

THE AUSTRALIAN INDUSTRY POLICY DEBATE: A CRITICAL EVALUATION OF THE INDUSTRY COMMISSION'S POLICY RECOMMENDATIONS¹

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The formulation of macroeconomic policy in Australia during recent years has been "constrained" by the existence of persistent current account deficits and the resulting accumulation of foreign debt. In spite of the implementation of tight fiscal, monetary and wages policies to curtail the demand for imports, however it is now generally understood that Australia's trading problems are a reflection of long term and deep seated structural weaknesses in the economy, weaknesses which have been exposed during the past decade as a result of increased global interdependencies in both commodity and financial markets. It is in the context of the need to achieve long term structural changes in the Australian economy that industry policy has been formulated and needs to be evaluated.

The purpose of industry policy is to achieve long term changes in the structure and orientation of production in an economy. In the case of a small open economy such as Australia, such policies are necessarily closely linked to international trade policies. The precise role of the government in the process of the achievement of structural change is the subject of much debate. It is possible to divide the industry policy debate protagonists into two groups. On the one hand there are those

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who argue that meaningful and sustainable structural adjustment is best achieved through the operation of market forces, therefore disputing the utility of an interventionist industry policy and instead calling for the freeing up of the market and the achievement of a 'level playing field'. In the context of the Australian industry policy debate, such an approach can be most clearly identified with the Industry Commission (IC), and is consistent with the recommendations emerging from the commissioned Garnaut (1989) and Hughes (1989) Reports, as well as the preferred strategies emanating from overseas institutions such as the World Bank and OECD in particular. On the other hand it is argued that there is an important role for government to complement or even replace market forces through specific sectoral planning and assistance packages. This alternative strategy, referred to here as the 'Managed Industry Policy' approach finds some support within the ACTU² and was accorded an important role in the recently completed Pappas Report (1990) commissioned by the Australian Manufacturing Council.

It is argued here that the approach to industry policy recommended by the IC is incapable of providing a solution to the structural difficulties confronting the Australian economy. The case against the IC's approach to industry policy is based on an examination of the economic content of the arguments presented in its official publications. This is not to suggest that the industry policy debate will be resolved through rational argument and a demonstration of the inadequacy of the theoretical views of the IC and its supporters. Such a belief would overlook the important political values which play such a significant role in shaping policy recommendations. Nevertheless, a critical assessment of the economic arguments which have been presented in support of the market-based approach is essential to the promotion of the alternative managed industry policy path.

A brief overview of the nature of the structural difficulties confronting the Australian economy is presented in Section II. The basis of the IC

2 See for example ACTU (1990). The ACTU has recently called for industry assistance in the form of "fast tracking" and tax concessions for industry. However under the leadership of Simon Crean and Bill Kelty, the industry policy component of the Accord has been somewhat neglected by the ACTU.

approach to industry policy is summarised in Section III, with a critical evaluation of its central propositions following in Section IV. The alternative managed (interventionist) industry policy stance is briefly stated in Section V, and a restatement of the paper's major conclusions is contained in the final section.

The Australian Economy: Structural Weaknesses

The structure of production in the Australian economy can be observed by looking at the composition of gross industry product³. The period of the Hawke Labor Government (1983-91) has not been characterised by dramatic changes in the structure of production (Table 1). A slight decline in the relative importance of manufacturing, represents the continuation of a process which has been occurring in recent decades. As a recent OECD (1989a) study has highlighted, during the 1970s and 1980s manufacturing has declined relative to services in all OECD countries, although the extent of this trend varies significantly between countries and has tended to weaken recently in countries such as Canada, West Germany and Japan. This trend arises partially as a result of a shift towards services as real incomes rise through time, and may also result partially from a decline in the relative prices of manufactured goods. It is also important to note that with the increasing sophistication of products and the continuing tendency to contract out operations activities such as maintenance, information management and research and development previously carried out in-house, the distinction between manufactures and services is becoming increasingly blurred. The decline in the share of agriculture in gross industry product since the 1960s is also consistent with the experiences of many OECD countries.

