis ... offers a rational alternative to higher trade barriers or to an excessively energetic safeguards mechanism.'[14]

'Though adjustment assistance could in principle be dealt with on a national ... basis, this could with great advantage be underpinned by an OECD approach.'[15]

Throughout the 1970s, the 'adjustment problem', spawned countless international and national conferences, study groups, committees and burgeoning quantities of literature, the central theme of which was the need for governments to devise special policy measures to facilitate the adjustment process.[16] Three theoretical rationales were commonly cited to justify government intervention: *efficiency* (reducing the 'social' cost of adjustment), *equity* (compensating the 'losers') and *expediency* (countering political resistance). In most of the literature, the

term 'adjustment' was normally understood to mean adjustment to imports (especially those from developing countries).

Administrative Explosion

As might have been expected,[1] governments of industrial countries proved only too willing to expand their administrations further in order to stake out a new economic responsibility for themselves.

In the *United States*, the Trade Act of 1974 revamped the existing TAA programme by making it easier for claimants to qualify for assistance: increasing the benefits available to workers and firms and extending benefits to 'trade-impacted communities' which were eligible for grants for infrastructure projects as well as financial assistance to private investors in the area.[17] A year earlier, the Comprehensive Employment and Training Act had been passed, to coordinate the different existing manpower projects and expand employment opportunities through job-creation projects and training programmes.

In *Canada*, eligibility requirements under the GAAP were made less stringent, in amendments made in 1971 and 1973, and the focus of adjustment assistance schemes was shifted from firms to whole sectors. The Textile and Clothing Board Act of 1971 established the first such sectoral adjustment scheme whereby an approved restructuring plan could be supported by government financial assistance and temporary protection.[18]

In *Australia*, the Structural Adjustment Assistance Programme (SAA) was introduced in 1974 to provide assistance to workers (income maintenance, re-location grants) and firms (closure compensation, consultancy grants, loan guarantees) adversely affected by trade liberalization and other government policies.[19] Also in 1974, the Australian Government instituted the National Employment and Training Scheme, which subsidized (re-)training, and in 1976 the Re-location Assistance Scheme was created to promote the regional mobility of labour.

In the *European Community*, the Social Fund was upgraded in 1971 in an attempt to make it a more effective instrument for dealing with the problems of labour adjustment through the increased provision of subsidies for the retraining and regional relocation of displaced workers.[20] In addition, the countries in the Community introduced separate measures to try to deal with their own particular problems.

In the United Kingdom, the Industry Acts of 1972 and 1975 increased the power of the government to assist uncompetitive sectors and regions. The Wool Textile Industry Scheme of 1973 was the first specially designed industry-wide scheme introduced under the 1972 Act. Its objective was 'to improve the industry's competitive position by providing it with assistance to (a) modernize production facilities, (b) improve industrial structure and (c) eliminate uneconomic excess capacity'.[21] In 1975, a Job Creation Programme was introduced in the United Kingdom, under which the Manpower Services Commission was to finance labour- intensive projects.

The Netherlands established a restructuring programme in 1974 which was designed to foster the 'anticipatory' adjustment of domestic industries to imports from developing countries.[22] To be eligible for assistance, firms were required to have devised a restructuring plan, entailing the abandonment of production directly competing with exports from developing countries and its replacement by some alternative activity.

In France, the Seventh Plan for the five-year period beginning in 1976 stressed the objective of 'adjustment of our industry to increasing international competition'.[23] An Inter-ministerial Structural Adjustment Committee was created in 1974 (including both the President and the Prime Minister) to coordinate public intervention in firms experiencing adjustment difficulty. In September 1978, the Special Fund for the Adaptation of Industry was created to provide subsidies and loans to new projects in structurally-depressed regions.

West Germany, Italy and Belgium, and Sweden, outside the Community, instituted broad adjustment-assistance measures and manpower programmes, although most were not related specifically to trade.[24]

In *Japan*, adjustment-assistance schemes had already been devised for particular industries, such as coal and textiles, in the 1960s. In 1978, an act was passed (Special Measures for the Stabilization of Specific Depressed Industries) which formalized the procedure for government intervention in problem industries, the stated objective of which was to reduce their production capacity.[25] Some fourteen industries, including steel, shipbuilding and textiles, were selected for restructuring. In addition, a number of manpower policy measures were implemented in the 1970s, including the New Vocational Training Plan, which provided for training in basic skills at government institutions, and the Employment Stabilization Fund, to assist labour mobility.

This enthusiastic response of governments to the 'adjustment problem' received a mixed reception. At first there was a period of almost general if muted approval. This is well illustrated by the relatively conciliatory tone of a report prepared by the UNCTAD Secretariat for the annual meeting of the Trade and Development Board in mid-1977.[26] Although stressing that, in most of the countries reviewed, more could be done to facilitate adjustment to imports from developing countries, the report was confident that existing programmes could be adapted for that purpose. The Netherlands programme, with its developing-country focus, was singled out as a model for other governments.[27]

Fall from Grace

The initial approval of the efforts of governments gradually gave way, however, to increasingly widespread concern about the nature of some of the intervention taking place in the name of adjustment assistance.[28] It appeared that, far from facilitating the shrinkage of uncompetitive sectors, adjustment subsidies were frequently being used to prop them up. This

was especially true of the assistance schemes for what were becoming known as the 'crisis' industries: shipbuilding, steel, textiles, clothing and footwear.

Much of the assistance provided to firms in these industries was based on the premise that a programme of 'modernization' could restore their competitiveness. For example, a central element in the United Kingdom's Wool Textile Scheme of 1973 was the provision of investment subsidies to firms on condition that their old machines were physically destroyed.[29] W.M. Corden, the Australian economist, dismissed this approach as 'straightforward protection'.[30] In fact, adjustment-assistance schemes for particular sectors frequently included trade restrictions, in order to give the industry a 'breathing space' to carry out its re-structuring programme.[31] Other measures designed for the same purpose included production subsidies, tax write-offs, 'temporary' employment subsidies *et cetera*.

A number of re-structuring programmes, motivated by the perceived need to reduce the capacity of problem industries as well as to modernize them, encouraged mergers and cartel arrangements. Among the best-known examples have been the Davignon Steel Plan for the European Community — which specified production quotas for member countries and minimum prices (supported by export restraints on external suppliers to the Community) — and the sectoral re-structuring plans in Japan, especially under the Depressed Industries Act of 1978, referred to previously.[32]

Enter 'Positive' Adjustment Policy

These developments were widely criticized and, in the late 1970s, a quest for greater purity in adjustment policy began. A number of papers appeared at this time which analysed the measures in place and suggested preferred forms of adjustment assistance.[33] At the international level, the OECD organized an intensive five-year programme of work under the pleonastic banner of 'positive adjustment policy'. A *communiqué* of the OECD Council issued in June 1978 proclaimed that:

> 'A progressive shift to *more positive* adjustment policies must ... be an integral part of the programme of better balanced growth in the world economy.'[34]

At about the same time, however, evidence was accumulating that many measures of intervention which *were* designed to play a 'more positive' role in the adjustment process were proving either ineffective or unworkable.

