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Recession, International Trade and the Fallacies of Composition

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A truly global recession has not been manifest since the Great Depression of the 1930s. As a result, the multilateral institutions put in place at the end of the Second World War to ensure that a major depression *never happened again* have not been tested. One of the lessons of the Great Depression was that governments had a major role to play in managing the economy. The use of subsidies to affect economic outcomes was one manifestation of this expanded role. In a recession, sector specific subsidies will likely be requested by firms. Subsidies can distort trade, leading to the potential for *beggar thy neighbour* subsidy wars. Subsidies will be difficult to discipline in a global recession.

Keywords: beggar thy neighbour, deficits, paradox of thrift, recession, subsidies

Fallacy of composition: a fallacy in which what is true in part is, on that account alone, alleged to be true of the whole.

Paul Samuelson, *Economics*, 1966¹

During the 1928 election campaign, Republican presidential candidate Herbert Hoover pledged to help the beleaguered farmer by, among other things, raising tariff levels on agricultural products. But once the tariff schedule revision process got started, it proved impossible to stop. Calls for increased protection flooded in from industrial sector special interest groups and soon a bill meant to provide relief for farmers became a means to raise tariffs in all sectors of the economy. When the dust had settled, Congress had produced a piece of legislation, the Tariff Act of 1930, more commonly known as the Smoot-Hawley tariff

Scholars disagree over the extent of protection actually afforded by the Smoot-Hawley tariff; they also differ over the issue of whether the tariff provoked a wave of foreign retaliation that plunged the world deeper into the Great Depression. What is certain, however, is that Smoot-Hawley did nothing to foster cooperation among nations in either the economic or political realm during a perilous era in international relations. It quickly became a symbol of the “beggar-thy-neighbor” policies of the 1930s. Such policies, which were adopted by many countries during this time, contributed to a drastic contraction of international trade. For example, U.S. imports from Europe declined from a 1929 high of \$1,334 million to just \$390 million in 1932, while U.S. exports to Europe fell from \$2,341 million in 1929 to \$784 million in 1932. Overall, world trade declined by some 66% between 1929 and 1934.

U.S. Department of State²

The most famous fallacy of composition in economics is the paradox of thrift, which comes to the fore when economies face significant downturns. If bad economic news begins to have a widespread influence on the psychology of consumers – their expectations regarding their future economic security turn markedly negative – then they will look for ways to reduce or delay their expenditures. This perfectly rational behaviour of individuals leads to a slackening of demand in the economy that leads to layoffs of employees and a consequent further reduction in consumer confidence. Further spending cuts follow, precipitating a downward recessionary spiral. According to Samuelson and Scott (1966),

An increase in thriftiness ... in time of depression ... could make the depression worse This surprising result is sometimes called the “paradox of thrift”. It is a paradox because most of us were taught that thrift is *always* a good thing

In economics we must always be on guard against the logical fallacy of composition. What is good for each person separately need not always be good for all; under some circumstances, private prudence may be social folly.

Under conditions of unemployment, the *attempt to save* may result in *less* not more saving. The individual who saves cuts down on his consumption. He passes on less purchasing power than before; therefore someone else's income is reduced, for one man's outgo is another man's income.

The result will all too likely be ... a worsening of the vicious deflationary spiral (pp. 252-254).

It is the *paradox of thrift* that governments must grapple with in major recessions, because consumer spending typically accounts for approximately 75 percent of GDP. Restoring consumer confidence requires augmentation of demand through government activity – and normally governments are limited to deficit-financed direct spending. Governments have three major mechanisms to stimulate demand: (1) lowering interest rates through the central bank, (2) tax cuts and (3) government expenditure. Unfortunately, the first two mechanisms' effects are muted in a recession. Consumers worried about their jobs are not likely to borrow to finance consumption – particularly big-ticket items such as houses or cars – even if interest rates fall. Further, if prices have been stable or the economy has been going through mild deflation, interest rates are likely to be low, so there may not be much room to cut rates.

Tax cuts, particularly cuts to income tax, while leaving consumers with more discretionary income, do not necessarily lead to increases in demand. This is because consumers do have discretion and often save or buy down their debt rather than make new expenditures. Thus, to offset the effects of the *paradox of thrift* in the short run governments need to get money into the hands of those who will spend rather than save it – those who are unlikely to save, such as the unemployed and those with lower incomes – and in the longer run to finance expenditure on infrastructure.³ These increased expenditures will likely result in government deficits.⁴ While there have been economic downturns over the sixty-odd years since an international set of rules for trade was put in place with the General Agreement on Tariffs and Trade (GATT) in 1947, a major sustained recession – or depression – has not occurred in modern market economies.⁵ Thus, the robustness in resisting protectionist pressures has never

been seriously tested. How would the current international trade architecture “stand up” to a sustained economic downturn?

