A Comment on Determining Industry Policy

by
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1. Introduction

Those who argue that industry policy discussion in Australia has become polarised have a point. Colin Carter's paper rightly draws attention to the unproductiveness of this. But his paper also reveals areas of common ground, where most participants in the debate seem to agree. For example, there is recognition:

- that past protectionist policies have been a disaster for Australia's economy;
- that there is an urgent need to reform the institutional and regulatory arrangements which have produced costly or inappropriate "infrastructure"—in energy, transport, communications, education, and in the public sector generally;
- the value of competition as a discipline on economic performance and a spur to productivity and efficiency;
- the need to reduce barriers in foreign countries to Australia's exports; and,
- that government is poor at "identifying successful businesses".

These areas of agreement represent significant progress and could not have been identified so confidently a decade or even five years ago. But it would be misleading to imply that remaining differences are minor or only matters of degree. While polarisation is to be avoided, nothing can be gained from pretending that there is agreement where none exists. (The continuing deterioration of trade relations despite successive multilateral "accords" in the GATT is the alternative model I have in mind).

Indeed, it should be said that even among the areas of apparent agreement, there is some ambiguity. For example, while the paper begins with strong anti-protectionist sentiments—and it is hard these days to find anyone who would claim to be a protectionist—much of what follows seems to be extolling its virtues.

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An address as discussant on a paper by Colin Carter, presented at the conference entitled Creating the New Australian Economy, Australian Graduate School of Management, University of New South Wales, 14–15 February 1992.

Similarly, while government is admitted to be poor at identifying successful businesses, much is made of the need for it to "nurture" key firms.

The main problem I have with the paper is its theme that "competitive advantage" provides a rationale for government assistance to particular firms and industries. While the concept contains useful insights, I do not believe that they are really new. More importantly, "competitive advantage" shares in common with "comparative advantage" (static and dynamic) an inadequate basis for policy prescription beyond the need to make the economic environment for firms conducive to competitiveness and efficiency. That in itself is no small task, of course, and much remains to be done.

While like Carter I think that different paradigms help explain the polarisation of the industry policy debate, unlike him I do not attribute this to competing theories (or "theologies"). Rather, I attribute it to competing *perspectives*—best summarised as "economy-wide" versus a "firm's-eye view". The insights gained as a general manager or management consultant are obviously important to the performance of individual firms. But it does not follow that they can be directly applied to the economy as a whole. Governments need to consider much broader ramifications of their actions as economic managers than do those who run individual firms.

2. Induced Prosperity in an Enterprise Need Not Make the Economy Prosperous

Clearly, to be prosperous a country needs prosperous firms and industries. But the source of a firm's prosperity is an important determinant of the linkage between the two.

The logic supporting those who emphasise the desirability of the "level playing field" is that government assistance to some players (or teams) can only be achieved by imposing costs on others. The Americans have an unwieldy acronym for the essential idea: TANSTAAFL—which stands for "There Ain't No Such Thing As A Free Lunch".

The mechanisms through which assistance to some firms imposes costs on others are not always easy to understand. The continuing divergence of thinking about the rôle of selective intervention is no doubt partly attributable to this. And economists may have taken too much for granted in justifying policy prescriptions. Indeed, I see it as the major challenge for the Industry Commission in getting its message across.

The fundamental cause of the TANSTAAFL arithmetic is the limited resources—physical, financial and intellectual—available to a nation at any given time. Assistance to certain segments of the economy allows the favoured enterprises to bid resources away from other enterprises, possibly forcing some out of business (or preventing new enterprises from emerging).

That is why it is wrong to think that assistance succeeds as a nationally beneficial strategy if it helps a firm beat its *foreign* competitors. Whether this is so depends on the extent to which other *domestic* competitors for scarce resources have also been beaten in the process—perhaps even within the same "industry"—and the benefits which have been thereby forgone.

What this amounts to is that one firm's competitive advantage, if fostered by government, may prove to be another firm's competitive *dis*advantage. I am not sure that Carter had this in mind when he speaks of treating the costs of support for targeted firms as an investment by society. But it is something which the Industry Commission must always consider in providing advice to government.

3. A Tax on Imports is a Tax on Exports

It also follows that promoting selected exports need not lead to higher GDP, or a rise in *aggregate* exports.

Some approaches may not even succeed in expanding exports of the targeted goods. At one point Carter argues that protection from imports can allow Australian firms to dominate the domestic market, gaining the scale and cost advantages needed for a successful assault on world markets. It has become a cliché to observe that in Australia such industrial infants have never achieved the hoped-for maturity, despite many years of nurturing. Why not? In part, the answer lies in the historical allocation of most assistance to the industries with the weakest prospects and the greatest inherent cost disadvantages (like clothing and footwear). In part, it is attributable to the insulation from world competitive incentive and discipline that protection provides. In other words, scale economies have come at the cost of lower productivity.