3 Gross industry product is equal to GDP (market prices) less the imputed value of income associated with ownership of dwellings and revenue from import duties, plus an imputed bank service charge.

Table 1: The Composition of Gross Industry Product (GIP), 1962-89

	% of GIP 1962-63	1982-83	1988-89
Agriculture	11.7	3.72	4.57
Mining	1.61	6.63	4.48
Manufacturing	27.31	19.56	18.31
Utilities	3.35	3.89	3.49
Construction	8.48	7.96	7.82
Services	47.57	58.24	61.32

Source: Derived from ABS (1990, Tables 15 & 73).

Table 2: Export Orientation of Industrial Market Economies, 1965-85

	Exports as % of GDP		% of Total Exports (Volume)			
			Manufactures		Services	
	1965	1986	1975	1985	1975	1985
U.S.A*	6	11	61	57	19	18
Japan	11	13	85	88	13	11
West Germany	19	33	74	76	16	15
France	13	22	53	54	29	27
U.K.	18	23	60	53	29	23
Italy	13	18	63	69	14	16
Canada	19	26	43	55	12	9
Australia	15	17	16	18	18	16
Netherlands	43	55	37	44	18	19
Belgium	36	68	68	63	16	20
Sweden	22	32	68	67	18	18
Switzerland	29	36	74	73	22	23
Austria	25	37	51	58	21	20
Denmark	29	32	38	42	29	23
Norway	41	36	36	26	41	25
Finland	20	25	73	66	11	15
Average	22.4	30.2	56.2	56.8	20.4	18.6

* Countries are ranked according to 1986 GDP levels. Source: World Bank (1990, Table 9), OECD (1989a, Table 4.6).

Whereas the broad structure of production in the Australian economy is not dissimilar to other industrialised western countries, its export orientation and composition depart radically from most of the OECD nations with similar per capita incomes. In the case of the sixteen leading industrial economies, manufactures on average account for just over 56 percent of total exports (Table 2). However in the case of Australia manufactured goods contribute only 18 percent of total exports. Almost 80 percent of Australia's merchandise trade is made up of primary products, a ratio comparable to middle income developing economies such as Argentina, Brazil and Mexico, with 77, 60 and 70 percent respectively⁴.

The atypical nature of the composition of Australia's exports is further illustrated in Table 3.

Table 3: Australia's Comparative Export Pattern*

	1970-72	1977-79	1984-86
Natural Resource Intensive	3.35	3.30	3.51
Labour Intensive	0.52	0.52	0.63
Scale Intensive	0.50	0.58	0.58
Differentiated Goods	0.22	0.22	0.18
High Technology	0.29	0.44	0.38

*The OECD countries included in the sample are; United States, Japan, West Germany, France, United Kingdom, Italy, Canada, Australia, Belgium, Finland, Netherlands, Norway, Sweden.

Source: OECD (1989a, Table 4.9).

4 World Bank (1988:244-45). It is interesting to note that between 1965 and 1986 the primary products percentage of merchandise exports in Spain fell from 60 to 28 percent.

Each entry in Table 3 represents the share of product type i in Australia's exports relative to its share in total exports in the OECD nations included in the sample. Once again, Australia's emphasis on natural resource based exports is highlighted with Australia's relative export intensity value of 3.51 followed amongst the sample countries by Finland with a value of 2.55 (down from a value of 2.97 for 1970-72). Also important are the particularly low export intensities occurring in the case of differentiated high-technology commodities where scale economies are important. Australia's relative export intensity values for these categories have changed very little over the sample time period and are significantly lower than is the case for smaller economies such as Sweden, Finland and Norway. The extremely low relative export intensity for differentiated goods is particularly significant, as the intra-industry trade between countries associated with such goods represents the fastest growing area of international trade during recent decades.