One example is the Trade Adjustment Assistance programme in the United States, mentioned previously, which was transformed in 1974, following widespread criticism of its operation in the preceding twelve years.[35] Provisions for adjustment assistance to workers and firms were expanded and made more generous; assistance was extended to whole communities experiencing adjustment difficulties and the criteria for granting assistance were considerably relaxed. These changes, together with greater efforts to promote the programme by its new administration, the Department of Labor, provoked a sharp rise in disbursements, which soon reached unsustainable levels. Payments to workers alone increased from $79 million in 1975-76 to about $1 billion in both 1980 and 1981.[36] Moreover, contrary to expectations, the vast expansion in spending on the TAA had no noticeable effect in improving the efficiency of the adjustment process or reducing political pressures for protection.[37] As a result, the government was obliged to undertake a new 'reform' of the TAA under the Omnibus Budget Reconciliation Act of 1981, tightening the eligibility criteria once more and reducing benefits.[38]

The selective measures of intervention, in which public assistance was provided to crisis industries for 'restructuring proposals', were frequently marked by failure. This applied not just to the modernization or 'rehabilitation' schemes, referred to above,[39] but also to the 'anticipatory' schemes designed to guide the transfer of resources to more promising alternative activities. The Dutch Government, reviewing its experience with the programme that had found such favour with UNCTAD, was forced to conclude that 'the idea that

an innovative, forward-looking restructuring programme could be carried out has proved to be largely illusory'.[40]

NOTES AND REFERENCES

1. Note the much earlier example given by Charles Kindleberger: 'It is seldom mentioned that when the Corn Laws [in the United Kingdom] were repealed, a fund of £2 million was established to extend the draining techniques of high farming among the landowners in England and another fund of £1 million was established in Ireland. In France, Louis Napoleon put 40 million francs into a loan fund for adjustment assistance to producers adversely affected by the Cobden-Chevalier treaty of 1860.' Charles Kindleberger, *Government and International Trade*, Princeton Essays in International Finance No. 129 (Princeton: Princeton University, 1978) p. 4.
2. *Adjustment Assistance Measures*, TD/121 (Geneva: UNCTAD Secretariat, 1971).
3. Charles Frank, *Foreign Trade and Domestic Aid* (Washington: Brookings Institution, 1977).
4. Caroline Miles, *Lancashire Textiles: Case Study of Industrial Change* (Cambridge: Cambridge University Press, for the National Institute of Social and Economic Research, 1968).
5. Kiyoshi Kojima, 'The Japanese Experience and Attitudes towards Trade Adjustment', in Helen Hughes (ed.), *Prospects for Partnership: Industrialisation and Trade Policies in the 1970s* (Baltimore: Johns Hopkins Press, 1973) p. 256.
6. Frank, *op. cit.*
7. Paragraph 35 of the United Nations International Development Strategy, cited in the UNCTAD document, *Adjustment Assistance Measures*, *op. cit.*
8. Various UNCTAD reports and *Redeployment of Industries from Developed to Developing Countries: Studies Undertaken by UNIDO*, ID/B/222 (Vienna: United Nations Industrial Development Organization, 1979).
9. *Adjustment for Trade: Studies on Industrial Adjustment Problems and Policies* (Paris: OECD Secretariat, 1975).
10. *Adjustment Assistance Measures*, Report of the Commission on the Expansion of International Trade, 102/86 (Paris: International Chamber of Commerce, 1970). Also, in 1981, the ICC sponsored a conference, held in the GATT building, on the topic of Structural Adjustment.

11. Gerard and Victoria Curzon, *Global Assault on Non-tariff Trade Barriers*, Thames Essay No. 3 (London: Trade Policy Research Centre, 1972) p. 32.
12. *Adjustment Assistance Measures*, *op. cit.*, pp. 9-10.
13. W.M. Corden, *Trade Policy and Economic Welfare* (Oxford: Clarendon Press, 1974) p. 111.
14. Geoffrey Denton, Seamus O'Cleireacain and Sally Ash, *Trade Effects of Public Subsidies to Private Enterprises* (London: Macmillan, for the Trade Policy Research Centre, 1975) p. 235.
15. David Lea, 'International Adjustment Assistance', in C. Fred Bergsten (ed.), *Toward a New World Trade Policy: the Maidenhead Papers* (London: Lexington, 1975) p. 313.
16. See the bibliography in Martin Wolf, *Adjustment Policies and Problems in Developed Countries*, Staff Working Paper No. 349 (Washington: World Bank, 1979).
17. *Certifying Workers for Adjustment Assistance: the First Year Under the Trade Act* (Washington: General Accounting Office, 1977).
18. Frank, *op. cit.*
19. For details of the Australian schemes, including budget allocations, see the *Annual Reports* of the Industries Assistance Commission, Canberra.
20. *Bulletin of the European Communities*, Commission of the European Community, Brussels, March 1971.
21. *The Wool Textile Industry Scheme* (London: Her Majesty's Stationery Office, for the Department of Trade and Industry, 1978) p. 3.
22. *Memorandum on the Restructuring of the Netherlands Economy and Development Cooperation* (The Hague: Ministry of Economic Affairs, 1974).
23. *Rapport sur l'adaptation du Septième Plan* (Paris: Commissariat Générale au Plan, 1978).
24. Surveys of national adjustment programmes and policies are contained in the following publications: the report of the OECD, *Adjustment for Trade: Studies on Industrial Adjustment Problems and Policies*, *op. cit.*; the report of the General Accounting Office (GAO) in the United States, *Considerations for Adjustment Assistance under the 1974 Trade Act: a Summary of Techniques used in Other Countries* (Washington: General Accounting Office, 1979); and *Employment, Trade and North-South Cooperation* (Geneva: International Labour Office, 1981).

25. *News from MITI*, Ministry of International Trade and Industry, Tokyo, 24 March, 1978.

26. *Adjustment Assistance Measures*, TD/B/C.2/171 (Geneva: UNCTAD Secretariat, 1977).

27. *Ibid*, p. 17. See also Santosh Mukherjee, *Restructuring of Industrial Economies and Trade with Developing Countries* (Geneva: International Labour Office, 1978) p. 73.

28. See A.J. Sarna, 'International Guidelines for Industrial Adjustment Policies', *Journal of World Trade Law*, Geneva, November-December 1981.

29. The report of the British Department of Trade and Industry on *The Wool Textile Industry Scheme*, *op. cit*. For an early article which shows the costliness of 'capital destruction subsidies' applied to the textile industry in the United Kingdom, see Simon Rottenburg, 'Adjustment to Senility by Induced Contraction', *Journal of Political Economy*, Chicago, December 1964.

30. Corden, *op. cit.*, p. 111.

31. The 'breathing space' approach to adjustment policy is well illustrated by the history of the Multi-fibre Arrangement. The temporary protection which it enshrined is now over twenty years old and makes a mockery of Article 1(4): 'Actions taken under this Arrangement shall not interrupt or discourage the autonomous adjustment processes of participating countries.' See *Textiles and Clothing in the World Economy* (Geneva: GATT Secretariat, 1984).