In the past, recessions have led to increasing pressure on governments to provide protection from imports. Of course, one industry asking for protection is like one consumer “tightening their belt” in the face of concern about their economic future – it is a rational thing to do. Widespread provision of protection in a recession, however, suffers from the same “fallacy of composition” problem that underlies the *paradox of thrift* in consumer behaviour. It is at the heart of *beggar thy neighbour*–based trade retaliations. According to Pomfret (1991),

An extreme case of producer-biased trade policy-making was the US Congress in 1929-30. In a situation in which each congressman supported protection for some import-competing activity, each was prepared to vote for others’ proposals in return for their vote on his own proposals, and nobody stood for the general interest, the special interests carried all before them. The Smoot-Hawley tariff of 1930 took US tariff barriers to record heights, as almost every group that requested protection was granted it. Over a thousand economists signed a letter requesting Congress to think twice before passing the tariff bill, but their advice was ignored.

Because it was so extreme, the 1930 US tariff carried the seeds of its own destruction. Very quickly America’s trading partners retaliated by raising their own trade barriers, or taking specific measures against US exports (for example, through public procurement decisions). It was soon recognized that the Smoot-Hawley tariff exacerbated rather than eased the economic depression (p. 164).

Of course, in recessions, isolating domestic markets from competition looks like a *cheap option* for augmenting domestic demand – consumers will have nowhere else to go except domestic producers. It looks like the costs of the recession are pushed onto foreigners instead of (future) domestic taxpayers. Even without retaliation, however, the income of negatively impacted foreign producers will fall, leading to a decline in demand in their country; part of this decline will fall on their imports. Given the inherent balance in the international trade and financial system, any short-term advantage gained from protectionism will be offset elsewhere. Direct retaliation through the erection of trade barriers only adds further distortions. Once trade barriers are erected, they are difficult to remove politically as the long battle to lower industrial tariffs in the GATT attests.⁶ The benefits to liberalization have, of course, been considerable. For example, Alan Greenspan (2007) suggests that

The cumulative effect of globalization since the end of World War II has added 10 percent to the level of GDP of the United States. Shutting our doors to trade would bring the American standard of living down by that

percentage. By comparison, the hugely painful retrenchment in real GDP from the third quarter of 1981 to the third quarter of 1982 was only 1.4 percent. Those who say it is better that fewer people experience the stress of globalization even if it means that some people are less wealthy are creating a false choice (p. 396).

In a recession, the proportion of GDP lost through the erection of trade barriers would likely be commensurately greater.

While the appeal of trade barriers for firms in struggling industries and the politicians who could supply barriers is likely to remain in future recessions, the institutional environment under which international trade is conducted is not that of the 1920s and 1930s. The international institutions put in place by those who vowed that a Great Depression would *never happen again* have been expanded upon. Members of the World Trade Organization have made international commitments to *bind* their tariffs so that they cannot be increased in the future. Hence, responding to requests for protection during a recession is no longer an unfettered policy option as it was during the Great Depression.⁷

The economies of the world are much more integrated than they were prior to the Great Depression. The use of the term *globalization* itself implies a recognition of the interdependence among markets. As a result, requests for protectionist barriers to market access may be considerably muted relative to previous economic downturns.

A lessening of requests for the imposition of, or for increases in, barriers to market access does not mean that firms will be reluctant to request assistance from their governments. Another major difference between the economy of the 1930s and that of today is the changed perception of the role of government. In the early 1930s governments were expected to play only a minor role in the economy. One of the few economic tools at their disposal was the erection of barriers to market access. The change in economic thinking that was spurred by the Great Depression, and in particular the influential work of John Maynard Keynes, envisioned a proactive role for government in the management of aggregate demand. Once an expanded role for government in the economy was accepted, the activities of government expanded rapidly into a vast array of industrial and social policies.⁸ The move into industrial policy led to a general acceptance of subsidization of firms as a policy option for governments. Although it has been widely criticized, governments “picking winners” and subsidizing them has become a central element of government policy in almost all modern market economies. In economic downturns this translates into *bailouts* of struggling firms.

Sector specific subsidies, however, distort trade (Gaisford, Kerr and Perdikis, 2003). Of course, the WTO has disciplines on the use of sector specific subsidies but, as yet, they have not been acknowledged as a constraint to government responses to a recession in the same way as have commitments on limiting barriers to market access.

For example, a bailout of firms in the automobile sector in one country keeps those firms in business and producing subsidized cars in competition with imported cars. This reduces demand for imported cars. The effect on international trade in automobiles is similar to the imposition of a tariff.⁹ Further, countries may decide to provide more broadly based subsidies to, for example, all firms in their export sectors. Eventually, these *beggar thy neighbour* subsidies may well invoke counteracting, sector specific subsidies as retaliation.