Australia's trade in elaborately transformed manufactures (ETMs) contributes only about 10 per cent of exports in Australia's case, whereas ETMs account for between 40 and 60 per cent of exports for most industrialised western economies. Indeed, over 70 per cent of what are classified as manufactured exports are actually semi-processed raw materials. Australia continues to export most of its raw materials in their crude form. In the aluminium industry, for example, only about 11 per cent of bauxite and alumina is smelted into aluminium metal, despite large reserves of the suitable energy resources for this energy-intensive transformation. It has been estimated that almost \$A10 billion would be added to Australia's export earnings if the basic ores were converted to aluminium metal before export (Pappas Report, 1990:9-10).

The difficulties associated with Australia's export composition are clearly illustrated in the most recent medium term stabilisation scenario undertaken by the OECD, where the target was to stabilise the foreign debt ratio to 36 per cent of GDP by 1994:

if the figures in the illustrative scenario are to be attained, exports of goods and services would need to rise by a little over 7 per cent per year. If the rise in natural resources and farm

exports can be assumed to be considerably less rapid than this, manufacturing and service exports would have to grow on average by around 10 per cent. (OECD, 1990, p.38)⁵

It is apparent that the current composition of Australian export production is not consistent with the goal of achieving stabilisation of Australia's foreign debt given that present living standards and associated consumption patterns are to be maintained⁶. The major challenge confronting the Australian economy is therefore to increase the export income generated from its production of manufactures. Central to the achievement of this goal is the role of industry policy as a means of reducing Australia's dependence on commodity exports which are subject to declining terms of trade and a falling share of international trade.

The Industry Commission View on Industry Policy

The economic thinking underlying the IC approach is clearly stated in its 1990 Annual Report;

For much of our history, governments have deliberately distorted the incentives that the market place would otherwise provide to large sections of the economy. Decision makers in both the private and public sectors have been given a misleading picture of what consumers and using industries were truly willing to pay for the goods and services they produce. For example, once government formed a vision that Australia needed a diversified and sizeable manufacturing sector, the

5 These estimates are based on some rather optimistic assumptions, such as world output growing at 3 percent and no change in Australia's terms of trade. The less optimistic view on natural resource and farm export growth is based on Australian Bureau of Agricultural and Resource Economics (1989) projections.

6 It has been argued that the current account deficit is in fact the consequence of capital inflows generated by 'excessive' corporate borrowing. Importantly, the capital inflows associated with the current account deficits have to a significant extent been used to finance the transfer of asset ownership. These capital inflows have added to Australia's debt servicing difficulties and served to reinforce the deep seated structural problems outlined above.

normal market incentives were set aside. Tariff and other assistance was provided to enable local producers to gain market share against imports. Through protection from foreign competition and the establishment and tolerance of public and private monopolies, governments have blunted the rewards and disciplines that competition provides. (IC, 1990:9)

The IC's strategy for improved economic performance in Australia involves the removal of "distortions" which hinder the operation of "market forces". It is envisaged that this will be achieved by policies such as microeconomic reform ("structural adjustment policies") and the abolition of assistance to producers. In addition the IC supports the existence of a role for government in fostering greater competition in world markets. Such policies, it is argued, will lead to significant productivity gains and enhanced international competitiveness. It is also argued by the IC that such policy initiatives would result in trade flows which would more closely reflect Australia's true comparative advantage, with internationally competitive producers being unburdened of assistance measures directed to 'less efficient' producers.

In its Annual Report the IC (1990:27-33) has estimated the effects of its recommended package of microeconomic reforms and abolition of assistance on key macroeconomic variables and sectoral outputs (Table 4). These estimates are based on simulation results derived from the multisectoral ORANI model.



TABLE 4: IC SIMULATED LONG-RUN MICROECONOMIC REFORM GAINS*

Variable	Removal of Assistance	Other Reforms	Total
<i>Macroeconomic variables</i>			
Real GDP	1.1	5.4	6.5
CPI	-3.8	-3.4	-7.2
Export volume	8.6	9.0	17.6
Import volume	6.2	5.4	11.6
Balance of Trade	<0.05	0.5	0.4
<i>Sectoral outputs</i>			
Agriculture	1.3	1.5	2.8
Mining	11.5	21.1	32.6
Manufacturing	-1.0	3.7	2.7
Services	0.9	3.5	4.4

* All results are expressed in percentage changes, except for the balance of trade which is expressed in percentage points worth of base-period GDP.