32. On Japan, see J. Mark Ramseyer, 'Letting Obsolete Firms Die: Trade Adjustment Assistance in the United States and Japan', *Harvard International Law Journal*, Cambridge, Massachusetts, Fall 1981.

33. For example, in Australia, the Industries Assistance Commission (an early advocate of adjustment assistance) noted: 'In the light of past experience with adjustment measures, the Commission considers that it may be appropriate to re-appraise the need for such measures and the form they should take. It is essential that adjustment measures include elements that actually promote adjustment and do not serve entirely as defensive measures to retard change.' *Annual Report 1979-80* (Canberra: Industries Assistance Commission, 1980) p. 38. See also Wolf, *op. cit.*, p. 27, and Ramseyer, *op. cit.*

34. 'Policies for Adjustment: some General Orientations', Council *communiqué* of 15 June 1978, reprinted in *Positive Adjustment Policies: Managing Structural Change* (Paris: OECD Secretariat, 1983) p. 111.

35. 'Bitter memories still survive from that period of illusory promises in which the hopes of workers were raised only to be dashed by repeated denials of benefits.' See Kent G. Cprek, 'Worker Adjustment Assistance: Black Comedy in the Post-Renaissance', *Law and Policy in International Business*, Washington, 1979, p. 595.

36. For details, see James A. Dorn, 'Trade Adjustment Assistance: a Case of Government Failure', *Cato Journal*, Washington, Winter 1982, p. 875.

37. *Restricting Trade Act Benefits to Import-affected Workers who cannot Find a Job can save Millions*, HRD-80-11 (Washington: General Accounting Office, 1980); *Trade Adjustment Assistance for Workers: Program Growth and Possible Changes* (Washington: Congressional Research Service, Library of Congress, 1981); 'The Upsurge in TAA', *Morgan Guaranty Survey*, New York, July 1980; and Dorn, *op. cit.*

38. The budgetary collapse of the TAA after the 1974 Trade Act was predicted in 1973 in a penetrating article by Dean Hinton, 'Comment: Policy Issues', in Hughes (ed.), *op. cit.* He noted: 'UAW is proposing a form of adjustment assistance, but when that form of adjustment assistance is put in the political context of the United States in the 1970s, the budgetary amounts implied are far, far greater than even the top estimates' (p. 179).

39. Frank, *op. cit.*; Wolf, *op. cit.*; Harold A. Bratt, 'Assisting the Recovery of Import-injured Firms', *Law and Policy in International Business*, No. 1, 1974; and Victoria Curzon Price, *Industrial Policies in the European Community* (London: Macmillan, for the Trade Policy Research Centre, 1981).

40. *Development Cooperation and the World Economy* (The Hague: Ministry of Economic Affairs, 1979) p. 82.

Chapter 3

Is There a Case for Adjustment Assistance?

THE FAILURE of adjustment-assistance programmes has tended to be blamed on the particularities of their design and implementation, the alleged shortcomings of the administrators of the programmes and inadequate funding.[1] Rarely has the intellectual case for adjustment assistance itself been questioned. This attitude is typified by one proponent's conclusion that 'even though the adjustment assistance concept is *sound in theory*, it has been a disaster in practice'.[2] Just how 'sound in theory' is adjustment assistance? The case rests on three arguments, each of which warrants a more critical examination.

'Costs' of Adjustment

> 'The person who loses wealth either via transfer of goods or the reduction of their exchange value is suffering a real loss of wealth, but not a cost. That loss is different in principle, in kind and in fact from a cost'
>
> — Armen A. Alchian, 'Cost', *International Encyclopedia of Social Sciences* (1968)

It is alleged that changes in comparative advantage, while on the whole beneficial, occasion 'adjustments costs', which may be reduced or eliminated by appropriate government intervention. The popular expression of this idea can be found in the notion of the 'social cost' of adjustment, which seems to suggest that adjustment is a costly activity for society as a whole.

There has been considerable confusion surrounding the whole discussion of adjustment costs, most of which can be traced to careless usage of the terms 'cost' and 'social cost', especially in non-professional parlance. In economics, *cost* can only arise from a decision; namely, a person's (or a government's) deliberate decision to sacrifice specific alternatives in the pursuit of a given course of action. The cost of the chosen activity, then, is the highest-valued alternative foregone. The *total* costs of producing something can be separated into the 'private' contractual outlays of a producer and 'external' costs, not reflected in the accounts of the producing unit, which the production activity imposes on bystanders. These 'externalities' are costs every bit as much as the monetary outlays on inputs, for they use up valued resources, even if the producer is not obliged to pay for them. (The classic example of a production externality involves a polluting factory and the implicit input 'clean air'.[3])

It was perhaps unfortunate, in view of the subsequent misunderstandings, that in 1920 Arthur C. Pigou christened the total internal and external costs arising from individual choice, the '*social* cost of producing X'.[4] Here the anthropomorphic conception of society is implicated, as if it were 'society' that was producing X. It would have helped clarity of interpretation if the expression 'social cost' had been reserved just for the external costs borne by those who did not participate in the production decision.

Nevertheless, in the context of production, these concepts of costs, irrespective of their labels, have meaning. But what could be the costs, properly defined, of *adjustment* or *change*? These have been characterized in the literature as: (i) declines in wealth that certain individuals may suffer in a changing economic environment and (ii) output foregone through transitional unemployment of displaced labour and capital.

Declines in Wealth

An example of the first usage can be found in the following passage from a recent OECD publication:

'If demand and supply factors cause an industry to decline, and in particular if it happens at an excessive rate, *this creates considerable costs*: workers may have to accept lower wage increases or may lose their jobs... In addition, capital may have to be written off before the technical end of the capital good's life span.'[5]

It suggests that adjustment costs comprise the decline in the values of private assets or of particular property rights, including the value of labour engaged in those occupations against which comparative advantage is shifting.

It is better, however, to speak of changes in *relative* asset values, to call attention to the fact that this decline in wealth is compensated by, and indeed makes possible, increases in assets and asset values elsewhere in the economy. Such declines in particular asset values in consequence of new activities developing within an economy are called '*pecuniary* externalities' and this may explain why they are sometimes confused with social costs. Indeed, the label and the whole concept are fundamentally misleading in that true external costs always involve a misallocation of resources, reducing the total wealth of the society below what it could be. Pecuniary externalities have no adverse effects on total wealth; they can be considered pure — costless — transfers. It promotes a fuller understanding to consider such changes as the vehicle of growth — the particular value losses being a necessary condition of the gains realized elsewhere. This is no less true when the activity reducing the value of particular assets in the economy is located abroad. The loss of comparative advantage in a particular line of production automatically entails a corresponding gain in others.

Thus the losses in asset values resulting from changes in comparative advantage are clearly not external costs, but they are not private costs either. They do not result from any conscious decision by the injured parties. It is the mere existence of a more efficient method, the *potential* availability of cheaper supplies, that reduces the value of these assets. Where there is no alternative foregone, the economist cannot

speak of 'cost'. This also applies to the extreme cases in which the original loss in capital values stemming from changes in the external economic environment represents a net loss to the economy at large. One example is the demise of the Chilean nitrates industry, a quantitatively important resource with no alternative uses. The point is that the Chilean Government was powerless to prevent or reverse the loss to its economy.