Australia with its relatively small economy depends on access of foreign exporters to generate the domestic market rivalry which Harvard's Michael Porter found so important to industrial success (Porter 1990). This is the real lesson for Australia from Porter's book.

Looking more widely again, it is an established but not always understood fact that suppressing imports must ultimately suppress exports too. That is why Australia, with its long history of protection, has such a low participation in international trade for an economy its size (CIE 1989). Industry Commission studies (1990) have shown that removing protection provides a bigger boost for exports than any other policy reforms. This growth is normally attributed to agriculture and mining. But manufacturing protection must also suppress production and exports of those manufactures that receive low or negative assistance. This has been found for other countries and confirmed for Australia in the recent study by Yetton, Davis and Swan (1992) for the Australian Manufacturing Council.

Protection has also encouraged production diversity instead of specialisation, which is manifested in Australia's low intra-industry trade, to which Carter refers.

The export tax effects of import protection are not confined to products using importable inputs. Other mechanisms by which exports are penalised include higher labour costs and exchange rate appreciation. Carter is wrong therefore to imply that textiles and clothing protection is relatively unimportant to Australia's competitiveness (or that rice protection is mainly a matter for consumers in Japan).

4. The Straw Economist

The foregoing is not to suggest that all intervention is counterproductive; rather, that there are some important tradeoffs that need to be considered. I think Carter has constructed a straw man in stating that economic advisers believe that "to intervene in the economy is always to hurt oneself".

Apart from the inappropriateness of lumping all economists together as if they were of a mind (which they are not), it is wrong to suggest that economics contains no rationales for intervention. Economic theory is well stocked with such justifications, under the heading of "market failure". Natural monopoly, public goods, external effects, information asymmetrics, etc., all can provide cases for intervention and much intervention has in practice been implemented on the strength of them. R&D assistance, public utilities, regulation of companies and financial institutions, etc., are just a few examples. (The Industry Commission has itself made recommendations for intervention in such cases.)

But when it comes to industries or firms that do not have special characteristics of this kind, it is true that selective assistance has generally been found wanting against economy-wide cost-benefit tests. Not because of some quaint attachment to Ricardian comparative advantage concepts, but as a consequence of examining the practical effects on *national* income operating through costs and prices facing (interdependent) firms and industries.

Even here, though, it is generally recognised that not all selective intervention is equally costly. Most economists would put price-distorting and entry-impeding interventions such as tariffs, quotas and regulatory controls higher on a cost hierarchy than say lump-sum subsidies, for example.

Carter also derides his straw economist for believing that foreign dumping is beneficial. When expressed like that it indeed seems absurd. What some economists have argued is that anti-dumping action is catching much *normal* trade and in those cases simply constitutes another form of protection. The Industry Commission has observed that while low cost imports may injure competing local firms, anti-dumping action may injure other firms using those goods as inputs. Agricultural fertilisers were a politically contentious instance in the mid-1980s, but the tradeoffs can also occur within the manufacturing sector itself. The problem once again is to achieve a broader perspective.

This applies also to the industry policy "initiatives" proposed at the end of Carter's paper. Some of them appear to be virtually pure benefit and therefore pose few evaluation difficulties. Such "no regrets" initiatives include our Uruguay Round endeavours, incentives for more efficient infrastructure provision and promotion of debate. Most of the others, however, would give rise to both costs and benefits. The policy-maker's task is to work out what the bottom line is likely to be—not for selected manufacturing industries (or the top ten firms) but for the economy as a whole.

From a national perspective, it is unlikely that "modifying competition" for traded firms would have a positive payoff; and the same applies to an extension of selective export assistance arrangements. Those holding the contrary view have pointed to overseas experience for support and this is an important part of Carter's own thesis.

5. Interpreting Overseas Experience

The paper essentially puts forward a two-part proposition:

i. Selective government intervention/assistance within manufacturing helped make other countries great.

ii. What has worked for them can work for us.

There are problems with both.

On the first, there has been endless debate. Carter is probably right when he says that observers interpret other countries' experience in the light of their own preconceptions. This is typically manifested in the examples one chooses to present. Just as Carter has presented examples which suit his own case, other examples can be found which would help tell a different story. But when one goes beyond individual policy measures to look at the broader economic, political and cultural environment of "successful" countries, it becomes clear that there is no simple pattern of causality.