Source: IC (1990:33).

According to the IC simulation of the proposed microeconomic reforms, real GDP in the 'long run' would be 6.5 percent higher than otherwise, or \$22 billion in 1988-9 dollars⁷. The CPI would be 6.3 percent lower than otherwise. The estimates suggest that the abolition of assistance would increase real GDP by approximately \$3.7 billion, (17 percent of the overall increase), while also contributing over 50 percent of the lower CPI figure. The "long-run" is defined as the time by which the

7 The estimated "long-term gains" from such reforms were as follows; Transport: \$10.7 billion, with reforms in domestic shipping, liner shipping, commodity handling, rail transport, domestic aviation. Post and Telecommunications: \$1.7 billion. Electricity Supply: \$1.4 billion. Contracting Out: \$3.4 billion, (by government to the private sector of certain services and inputs). Water Services: \$1 billion. Removal of Rural and Manufacturing Assistance: \$3.7 billion. Full details can be found in IAC (1989) and IC (1990).

economy has "fully adjusted" to the specified economic shocks, a period which the Commission has argued "could be up to 10 years" (IAC, 1989:14).

According to the IC simulations, the major contribution which the removal of assistance makes to GDP performance is through access to cheaper inputs for the mining and agriculture sectors. Of the projected increased export volume, 49 percent is attributed to the removal of assistance. However the removal of assistance also contributed 53 percent of the simulated 11.6 percent increase in import volumes. Significantly it is the mining sector which is projected to benefit most from the proposed reforms. The IC explains these results as arising because "few reforms impose direct costs on this sector", while it is more able to take advantage of the cheaper inputs costs said to rise because of reductions in assistance than is agriculture, which is "constrained by available resources such as arable land" (1990:32). Importantly, the 'benefit' to be derived from the microeconomic reforms package can be seen primarily to bolster Australia's traditional export sectors. At a disaggregated level the TCF, motor vehicle, and miscellaneous manufacturing industries are the only industries to suffer "significant long-term declines". However the magnitude of these projected declines is not reported in the IC's conclusions.

The Industry Commission Package: A Critical Evaluation

Three key elements of the IC proposals deserve scrutiny. The first relates to the methodology upon which the IC simulation analysis is based. The second to the capacity for the IC proposals to deliver sustainable current account improvements. Thirdly, the theoretical validity of the IC's criticisms of the alternative managed industry policy strategies is examined.

The IC Simulations.

Regrettably, meaningful discussion of the methodological framework upon which its estimates are based is not provided by the IC. In an earlier version of its simulation exercise, the IAC (1989:19) noted that its estimates were based on "information collected by the Commission for its inquiry work and drawn together using the ORANI model". Notably absent is any detailed discussion of the nature and sensitivity of the assumptions underlying the choice of parameter values used in this simulation exercise. Nor is there any consideration of the limitations of the ORANI model itself. By way of a footnote, the IC (1990:30) warns its readers that the "critical assumptions" underpinning the long-term nature of its projections are as follows:

- a) sufficient flexibility in industry capital stocks is assumed so that after-tax rates of return are restored in the long run (a period of about 10 years) to the values they would have had in the absence of microeconomic reform, and
- b) real wages and occupational relativities are sufficiently flexible to keep occupational employment rates constant.

These "critical assumptions" are representative of a number of similar 'neoclassical' optimising and market clearing assumptions which provide the theoretical framework for the ORANI model. The derivative demand and supply curves ensure that, given a sufficient time period, all productivity gains and related cost savings are reflected in market prices which in turn signal sectoral resource transfers. However the very nature of the responsiveness of prices to demand

conditions has been challenged by macroeconomic studies which instead suggest that non market-clearing behaviour is the norm.⁸