An investment decision is about converting generalized (liquid) purchasing power irrevocably into real assets, the value of which will be determined throughout their lives by the essentially uncertain prospect of their future earnings. These assets may be valued in three different ways:

(a) by their *book values*, reflecting the (non-economic) conventions of cost accounting and tax system;

(b) by their *market values*, reflecting their discounted earnings in the market as it is actually constituted; and

(c) by their *social values*, which are determined by the rate of return that each capital good can earn when the output for which it has been shaped is obtained in the most efficient manner known.

Now it is true that, although nothing can be done about a decline in the social value of capital, governments can attempt to maintain its market value by subsidizing the return on it with an income transfer from the society at large. This policy reaction, however, *creates* social cost instead of reducing or removing it.[6] Consumers suffer and other industries suffer; and resources remain tied in low-productivity occupations, while economic development in conditions of unobstructed trade would push them towards higher productivity uses. A final irony is that only a small proportion of the owners of assets in the protected industry can be helped by policies of this kind. Those (for example, pension funds) who hold the equity of the protected industry in diversified portfolios will lose on balance, relative to the development which would have taken place if the progress of the industry had remained unobstructed. This is because the adverse effect

of protection on the rest of the economy — hence on the valuation of the rest of the portfolio — must more than offset whatever favourable effect there may be on the equity of the protected firms.

Transitional Unemployment

The second alleged source of 'adjustment costs' is the transitional unemployment that is associated with the displacement and reallocation of labour and capital. The costs are commonly measured by an imputed value-in-employment for the idle factors and sometimes by the charge that the support of the unemployed implies for public budgets.[7]

If output were foregone unnecessarily during the adjustment process — that is, if something could be done about it, without losing more output in the process — then this would indeed be a social cost, although it does not necessarily follow that it would represent a cost of *adjustment*. To determine the true nature and origin of such cost, the analysis must be developed more systematically. In the *perfect competition model*, which postulates an ideal apolitical world of perfect foresight where all resource flows are frictionless and instantaneous (displaced workers immediately re-employed), it is clear that adjustment to a change in demand or supply (for example, increased imports) cannot result in any lost output and there could be no social cost.

At a lower level of abstraction, *an 'imperfect', yet efficient, economy* can be imagined in which

(a) the micro-economic role of government is confined to protecting property rights, making competition work and supplying pure public goods and

(b) economic agents make decisions in an environment where there is risk, uncertainty and positive transaction costs.

In such a world, there would be adjustment frictions: workers displaced by imports would not enter new jobs immediately; they would have to search for them, perhaps shift localities, and in the meantime they would not be 'producing' anything. But this minimum search time does not represent a cost to society because it reflects a necessity which cannot be changed by human will. In fact, the minimum search time between jobs in such an economy is itself socially valuable (and should lengthen with higher average income levels).[8] It gives individuals the opportunity to correct past errors, to find jobs that are more satisfying to them and to contribute more to GNP. (Labour will on average always be moving from lower-valued to higher-valued uses in this setting.) In any case, in the world posited here, frictions of this kind would be short in duration, relatively insignificant in extent, and social provision for reducing the hardship they cause could be easily made from the increment to national income which adjustment makes possible.[9]

Finally, we descend to our *contemporary 'mixed-up' economies*, made rigid and inefficient by an accumulation of policy measures and other organizational impediments to the proper operation of the market. (These are examined in some detail in Chapter 5.) Even in this situation, most of the capital and labour released from uncompetitive firms will eventually find new employment. Nevertheless, serious imperfections in the legal-institutional framework in which the market operates can cause the transitional unemployment of labour and capital to be both extensive and prolonged. Where these imperfections are correctible, the loss of output is in principle avoidable and thus strictly unnecessary — a social cost, strictly speaking. But that also means that it cannot be attributed to the (need for) adjustment. It may well be that the stress of change in periods of cyclical downturn calls attention to the costs of market impediments, while in the preceding period their existence was either unnoticed or considered acceptable. In that case, the correction of these costly imperfections would be an *additional benefit*, rather than a cost of adjustment.

It should be further borne in mind that these costly market impediments reduce the efficiency of adjustment to *all* changes, not merely that of adjustment to imports. In the total of social

costs so occasioned, those associated with imports usually represent a small fraction; more often than not, it is the market impediments themselves which make the import-competing industry vulnerable to import competition in the first place.[10]

It emerges that what is commonly described as the cost of adjustment is caused not by the necessary adjustment as such, but by *correctible* pre-existing market imperfections. Where these imperfections cannot be corrected, or only by incurring greater cost in the process (for example, because they are institutions forming part of the constitutionally-legitimate social fabric of an economy), it is impossible to speak of social cost at all. An institutional setting that embodies the value judgments of society is a *parameter* of the market and should not be measured against an apolitical ideal, such as the perfect competition model.[11]

The Second Best

This is relevant to those attempts to justify adjustment assistance on second-best grounds. The presumption is that there are certain market distortions impeding the re-allocation of displaced factors which, for (usually unspecified) political reasons, cannot be tackled directly.[12] Instead, economists have set about devising ingenious schemes of 'countervailing' action involving lump-sum subsidies and taxes.[13] The intuitive appeal of this approach is shattered, however, by the realization that the initial, untouchable distortions are either implicitly or explicitly the *outcome* of government policies in the past. The second-best approach fails to explain how a government which at one time implemented certain measures (or allowed certain private organizational devices to develop) *and is now politically stuck with them*, could be politically capable of offsetting these measures by indirect means. Moreover, as was noted in an article in *Economic Inquiry*:

> 'In its broadest form the distortion-creating constraint represents an economic advantage to a particular sector of the economy. The advantage is politically conferred and the persistence of the distortion is determined by the structure of the political process (e.g., majority rule or unanimity, freedom of entry, etc.). Once the political choice has been effected within a generally accepted democratic framework, to describe it as being 'politically infeasible to remove' is to present, not a constraint on policy, but an instance of its achievement and endorsement.'[14]

In addition to these internal contradictions, the second-best approach presumes (i) that government has the *technical* ability to identify and implement second-best solutions (solutions which are especially complex in the case of adjustment assistance, requiring variable 'dynamic subsidies' and the like)[15] and (ii) that the additional interventions will themselves give rise to no social cost. The appropriateness of these presumptions is considered in subsequent chapters. It might just be noted here that, in practice, the bulk of adjustment policy measures — crisis cartels, modernization schemes, supplementary unemployment benefits *et cetera* — bear no resemblance to the ingenious solutions proposed by second-best theorists.[16]

Equity Considerations

> 'When considerations of national policy make it desirable to avoid higher tariffs, those injured by that competition should not be required to bear the full brunt of the impact'
>
> — John F. Kennedy, Message to the United States Congress on the Reciprocal Trade Agreements Program (1962)

The argument for adjustment assistance on equity grounds is often associated with, but conceptually distinct from, the argument based on the presence of adjustment costs. It suggests that, since the benefits of trade are widely spread, whereas the (lesser) losses to which it may give rise are concentrated on relatively small groups, equity demands that the latter should be compensated by transferring to them a part of the benefits.[17]