The process of determining which firms to subsidize in an economic downturn is no different from that which underlies the erection of barriers to market access. The selection of those firms or industries that are worth saving during a recession is, in essence, a process of picking winners. It is subject to difficulties similar to the difficulties encountered in picking winners as part of an industrial strategy.¹⁰

In a recession, there are three potential reasons why firms may be failing: (1) declining demand due to the recession, (2) deteriorating international competitiveness¹¹ and (3) poor management. A prudent government would not wish to extend protection in the case of the latter two reasons. Of course, all three factors may be at work in firms or sectors. In any case, it will be very difficult for governments to establish which factors are actually causing the firm(s) to fail. In periods when government resources are badly stretched, supporting relatively inefficient or badly managed firms seems particularly wasteful. Propping up badly managed firms penalizes well managed firms who would benefit from the exit of the poorly managed firms – which seems particularly perverse. Yet, badly managed or internationally uncompetitive firms may be the ones to first appear distressed. As is normal with requests for protection, these firms are likely to be the most active in lobbying their governments.

There is, of course, a major difference between the widespread imposition of *beggar thy neighbour* barriers to market access and putting in place widespread *beggar thy neighbour* sector specific subsidies. As suggested above, from the political perspective, barriers to market access appear to be a *cheap* policy option – they don't require a budgetary outlay.¹² To the extent that governments worry about deficits, the range of sectors covered if a government chooses to put subsidies in place and the degree of support selected sectors receive may be constrained. It may be that initial subsidies may not be particularly constrained by budgetary concerns but if, as with

barriers to market access in the Great Depression, a *beggar thy neighbour* retaliation in the form of a subsidy war ensues – and the fallacy of composition becomes evident because the expenditures achieve little – budgetary worries may come to the fore.

Dismantling a spate of retaliatory subsidies will be subject to a set of pressures somewhat different from those associated with the dismantling of Great Depression-era barriers to market access that has engaged the GATT/WTO since 1947. Firms receiving protection, whether market access-based or subsidy-based, can be expected to lobby hard to retain it. Unlike barriers to market access, however, subsidies present policy makers with budgetary expenditures they may want to reduce. On the other hand, barriers to market access are perceived as being in the purview of trade policy; subsidies are by contrast often seen as domestic policy prerogatives, and sovereignty concerns may well play into the political dynamic associated with their abandonment. Being seen as *giving in to foreign pressure* may be politically difficult in the case of subsidies.

The major institutional mechanism in the WTO for disciplining subsidies is countervailing duties. The domestic institutions used to determine if *unfair* subsidization is taking place, and whether or not those subsidies deemed unfair are causing injury, are both cumbersome and costly to countries that initiate cases. They were not intended, or designed, for use in situations where the use of sector specific subsidies is widespread, as may be the case in a worldwide recession. One can certainly expect an increase in the number of countervailing duty cases being brought forward in various countries, but the number of cases accepted will be limited by the resources allocated to domestic institutions that can undertake investigations.¹³ One suspects that any substantive relief from trade distorting subsidies will have to await multilateral negotiations.

The subsidy negotiations in agriculture, which have been ongoing since the start of the Uruguay Round, may provide some insights into the process of multilateral subsidy reductions. There are likely benefits available from negotiating a cooperative solution for subsidy reductions (Gaisford and Kerr, 2003) and, in fact, the Uruguay Round produced a solution that effectively stopped the *beggar thy neighbour* subsidy war between the European Union and the United States. Reducing or eliminating the existing subsidies has, however, proved much more difficult in the Doha Round. There are limits to what a cooperative solution can achieve (Gaisford and Kerr, 2003), and there simply may not be any *low hanging fruit* remaining (Kerr, 2000). While it may appear that the Doha negotiations, if an agreement is achieved, will have some achievements in the area of subsidies, the reality is that there will be few or no meaningful reductions. The draft modalities on the table in the fall of 2008 provide for

the elimination of export subsidies, more stringent limits on the *amber box* subsidies and a cap on *blue box* expenditures – but whether these provisions will act as truly binding constraints on domestic support for agriculture depends crucially on the details of the final agreement (Brink, 2006). Further, as there is not at this stage any constraint on *box shifting*, countries will be able to restructure their payments to fit within the criteria of the unconstrained, non-actionable *green box*. Thus, any real reductions in agricultural subsidies are only likely to arise from a domestic policy desire to reduce budgetary outlays.

The lesson that the experience with agricultural subsidies at the WTO suggests is that subsidies put in place during a recession may be with us a long time and progress on trade liberalization may be set back considerably. Policy makers need to be cognizant of, and give due consideration to, the fallacy of composition associated with widespread use of sector specific subsidies.