The real macroeconomic gains to be derived from the projected structural changes are uncertain in the absence of the assumed price flexibility and clarity of market signals. In addition, the notion of non-market clearing behaviour introduces the important question of the time dimension employed in simulations utilising an ORANI type framework. The ORANI model is a 'single period'⁹, or 'timeless' model, with the IC suggestion of ten year adjustment period representing a purely arbitrary presumption. It is probable that the projected gains (if forthcoming!) would occur over a much longer time than the IC is willing to concede. This would highlight the importance of considering the nature of the adjustment process itself, both in terms of the 'short-run' ('temporary'?) effects on the balance of trade and foreign debt ratios, as well as the dependence of the 'long-term' outcomes on the adjustment process itself. The Commission's admission that "the results also abstract from adjustment costs that may be incurred as the economy moves to its new structure" therefore underlines a very significant limitation of the analysis it is presenting. Similarly the IC has failed to address the serious limitations of ORANI when "market imperfections" are encountered. As Powell (1985:51) conceded the "absence of scale economies and/or non-competitive market structures is an area of weakness in ORANI". It is these "imperfections" which characterise the market structures which the IC claims to be analysing.

Clearly, considerable methodological problems arise in the type of analysis used by the IC to derive its projected gains from its favoured macroeconomic reform package.¹⁰ That these difficulties are not addressed by the IC severely limits its credibility. An informed debate

8 This point is discussed further by Cronin (1984) and Pagan and Shannon (1987). Similar criticisms of the methodological approach supported by the IC were expressed in the ACTU's submission to the Uhrig Report (1984) which reviewed the functions and operations of the IAC. See also Cronin's (1985) discussion in the context of "short-run" simulations using the ORANI model.

9 The importance of this limitation is highlighted by Dixon (1990).

10 Significantly, the ORANI results have not been subjected to any form of sensitivity analysis, which would further question the robustness of the estimated projections.

on the direction in which industry policy should proceed requires a more thorough analysis from the Australian Government's principle advisory body on industry policy.

The IC Reform Package: Current Account Implications

The projected increases in real GDP resulting from the proposals would, *if realised*, increase Australia's debt servicing capabilities¹¹. More important is the lack of any significant improvement in the trade balance arising from the IC supported policies. The increased export volumes are not specified for individual sectors. However it is apparent from the sectoral output effects of the policies that it is the mining and agriculture sectors which account for most of the estimated increase in export volumes. The IC simulations imply only a very limited role for manufactured exports as a consequence of the microeconomic reform programs and the elimination of assistance in the 'long run'. Indeed, given unchanged domestic consumption patterns, the simulations would be consistent with a continuation in the current trend of a deteriorating manufacturing trade balance.

The 'long run' export volume projections are primarily based on supply side gains arising from productivity increases and resulting cost savings for the primary goods sectors. These projections neglect the serious demand limitations facing Australian primary exporters. These limitations arise partly as a result of the continuing decline in the share of international trade of primary products, with this share falling from 45 percent in 1963 to 28 percent in 1987. New primary producers continue to emerge and expand from amongst the developing countries, a prime example being Brazil which has now surpassed Australia as the world's leading iron ore exporter. Moreover, world trade in agricultural products continues to be severely constrained by barriers to trade such as the Common Agricultural Policy of the EC and the United States'

11 Conflicting estimates in relation to the direction of changes in GDP in a zero assistance scenario are also available, for example the study undertaken by the National Institute of Economic and Industrial Research (1989) suggests that GDP would be 1.6 percent *lower* with zero protection.

Export Enhancement Program. Meaningful projections of increased primary sector export volumes must be therefore be accompanied with details relating to precisely how and where increased market penetration is to be achieved.

Similarly, any potential long term gains to the balance of trade from such export volume movements need also to be considered in the context of the tendency for a secular decline in the terms of trade for such commodities relative to manufactured goods (Spraos, 1980). The long term viability of adopting or encouraging such a trade strategy is surely questionable. Likewise, the potential for substantial growth in net services exports would also appear to be limited, with Australia's small surplus in travel-related services offset by growing deficits in shipping and banking and finance. The rate of growth of international trade in services is lower than that of manufacturing trade. As the Pappas Report (1990:21-22) has highlighted, Australia's relative lack of industrial scale and corporate headquarters has meant that it is a net importer of high value added services such as corporate advice.