It is essential to distinguish two situations in which this argument is employed. It has some validity in the context of *trade liberalization*. Here the equity issue relates to property values enhanced by the government act which instituted protection in the first place; these values could be reduced by the subsequent government decision to reduce or dismantle that protection. As the earlier discussion shows, the level of protection is an important determinant of asset values (that is, private or market, not social asset values) in the protected industry. Those individuals who obtained a capital gain when protection was instituted might have already realized it; and the subsequent owners who acquired these assets at their new prices suffer a loss when protection is reduced.[18] (The same reasoning holds, it should be added, for the specific property rights — such as seniority, pension rights and the human capital accumulated through training and experience — acquired by the workers employed in the protected industry.) As has been pointed out in an important essay, the transition from the actual state to the preferred one is not without private losses; and the normative significance of these transitional losses 'which arise because pre-existing rules and institutions have legitimized claims and expectations' has not been sufficiently emphasized.[19]

In principle, the losses imposed by policy reversals can be minimized by the change being announced sufficiently in advance. In the case of changes in trade policy, the institutional framework in which they occur ensures that these conditions are satisfied.

The negotiations for trade liberalization take a number of years and industries which will suffer major reductions in protective barriers receive an early warning.

The agreed liberalization is normally then implemented in pre-announced stages, again giving the affected industries time to adjust.

Finally, there are escape clauses in these agreements to help industries which seem to be overwhelmed by imports, in spite of the anticipatory adjustment period.

It was on the basis of this last consideration, that the escape clauses provided for in commercial treaties and national statutes traditionally stipulated that emergency protection would be available to domestic producers suffering injury through an increase in imports *in consequence* of the tariff concessions specified in the treaty. For example, the Trade Expansion Act of 1962 in the United States authorized adjustment assistance in cases where the 'major cause' of injury was an absolute increase in imports resulting 'in major part' from past trade concessions.[20] These criteria, although much criticized subsequently for being too harsh, were in fact perfectly appropriate to the declared equity objectives of the TAA programme. (The fact that actual disbursements were relatively small is irrelevant, except as an indication of the unimportance of injury through trade liberalization at that time.)

It is a very different situation when adjustment assistance is advocated as an alternative to *increased protection*. In the former case, the equity claim arises from the fact that the values of private property rights have been changed by a government action. In the situation now discussed, government is called upon to mitigate the adverse consequences of economic competition (a normal state of economic life which benefits society at large) for a particular group. Indeed, the government is held to ransom, the powerful pressure groups demanding more protection or else an acceptable alternative.

In a situation of this kind it is impossible to justify adjustment assistance on equity grounds. Equity, or justice, is nothing if not a general principle; and the feature of 'widespread benefits and concentrated costs' is present in *all* instances of economic innovation, whether originating at home or abroad. Societies do not systematically compensate for the adverse effects of innovation on individuals, for several good reasons. One is, properly, equity: individuals should be supported by society for a general reason, such as poverty. If the adverse effects of a particular event, such as innovation, were selected for compensation, many of those qualifying might

not be poor at all. The main reason, however, is that the effects of such a policy are bound to be far-reaching and unforeseeable. A government's obligation to compensate all the adverse effects which economic progress has on the welfare of particular groups would amount to socializing all the major economic risks. It is impossible to form a reliable *ex ante* judgment as to all those side-effects of such a policy which can be subsumed under the label of 'moral hazard', or to estimate the policy's effects on the incentive to innovate; all that can be said is that the whole social order would be profoundly changed. (These issues are considered in the next chapter.) It should be noted, though, that the balance of interests and political forces in society is strongly tilted against such a sweeping change. In all cases of domestic innovation, there is a well-defined group of producers benefiting from it, balancing out the adversely affected group of producers who have to adjust. In that political situation, the claim for special compensation is not likely to be raised.

One may ask whether it would it be a sufficiently general principle if the government decided to compensate domestic producers for all adverse effects of changes in comparative advantage. On any theory of justice, this, too, would represent an arbitrary designation of particular change as a cause for compensation. There is no reason to suppose that international shifts in comparative advantage are more frequent, drastic or harmful to particular groups than economic change of domestic origin. In effect, changes in international comparative advantage *originate* from changes within national economies. As it would be more general, however, a policy seeking an equal treatment of export and import-competing industries would represent an improvement on a policy compensating damages caused by imports only. Unfortunately there is a prohibitive political consideration. Export industries may be as often affected by adverse shifts in comparative advantage as import-competing ones. But they could not benefit to the same extent from a re-structuring financially assisted by the government. Their sales in foreign markets would soon run

up against internationally sanctioned measures prohibiting subsidies and unfair competition.

Political Expediency

> 'The role of the economist in discussion of public policy seems to me to prescribe what should be done, politics aside, and not to predict what is politically feasible and then to recommend it'
>
> — Milton Friedman, 'Comment on Monetary Policy', *Essays in Positive Economics* (1953)

As described, the equity argument for adjustment assistance has some limited justification in the context of adjustment to reductions in existing trade barriers. In situations in which the equity argument does not hold — namely when increased protection is being demanded — adjustment assistance has still been advocated on political grounds.[21] The 'expediency' argument presupposes that government cannot afford to withdraw or refuse a request for protection unless some alternative form of assistance (a bribe, in effect) is provided.[22]

This line of argument is one which commonly confronts those who propose policies on the basis of general criteria, such as economic efficiency. Unless such advice is tempered by the probability of it being accepted, the adviser is charged with being 'unrealistic' or naïve. 'That's alright in theory, but it won't work in practice' is a comment of such universal application that Immanuel Kant was provoked to write a book under that title.[23] A fundamental issue, however, is whether 'political feasibility' is ever a sufficiently determinate concept for it to provide a useful criterion for economic policy decisions. Who can know in advance whether a given line of action is politically feasible or not?

Economists tend to abandon the scientific method of their profession when it comes to politics. Their record in political second-guessing, though, is not a flattering one. Even as astute a member of the profession as Lord Keynes was open to criticism on that score. One example is his advocacy of a tariff

for Britain in 1931. As has been observed: 'Keynes as professional economist thought devaluation was appropriate at that time, but Keynes as amateur political scientist thought that *politically infeasible*, so he recommended a tariff. Six months later, Britain devalued, but the tariffs introduced in that year are still in place.'[24]

The assignment of 'political feasibility quotients' requires knowledge of existing attitudes, as well as the strength with which they are held and how they will be reflected in action. It is also necessary to know how attitudes will be affected by the force of ideas and events and, in particular, by the policy proposals being contemplated and the political skill with which they are presented and defended.[25] Perhaps the most remarkable instance of the force of ideas upon attitudes is Adam Smith's *The Wealth of Nations*, a book devoted to the promotion of free trade, which was published in 1776 when its antithesis, mercantilism, was orthodoxy. It took a mere 70 years for his truly radical ideas to become the new orthodoxy (an event, moreover, which Smith himself considered not to be politically feasible[26]).