The institutions put in place to ensure that trade policy would contribute to ensuring that a Great Depression never happened again have not been tested by a major and widespread economic downturn. While individual countries and regions have experienced recessions since the end of the Second World War, a global recession has been avoided. If a significant worldwide recession rears its head, the approach to economic management, and in particular the role governments are expected to play in the economy, will be very different than in the 1930s. Hopefully, progress has been made in understanding how to dampen a downward recessionary spiral. The potential of fiscal stimulus to counteract the deficiency in consumer demand arising from the paradox of thrift was not understood at the start of the Great Depression. Along with the realization that government could/should have an active role in the management of the economy, however, came an acceptance of a wider presence of government in the economy. Subsidies for firms comprised one element of this expansion. In addition to active subsidisation for reasons of industrial policy, bailouts of struggling firms became more acceptable. Subsidies for failing firms can distort trade. While the trade distorting effects of subsidies are recognized in the WTO, the commingling of domestic policy and trade policy associated with sector specific subsidies makes it politically difficult to discipline the use of subsidies for trade policy reasons. Thus, the multilateral trade policy institutions are unlikely to operate as envisioned by their founders. Unless policy makers come to recognize the fallacy of composition that underlies the granting of sector specific subsidies, these subsidies are likely to contribute to economic malaise during a global recession.

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Endnotes

1. This quotation is actually taken from the First Canadian Edition of Paul Samuelson's famous introductory text on economics for first-year university students, which was co-written with Anthony Scott (Samuelson and Scott, 1966, p. 11).
2. U.S. Department of State (n.d.)
3. Infrastructure projects normally have long lead times – 18 months or longer – and thus are not useful for counteracting falling consumer confidence at the beginning of a recessionary spiral.
4. Deficits are likely to be the result in any case. If the government does not act to stimulate demand, tax revenues will decline, leading to a deficit. A stimulus-based deficit will leave the economy in much better shape than will a tax-decline deficit. Of course, in a recession, governments must resist the urge to “belt tighten” as tax revenues fall, because cuts in government expenditures lead to less demand in the economy (and less tax revenue), contributing to the downward spiral.

5. Sometimes there are benefits to being in the “greying” quartile of the economics profession. As I watch governments and central banks (and their economists) attempts to deal with the growing economic crisis in the fall of 2008, I am struck by their *struggle* to embrace fiscal policy stimulus and deficits. That is why I chose to quote from Paul Samuelson and Anthony Scott’s 1966 introductory economics text – it is the one I used in my principles of economics course as a student. While, despite the perception of my current students that I have characteristics akin to a dinosaur, I am not old enough to remember the Great Depression, I am old enough to have been taught by economists who did. In fact, they were obsessed with ensuring that it never happened again. They had thought very deeply about it and they drummed their prescriptions into their students. I distinctly remember, however, wondering what it had to do with me. In the latter part of the 1960s when I was an undergraduate the global economy had already experienced more than 20 years of relatively steady growth and governments seemed to be able to keep the economy on a relatively even keel. My professors kept hammering away at the *paradox of thrift*, consumer confidence, recessionary spirals and deficit financing. Given the focus of academics of the time, it is probably no wonder that economists were so ill-equipped intellectually to deal with the persistent inflation that arose as the next major macroeconomic problem. Of course, the *inflation* stimulated a great deal of new thinking in macroeconomics that emphasised monetary policy and dismissed fiscal policy – and along with it deficit financing. Eventually the inflationary demon was brought under control but it apparently remains, even in the 2008 crisis, the main demon in the minds of non-grey economists. In some cases, however, it appears that policies that are clearly inappropriate when inflation is the problem – fiscal stimulus and deficit financing – have themselves become demons for those trained in the last twenty-odd years. While “populist” politicians have been quick to accept the need for government “stimulus” packages, others have found it more difficult to put their demons behind them in the changing economic circumstances.
6. The battle has been even more difficult in agriculture, where long-standing barriers to market access have remained largely intact or have even increased.
7. Given the flaws in the current antidumping mechanisms (Kerr, 2006) one can, however, expect an increase in antidumping cases during a prolonged recession.
8. A far greater role than that envisioned by Keynes.
9. In the case of a bailout of General Motors, Ford and Chrysler, there will be a negative effect on foreign-owned automobile operators such as Toyota that have production facilities in the United States. In effect, such a bailout is a penalty on efficient automobile manufacturers in the United States to the benefit of inefficient producers.
10. See Davies and Kerr (1997) for a discussion of the problems associated with picking winners.
11. The effects of which may be accelerated during an economic slowdown.
12. The costs are imposed on consumers through higher prices.

13. In the Uruguay Round Agreement on Agriculture a so-called Peace Clause was agreed, which provided for a temporary moratorium on the use of countervail measures.

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