The demand constraints outlined above imply that the long term sustainable export volume increases estimated by the IC are unlikely to be forthcoming. Consequently the relatively meagre projected trade balance improvement is called into question. Certainly the IC's (1990:70) claims that the reforms would allow the average household to raise spending by \$2300 a year "without any net adverse effects on the current account" is not substantiated and is difficult to accept. Rather a further widening current account is implied, threatening the viability of any output gains associated with the microeconomic reform packages. It is difficult to escape that reliance on a long term economic development strategy for Australia which implies a major role for commodity and services exports is not only precarious, but indeed implausible given the goal of maintaining existing living standards.

The IC's Objections to a Managed Approach to Industry Policy

In evaluating the IC's industry policy stance, a consideration of the most important arguments levelled against the Managed Industry approach is

pertinent. Support for the IC approach is often strongly linked to a critique of the alternative more interventionist industry policy strategy.

In its 1990 Annual Report, the IC has responded directly to export-orientated assistance measures recommended in the Pappas Report. While applauding the Report's support for microeconomic reforms, the IC parts company with its advocacy of additional measures to assist selected manufacturing industries. The IC argues that the Pappas Report "fails to recognise the significance of the costs these measures would impose on other industries, activities and taxpayers" (1990:15). The IC argues that the Report's recommended increased depreciation allowances for investments exceeding \$20 million in export orientated value added resource processing projects would disadvantage small firms and non-exporting industries. However, to the supporters of the managed industry policy approach the relevance of these arguments is questionable, because the purpose of the policy recommendations is to *encourage* the flow of resources into export-orientated activities where efficiency gains may be realised through the exploitation of economies of scale. If in the absence of such policies export earnings fail to increase, the costs to taxpayers would be considerable in terms of higher domestic interest rates and/or inflation, or declining living standards associated with the required domestic demand management policies.

In a similar manner the Hughes Report argues that the "economy wide impact of subsidies are rarely beneficial" as they "merely lead to a shift of production from unsubsidised to subsidised activities" (1989:37). The reference to the 'economy wide effects' of assistance introduces to the debate the important notion of apparent welfare losses associated with reductions in allocative efficiency resulting from the 'distortions' created by the assistance measures. Such an argument is often put forward as the basic theoretical economic argument against these forms of government interventions.

However the critical limitations of the neoclassical general equilibrium analysis from which these welfare implications are derived are rarely acknowledged. The analysis is based on a number of very special assumptions, few of which manage to survive once the analysis shifts

from the abstract world of the general equilibrium models to the 'real world'. In the context of their own theoretical apparatus, these general equilibrium theorists need to derive their efficiency and welfare conclusions in the rarely chartered territories of 'second best theory'. In this context the implications of 'second best theory' are worth reiterating;

there is no *a priori* way to judge as between various situations in which some of the Paretian optimum conditions are fulfilled while others not. Specifically, it is *not* true that a situation in which more, but not all, of the optimum conditions are fulfilled is necessarily, or is even likely to be, superior to a situation in which fewer are fulfilled. It follows, therefore, that in a situation in which there exists many constraints which prevent the fulfilment of the paretian optimum conditions, the removal of any one constraint may affect welfare or efficiency either by raising it, by lowering it, or by leaving it unchanged. (Lipsey and Lancaster, 1956:11-12).

The significance therefore of 'second best theory' considerations is that in a world characterised by imperfect competition, scale economies and prevailing trade barriers, negative efficiency and welfare conclusions do not automatically emerge from an appeal to the principles of neoclassical welfare economics.¹² Indeed such conclusions become even more difficult to justify theoretically when efficiency is analysed in its more appropriate dynamic setting when factors such as increasing returns to scale are considered.