It may be worth examining the foundations of the 'realistic' argument that the refusal of protectionist demands requires bribery. Vested interests, pressure groups, are minorities by definition. Their function is to re-distribute income from society at large to their own members. If government believes this to be against the interests of society, then on ethical grounds it has no business in trying to bribe such pressure groups. Practical politics may require, however, that ethics give ground occasionally to electoral considerations. But since these pressure groups *are* minorities after all — and anti-social minorities at that — the electoral consequences of offending them should not be grave in most cases, provided that the electorate at large has a proper understanding of what is at stake.

Perhaps import-competing groups are felt to be special minorities in this respect, because they are able to appeal to the xenophobia latent in every society, whereas the conflicts

engendered by other minority groups are internalized. Or perhaps society gives these groups its support because it does not understand the costs and distributional consequences which are entailed in that support. In these circumstances, however, the proper function of democratic government is not to ignore, let alone help promote, the misconceptions and ignorance on which pressure groups depend, but to bring about a proper understanding in the community at large of the consequences of different policies. (As has been argued, 'no policy which is for the advantage of the people is incapable of being effectively explained to them'.[27]) The alternative is to try to bribe (and stay friends with) producer groups, and while this is undoubtedly more congenial to politicians, it represents an escape from their main constitutional responsibility. This has far-reaching consequences which, as later chapters will attempt to show, are at the heart of the 'adjustment problem' itself.

Those proposing compensation as the 'price to pay' for liberal trade — with the implication being that it will be a *small* price relative to the benefits — must explicitly address two important questions:

(a) What sort of bribe (and how much) will be needed in each instance?

(b) What will be its 'general equilibrium' effects?

Consideration of the first question reveals that the problem with a bribe is that, unlike compensation to redress an injury, there is no theoretical basis for determining *ex ante* the sum to be provided. This will evolve through a bargaining process between the representatives of government, industry and labour. There are a number of reasons for believing that the smallest amount needed to bribe these groups successfully will normally be very large. The very fact that the government could have been put in this position at all would indicate that the industry has considerable bargaining strength. For their part, the vested interests will attempt to extract as much as they can from the government. The minimum compensation acceptable to them would be equal to the expected net returns

from staying in an adequately protected industry less the expected net returns from alternative employment.

A number of studies have shown that many workers in declining industries are less adaptable and employable than the average.[28] For such people, job security (the *status quo*) understandably takes precedence over the alternatives. (In effect, their wages contain a rent component.) Clair Wilcox, one of the first economists to write on the subject of adjustment assistance, described the problem confronting government as follows:

> 'It is scarcely possible to make friends or influence people by telling them that you intend to take action that may put them out of business, destroy their jobs or reduce their incomes, even though you promise to take care of them by providing some sort of public assistance while they go through the agonies of adjustment... Business and labor do not want it. They would prefer to stay where they are, doing what they are doing and receiving the incomes they now enjoy.'[29]

Indeed, the possibility cannot be ignored that an announced policy of compensation for liberal trade would *intensify* the opposition to it by focussing public attention on the costs to the few, rather than the benefits to the many, of freer trade.

Such considerations suggest that the subsidy-equivalent of the bribe needed for a particular industry could be so large as to preclude it, for budgetary reasons, from being offered in the 'clean' lump-sum form assumed by many economists. (Note the collapse of the TAA programme in the United States once it lost its strict 'equity' rationale, described in Chapter 2.) The negotiated compensation is more likely to involve a package of measures, some of which will be chosen primarily for their budgetary convenience — like 'temporary' import restrictions, for instance. This, too, is confirmed by the actual experience with industry-specific adjustment schemes (textiles under the MFA).

The discussion so far has only taken into account the politically expedient approach within the confines of a single

industry, at a given moment in time. But the compensation of one vested interest group in such a fashion must be expected to provoke demands for similar treatment from many other groups — both within the traded goods sector and outside it. Given an unprincipled expediency approach to government policy, it is worth everyone's while to flex their political muscles. In effect, the government is rewarding anti-social behaviour. Apart from the waste of productive resources to which this gives rise, the pressure upon governments would soon become unbearable because, under the assumptions on which the whole approach is based, they could not afford to resist.

NOTES AND REFERENCES

1. See, for example, Peter Henle, *Trade Adjustment Assistance for Workers: Issues of Program and Purpose* (Washington: Congressional Research Service, Library of Congress, 1976); Malcolm D. Bale, 'Adjustment Assistance: Dealing with Import-displaced Workers', in Walter Adams *et al*, *Tariffs, Quotas and Trade: the Politics of Protectionism* (San Fransisco: Institute for Contemporary Studies, 1979); Cprek, *op. cit.*; Leslie Stein, 'Trade Adjustment Assistance as a Means of Achieving Improved Resource Allocation through Freer Trade', *American Journal of Economics and Sociology*, Lancaster, Pennsylvania, July 1982.
2. Tracy Murray, *Adjustment Policies and the Need for an Early Warning Capability*, Paper presented to the International Symposium on 'Industrial Policies for the 80s', Madrid, 5-9 May 1980, p. 6.
3. For a detailed discussion about the true nature and policy relevance of externalities, see the seminal article by Ronald H. Coase, 'The Problem of Social Cost', *Journal of Law and Economics*, Chicago, October 1960. See also, Steven N.S. Cheung, *The Myth of Social Cost*, Hobart Paper No. 82 (London: Institute of Economic Affairs, 1978).
4. Arthur C. Pigou, *The Economics of Welfare* (London: Macmillan, 1920).
5. 'Policies for Adjustment: some General Orientations', in *Positive Adjustment Policies: Managing Structural Change*, *op. cit.*, p. 58. See also, H. Peter Gray, 'Senile Industry Protection: a Proposal', *Southern Economic Journal*, North Chapel, North Carolina, April 1973.

6. For an interesting attempt to argue the contrary, and a rebuttal of that argument, see Gray, *op. cit.*, and Geoffrey Wood, 'Senile Industry Protection: Comment', *Southern Economic Journal*, January 1975, respectively.

7. See Stephen P. Magee, 'The Welfare Effects of Restrictions on US Trade', *Brookings Papers on Economic Activity*, Washington, No. 3, 1972; Robert E. Baldwin, John M. Mutti and J. David Richardson, 'Welfare Effects on the United States of a Significant Multilateral Tariff Reduction', *Journal of International Economics*, Amsterdam, August 1980.

8. Armen A. Alchian, 'Information Costs, Pricing and Resource Unemployment', *Western Economic Journal*, Los Angeles, June 1969.

9. These points can be illustrated with the following analogy. There is not just the possibility but a certainty that some minimum number of houses in a large city will burn down this year. That number could be reduced very sharply, perhaps to zero, by placing a fire station on every block. From the point of view of cost, however, that would be absurd. So each municipality tries to determine the least-cost combination of the three elements of social cost relevant in this case: (i) the probability that a house will burn down, (ii) the cost of the fire insurance that most members of the community will carry in the face of that probability and (iii) the cost of the public good of fire-fighting services. If, in this situation, the actuarially foreseen number of insured houses actually burns down, is it a social cost? The society is obviously poorer than it would have been if the houses had not burned down, but that is irrelevant. The point is that the cost of preventing their destruction (a fire station on every block) would have exceeded the value of the lost houses. Thus the fires inflict no cost on society apart from the private production cost of the insurance companies. Like house fires, unemployment is an insurable risk — that is, people are able to pool the risks of individual losses — and the pay-out on insurance claims obviously does not represent a social cost.