The Industry Commission's own study of the experience of the dynamic Asian economies did not conclude that selective intervention had made *no* contribution to these countries' rapid development (IC 1990). What it did conclude was that such interventions appeared neither necessary nor sufficient in explaining their success. For one thing, no two countries had an equivalent set of industrial interventions. What most did share in common was:

- a pro-growth consensus, often following a crisis period;
- high saving rates (often induced by government regulation);
- a "plentiful, flexible and competitive" supply of labour;
- vigorous competition in product markets, either generated domestically or internationally;
- a capacity of their political systems to resist interests; and,
- the technology "catch-up" factor.

Clearly, Australia can learn from the successes (and failures) of other countries. But even where individual policies appear to have been successful for them, it need not mean that they would be appropriate for us. Carter seems to argue at one point that because Australia's level of manufacturing development is equivalent to that of Japan in the 1950s, we would benefit from a protectionist regime comparable to that of Japan at that time. Even if it were accepted that Japan's early protectionism had been a plus for that country (there are many studies which conclude the opposite) Australia differs in critical respects from Japan in the 1950s: we are a country with a small population (market), relatively high and rigid wages and an abundance of mineral and agricultural resources—all of which would make, and did make, a manufacturing protection policy ill-advised.

Australia's own industry policy history provides a more "controlled" experiment than that of other countries. As has been often observed, Australia *has* tried many of the policies that may appear to have been effective overseas. (In particular, we have had as steep and escalating a tariff as Japan ever had.) As is now generally recognised, these policies have not benefited Australia. I take this as a sign that they probably weren't among the more important contributors to other countries' economic success either.

6. The "Implementation Problem"

Carter's paper argues for a more interventionist approach by government as an in-principle issue, separate from the question of implementation. But it is fundamental to effective policy formulation that measures can be implemented to meet their objectives.

A superficially appealing analogy is drawn, as in *The Global Challenge* report (AMC 1990) of Government as a CEO, with a portfolio of firms and industries. In this view of government, the economy is presumably managed by promoting some ventures and pulling back on others in accordance with perceived competitive advantage.

At a technical level, the information requirements of such an approach would be very great, if not prohibitive. Carter himself admits that government is poor at identifying successful businesses. His paper, like others in the "strategic" intervention literature, nevertheless cites Airbus Industries as an example of successful government-induced competitive advantage. Many contrary examples could, of course, be cited, Concorde being the first that comes to mind.

The real problem, though, is that industry policy decisions do not have the luxury of being made on "technical" grounds, in a political vacuum. Scott has criticised Adam Smith's view of industry as "pre-industrial", with a focus on guilds and little understanding of the complex nature of firms in an industrialised society. But Smith's insights about the *political economy* of industry policy remain apposite. As demonstrated by Mancur Olson (1982) in his important book *The Rise and Decline of Nations* (less trendy than subsequent books by Porter, Reich and others, but in my view much more insightful in explaining the phenomenon described by its title), government support goes to the *best organised* firms and industries. By definition, these are not the firms of the future. More typically, they are those that are just clinging on to the present.

That is also the problem with a "visionary" approach. At one level, it is a motherhood statement to say that Government must have a vision for its society. But specific *industry policy visions* tend to get hijacked by the industries of the past. Government, once offering support, tends to get locked in; and what we end up with might be better described as tunnel vision.

The solution lies in public scrutiny, debate and understanding of the tradeoffs in different policy approaches. On this, I am profoundly in agreement with Carter. But I disagree with his claim that Australia has been denied such a debate. The conference to which this paper is contribution, and those that preceded it, are just one manifestation of a very lively and informed debate that has been taking place in this country. The quality of recent public discussion about industry policy contrasts greatly with Australia's earlier history, when the community was deluded into thinking that Australia could protect itself from the realities of the world economy and still prosper.

It is to be expected that not all of the answers that have emerged from this debate—and are becoming reflected in policy—will please everybody. But at least we do have some measure of consensus about the failed policy experiments of the past. That in itself is an important basis for avoiding policy failure in the future.

(Date of receipt of final typescript: June 1992.)

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Appendix

Estimating Long-Run Effects of Certain Microeconomic Reforms

	Reform of:							
	Transport Excluding Rail	Post-and Tele-communications	Electricity Supply	Rural and Manufacturing Assistance	Improved Provision of Water Services	Rail Transport	Contracting Out	Total
Real GDP	2.0	0.5	0.4	1.1	0.3	1.2	1.0	6.5
Export Volume	2.5	0.7	0.4	8.6	0.3	3.4	1.7	17.6
Import Volume	3.3	0.3	0.2	6.2	0.1	1.0	0.5	11.6
CPI	–2.4	–0.3	–	–3.8	–0.2	0.3	–0.8	–7.2
Real Pre-tax Wage Rate	4.5	0.6	0.5	1.6	0.4	0.8	0.8	9.2
Aggregate Employment (persons)	0.4	–	–	0.1	–	–	0.1	0.6