It is now well recognised by most economic theorists that the existence of increasing returns (particularly those internal to the firm) offers a direct challenge to some of the most fundamental efficiency-based

12 Neary (1988) discusses these issues further, looking particularly at the efficiency and welfare implications in a world characterised by economies of scale and imperfect competition. An insight into the extent and variety of trade barriers can be found in OECD (1989a:137-40), OECD (1989b), and Pappas Report (1990:52-53). Within the manufacturing sectors, non-tariff measures remain particularly important in steel, textiles and clothing and automobile industries. See Nogues et al (1986) for details. The sharp increase in the incidence of restrictive measures at the multilateral level is outlined in OECD (1989a:146).

welfare propositions derived from standard general equilibrium analysis. Perhaps less well known is the emergence during the past decade of alternative theories of international trade in which perfect competition and the principle of comparative advantage have been replaced with theoretical structures emphasising increasing returns and the associated 'market imperfections'. The construction of such models has been complicated by the serious logical difficulties associated with modelling imperfect competition within a general equilibrium framework, however Krugman's (1987) survey of these attempts clearly indicates that once increasing returns and imperfect competition are accepted as parts of the explanation of international trade, we are existing in a 'second-best' world where government intervention can in principle improve on market outcomes. Importantly, under these circumstances 'strategic trade policy' analysis points to circumstances in which a government can raise national welfare at another country's expense by supporting its domestic firms through a policy of subsidy assistance.

As Krugman (1987:132) states, free trade "is an idea that has irretrievably lost its innocence". Such a conclusion is all the more compelling when the dynamic dimensions of the increasing returns process are recognised. Kaldor (1981), for example, drawing on Myrdal's (1957) principle of 'circular and cumulative causation', illustrates that, under a regime of 'free trade' success breeds further success and failure begets more failure. In such a setting the removal of assistance to Australian manufacturing and its exposure to 'competition' from already established manufacturing exporters would have the effect of reinforcing the weaknesses in the manufacturing sector. Furthermore, the dynamic process just outlined emphasises the *endogenous* nature of comparative advantage.

In sum, the IC approach to industry policy is lacking in theoretical support. The empirical work undertaken by the IC does little to alleviate this situation. The seemingly strong support for the 'level playing field' strategy offered by principles of economic theory becomes less apparent and more ambiguous once one ventures beyond the confines of elementary economic models. Rather, the limitations of this approach are illustrative of the dangers associated with confronting

complex economic dilemmas with simplistic underdeveloped economic analysis.

The Managed Industry Policy Approach

The supporters of a managed industry policy approach argue that government intervention and assistance to industry is required in order to restructure Australia's production to overcome the current account difficulties which threaten the economy's long term growth prospects. Specifically, assistance is required for the manufacturing sector if the current trend of an increasing trade deficit for this sector is to be reversed. It is generally agreed that such assistance needs to be predominantly export-orientated, and that ultimately it is only a more export orientated manufacturing sector which will strengthen the import competitiveness of these industries. For the reasons outlined above, grave doubts are expressed about the ability of exports from the primary goods and services sectors to offset the manufactured goods trade deficit over the long term. As previous Government initiated reports such as the Vernon Report (1965), Jackson Report (1975) and Crawford Report (1979) have argued, the key lies in increased manufactured exports.

It should be noted here that the supporters of a managed approach to industry policy are unopposed to many of the IC proposed microeconomic reform policies outlined above. This point is clearly stated by ACTU (1990:23):

In addition the Industry Commission and others are quite correct in emphasising that significant improvements on the water front, in transport, power and communications are necessary to improve Australia's export performance. What the ACTU and PCEK [Pappas Report] have argued is that these factors mentioned above are *necessary but not sufficient conditions* for the kind of export Australia requires in the 1990s and beyond. [Emphasis added].

Secondly, support for a managed industry policy approach should *not* be interpreted as support for a return to the inward looking protectionist

manufacturing policies of the past. This position is highlighted by the ACTU's (1990, p.127) statement on tariffs;

The ACTU reiterates its position that it will oppose tariff reductions unless they are part of a total package including positive industry assistance initiatives and structural adjustment assistance.