10. This insight was expressed by an experienced civil servant to one of the authors as follows: 'Only too often it is not imports that cause 'injury' but prior injury that attracts imports.'

11. See, Harold Demsetz, 'Information and Efficiency: another Viewpoint', *Journal of Law and Economics*, April 1969.

12. For example, it has been argued that, 'ideally, it might be best to eliminate the market imperfection causing resource immobility. But, in practice, trade adjustment schemes present themselves as useful second-best instruments, even though they might degenerate into social insurance programmes for the inefficient.' Stein, 'Measures to Assist Adjustments to Freer Trade', *American Journal of Economics and Sociology*, July 1983, p. 324.

13. See J. Peter Neary, 'Intersectoral Capital Mobility, Wage Stickiness and the Case for Adjustment Assistance', and Michael Mussa, 'Government Policy and the Adjustment Process', besides other contributions to Jagdish N. Bhagwati (ed.), *Import Competition and Response* (Chicago and London: University of Chicago Press, for the National Bureau of Economic Research, 1982).

14. Michael McKee and Edwin G. West, 'The Theory of the Second Best: a Solution in Search of a Problem', *Economic Inquiry*, Los Angeles, July 1981, p. 447.

15. As presented in the models of Michael Bruno, Michael Mussa and Neary in Bhagwati (ed.), *op. cit.*

16. Harry G. Johnson's famous dictum comes to mind:

> 'The fundamental problem is that, as with all second-best arguments, determination of the conditions under which a second-best policy actually leads to an improvement of social welfare requires detailed theoretical and empirical investigation by a first-best economist. Unfortunately, policy is generally formulated by fourth-best economists and administered by third-best economists; it is therefore very unlikely that a second-best welfare optimum will result from policies based on second-best arguments.'

17. See, among others, Frank, *op. cit.*; Murray, *op. cit.*; and C. Michael Aho and Thomas O. Bayard, 'Costs and Benefits of Trade Adjustment Assistance', Paper presented at a conference convened by the National Bureau of Economic Research on the Structure and Evolution of Recent US Trade Policy, Cambridge, Massachusetts, 3-4 December 1982.

18. See Gordon Tullock, 'The Transitional Gains Trap', *Bell Journal of Economics*, New York, Autumn 1975.

19. Harold M. Hochman, 'Rule Change and Transitional Equity', in Hochman and G.E. Peterson (eds), *Redistribution Through Public Choice* (New York: Columbia University Press, 1974). Note that Hochman, too, uses 'costs' interchangeably with 'wealth losses'. There could only be a *true* cost from rule changes if they adversely affected production incentives. Mr Hochman recognizes this when he writes later of 'demoralization costs' (p. 327). But in the case of trade liberalization, the rule changes are more likely to be salutary

in their effect on production incentives, by reducing rent-seeking and moral hazard; that is, the 'demoralization' effect would be focussed on *un*productive activity.

20. See Stanley D. Metzger, 'The Escape Clause and Adjustment Assistance: Proposals and Assessments', *Law and Policy in International Business*, Summer 1970.

21. See, among others, Peter J. Lloyd, *Non-tariff Distortions of Australian Trade* (Canberra: Australian National University Press, 1973); Wolf, *op. cit.*; Neary, *op. cit.*; and also Aho and Bayard, 'American Trade Adjustment Assistance after Five Years', *The World Economy*, London, November 1980, where it is observed:

> 'In the real world where political and distributional questions often dominate efficiency considerations, a second-best and admittedly distortionary compensation policy may be considerably more efficient as a government response to interest-group lobbying than a third-best policy of increased trade restrictions.'

22. This obviously does not hold as a *general* proposition. There are numerous examples of governments refusing protection without resorting to other assistance.

23. Immanuel Kant, *On the Old Saw: That May be Right in Theory, but it Won't Work in Practice* (Pittsburg: University of Pennsylvania, 1974).

24. Peter G. Warr, 'The Case Against Tariff Compensation', *The Australian Journal of Agricultural Economics*, August 1978, p. 88.

25. For a detailed discussion, see Clarence Philbrook, 'Realism in Policy Espousal', *American Economic Review*, December 1953.

26. Warr, *loc. cit.*

27. William H. Hutt, *Politically Impossible...?* (London: Institute of Economic Affairs, 1971).

28. See H.G. Johnson, 'Forward', in Denton, O'Cleireacain and Ash, *op. cit.*; Bale, in Adams *et al*, *op. cit.*; Graham Glenday, Glenn P. Jenkins and John C. Evans, 'Worker Adjustment to Liberalized Trade', Staff Working Paper No. 426 (Washington: World Bank, 1980); Aho and James Orr, *Demographic and Occupational Characteristic of Workers in Trade-sensitive Industries*, Economic Discussion Paper No. 2 (Washington: US Department of Labor, April 1980).

29. Clair Wilcox, 'Relief for Victims of Tariffs Cuts', *American Economic Review*, December 1950, p. 885. The same point is made by Dean Hinton, 'Comment: Policy Issues', in Hughes, *op. cit.*, who also notes: 'This really becomes binding when we look at it from the level of the union leadership. If union members move, the leader does not have a union, he does not have a dues check-off, he does not have anything; this is one reason why I presume Nat Goldfinger [an American trade union leader] talked about adjustment assistance as a burial program or some such phrase.'

Chapter 4

Public Assistance and Private Incentives

'The most disquieting effect of the tariff has been the stimulus it has given to demands for government assistance of all kinds, with the consequent demoralizing effect on self-reliant efficiency throughout all forms of production'

— J.B. Brigden *et al.*, *The Australian Tariff: an Economic Enquiry*, Brigden Report (1929)

FISCAL THEORY and policy devote considerable effort to analysing the impact on economic behaviour of the announcement, or even the expectation, of a new tax. Such a tax represents an important new datum which forces a re-arrangement of the existing plans of all economic agents affected. The policy-maker needs to know whether this re-arrangement will on balance foster or hinder the kinds of economic activity which in his view promote social welfare. This consideration has an equally important place in the discussion of adjustment assistance and industrial policy in general. If they are to be efficient, they must take into account the changes in the behaviour of firms, industry associations and labour unions which will result from the knowledge that government intends to intervene.

Public subsidy programmes for producer groups have effects on production incentives which may cost a country far more than the administrative costs of the programmes. Yet an awareness of these costs is typically absent from the literature recommending government action to 'improve' the adjustment

process or 'promote' industrial development. Instead, it is normally assumed that subsidy payments of this kind 'represent a transfer and therefore are not a social cost'.[1] This chapter considers two ways in which such transfers can give rise to social costs.

Moral Hazard

First, there is the issue which insurance theory labels 'moral hazard'. The fact of being insured against a particular kind of accident may so alter the behaviour of the insured person as actually to increase the probability of that accident happening. (For example, someone insured against theft may become less careful in locking the apartment.) The intangible, loss-producing propensities of individuals and enterprises are triggered off by insurance against loss. Since all the industry-oriented forms of adjustment policy entail insurance against the rigours of the market, the problem of 'moral hazard' assumes some importance.

An industry experiencing pressure from imports can, if left to its own devices, adjust only by innovating. It will abandon certain lines of production and concentrate on improving others, trying to offer some additional quality or service to distinguish its own product from the imported one. In this effort it can be aided by its own labour force, which will adapt its wage-bargaining strategy to the perceived danger of the industry's market, and *a fortiori* its employment, shrinking in consequence of comparative advantage shifting against it. Indeed, the rate of change in comparative advantage can be to a considerable extent controlled by the import-competing industry, since its competitive position *vis-à-vis* foreign suppliers is largely determined by the relation between the growth of the money wages it pays and of the labour productivity it generates.

If public subsidies are used to promote the withdrawal of productive factors from the industry under import pressure, it is likely that some of the innovations which otherwise would have been made will not occur. Two reasons are that subsidies for the scrapping of capital installations will reduce the pressure

on enterprise and management, and that the availability of additional benefits to workers made redundant by imports will influence the bargaining strategy of unions in the import-competing industries. At the limit, if the government guaranteed domestic industry a fixed share of the domestic market, there would be no way to control the industry's wages — and thus the wage level in general, since industries pay active attention to their wage relativities.

A special problem arises in those situations where the government provides finance at less-than-market rates for specific projects. In principle, the best test of the commercial viability of such projects is the terms on which the necessary finance can be obtained from the capital market. Commercial finance is almost always obtainable, but on conditions of varying severity. Even the most radical solutions that the institutions of the capital market devise in cases of industrial failure — solutions such as takeover, reorganization or even receivership and liquidation — are instruments of adjustment. They are essentially accounting operations involving a correction of book values; their purpose is to secure better management for socially-valuable real assets.[2] They all begin to operate on the perception of a discrepancy between the book value, or actual market value, and the *potential* market value of the enterprise in difficulty. Takeover incentive is provided by the realization that the present management is not getting out of the existing assets all that they are capable of yielding. There is a continuum between less-than-maximum profits and actual losses. When there are large losses and debts there is no longer an incentive for a takeover. The alert entrepeneur, perceiving the higher earnings potential of the assets in question, may discuss a 'consolidation' with the main parties involved, this being a form of privately-agreed bankruptcy. Otherwise, he will wait until after bankruptcy proceedings, assuming control of the assets only after they have been purged of debt.

Government-sponsored financial salvage schemes to avert bankruptcy (provision of capital, credit guarantees) have two effects, both undesirable.

First, they generally serve to sustain the existing management under whose stewardship the crisis occurred. Government finance will always be preferred by the management to the otherwise available private finance, because the conditions and supervision entailed in the latter would be more stringent.

Second, the injections of general taxpayers money serve to reduce the losses of those private investors who hold the equity of the enterprise. By contrast, when a salvage plan is devised by the financial institutions of the market, the risks are, properly, borne by the holders of equity.

Another important difference between the 'salvage plans' of government and the market is that the latter will always be self-terminating. Financial institutions know the point at which they must cut their losses, and stop throwing good money after bad, whereas the government will generally continue to do so far beyond this point. Being aware that it embodies social authority, government finds it difficult to admit mistakes. It may need an acute political crisis to be able to cut off its support to lame ducks.

Finally, assistance to the 'growth sectors' or 'sunrise industries' could be the most counter-productive of all. The firms through which industrial progress is unfolding do not need public assistance. They can obtain from private sources all the capital they can handle. Offering them more capital at subsidized rates of interest is not only unnecessary, it could actually be harmful. This is an area of enterprise where the failure rate is inevitably (and necessarily) very high. Public assistance to such firms — socialization of risk — would give them an incentive to take risks that would otherwise not be taken. Premature expansion of such firms would entail a dilution of their main asset, management capacity.

Rent Seeking

A second important way in which transfers create cost is through the diversion of resources (especially managerial expertise) from productive activities to lobbying government.

This activity is perfectly rational for profit-seeking enterprises operating in an institutional environment which includes the possibility of government assistance. The 'investment' in lobbying will continue to the point where its expected returns have declined to the level derivable from alternative activities. From a firm's point of view, it makes no difference from which source its profits flow, as long as they are maximized in aggregate. From society's viewpoint, however, it matters a great deal, for lobbying activity, by contrast to the alternative uses to which the firm's resources may be put, generates no social product. It has to do with the distribution of national income, not with its creation. To distinguish it from other, productive, forms of profit-making activity, lobbying has been called *rent seeking*, which has been described as 'behaviour in institutional settings where individual efforts to maximize value generate social waste rather than social surplus'.[3]

The rising importance of rent-seeking activity to the private sector is demonstrated by the shift in the composition of managerial staff of even relatively small corporations from people with technical skills relevant to the industry in question in favour of lawyers.[4] It is also apparent in the many industry associations and in the growth of small consultancy businesses, the activities of which are entirely concerned with lobbying (preparation of submissions for their clients as well as more discreet ways of influencing the political decision-making process).

The cost to a society of rent-seeking depends on how easy it is to obtain government assistance. At one extreme, one can imagine a country with a constitutional prohibition on selective public assistance to industry interests. In such a country there would be no resources wasted in lobbying government. The return on any such use of resources would be known to be zero. Once there is the possibility of government intervention, however, the amount of rent-seeking will be determined by expectations, which will in turn be largely based on the actual policy experience. For example, in another country, assistance may have been given only in

precisely-specified situations, following an exhaustive legislative discussion and majority agreement about its objects and means. In these circumstances, too, there would probably not be much rent-seeking, for special-interest groups would soon learn that proposals to reassign income to them at the cost of other groups would meet opposition within the legislature. The expectation of obtaining rents would be relatively low.

A third situation, corresponding more nearly to present reality, is that of a 'flexible' government approach towards selective public assistance. At certain times, the emphasis may have favoured different categories of claimant and the legislative history may have been a varied one, with a considerable degree of discretionary power being exercised by the executive. It should be clear that in this situation the probability of successful lobbying will be relatively high and many groups will have an incentive to participate. Lobbying activity will be devoted (i) to increasing the benefits to existing recipients and (ii) to extending assistance to other groups (or opposing such an extension). It will be directed both at the political process and at the administration.

The magnitude of the cost of rent-seeking will now depend on the magnitude of the expected transfers. It will also depend on how selective are those transfers. For example, a large-scale re-distribution of income effected through income tax may be very great in the aggregate, but not give rise to much lobbying activity because the groups involved are too large to form an effective coalition.[5] When the size of the group, though, is such that the expected cost or benefit per member of the group becomes quite large, members will be more likely to form a coalition for lobbying purposes or even to lobby individually.

It could be argued that the very inactivity of the large, unorganized groups of taxpayers and consumers bearing the burden of industrial support would reduce the need for much lobbying effort by the industry concerned. But the competition is generally not between those who pay for, and those who receive, the transfers; it is mostly among those on the 'demand'