The principle underlying the managed industry policy is the recognition that comparative advantage is not a characteristic which is somehow pre-determined, but is instead a largely endogenous (conscious) process in which nations to a significant degree can *create* competitive advantage. This principle forms the basis of Porter's (1990:73) critique of traditional approaches to international trade theory:

National prosperity is created, not inherited. It does not grow out of a country's natural endowments, its labor pool, its interest rates, or its currency's value, as classical economics insists

This idea draws heavily on the notion of dynamic economies associated with 'learning by doing' and accords only a minor role to the static allocative efficiency gains claimed to arise from the removal of 'impediments' to market forces introduced by specific government interventions. The role of government is seen as initiating and reinforcing the dynamic processes associated with fundamental structural changes in an economy. In the Australian context this involves the redirection of resources into export-orientated manufacturing activities. It is a policy strategy which does not simply correspond to the government 'picking winners', but rather a policy of 'rewarding winners'.

Conclusion

The major structural problem confronting the Australian economy is the inability of its existing production patterns to generate sufficient export income to reverse the persistent current account deficit. Amongst the highly industrialised western economies Australia's reliance on primary products for the great majority of its export income is unique.

Australian manufacturing, due to a significant extent to past industry policies, is highly protected and largely inward looking resulting in a large and growing trade deficit in manufactures. The growing current account deficit represents the major constraint to the formulation of macroeconomic policies in Australia, and therefore a solution to the structural weaknesses underlying this problem must be seen as the major target of industry policy.

There exist fundamental differences in relation to the question of the appropriate industry policy strategy for Australia. On the one hand, what has been referred to as the Industry Commission view argues that the key to an improved economic performance in Australia lies in microeconomic reform policies and the eventual removal of assistance to all producers. However such policies are unlikely to provide a solution to the structural problems forming the basis of Australia's persistent current account difficulties. The alternative approach, detailed in the Pappas and ACTU (1990) Reports, calls for positive export assistance schemes for manufacturing in particular, arguing that the traditional primary sector exports together with services are not capable of producing the required improvement in the trade balance. Correctly implemented, this managed approach has the *potential* over time to reverse the deteriorating manufacturing trade balance trend. As is characterised by its March 1991 Industry Policy Statement, the current Government's industry policy has more recently been more consistent with the approach recommended by the IC, with emphasis being placed primarily on microeconomic reforms and a programmed reduction in protection¹³. Some recent statements attributable to prominent members within the current Labor Government suggest that there may be some pressures in the future to adopt some of the measures recommended by the supporters of a more managed export assistance based industry policy stance. Contrary to the IC's industry policy recommendations, such a change in policy direction would appear to be imperative.

13 The changing industry policy stance of the current Labor Government is discussed in further detail in the context of the industry policy debate in Hart and Richardson (1991).

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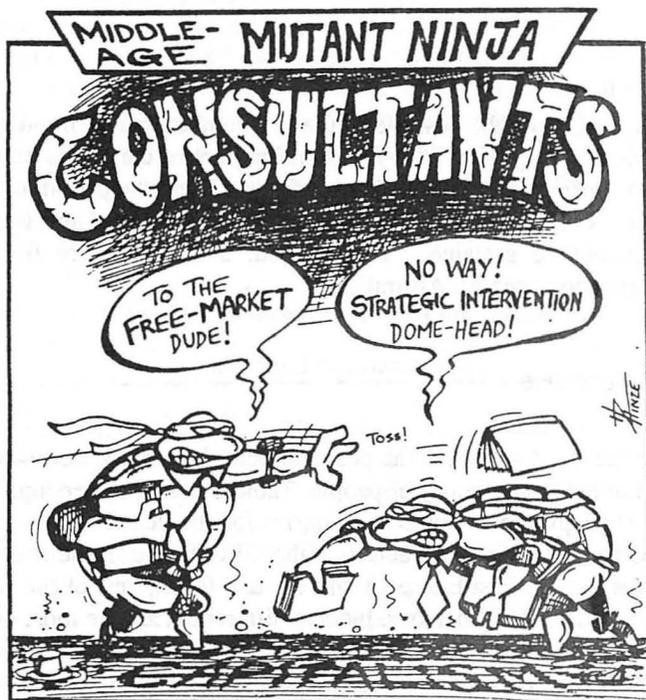
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