Thumping the Table:

Key Questions for the Labor Party's 'Industry Policy'

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Introduction[1]

Is industry, in particular manufacturing, characterised by market failure that demands government intervention? The recently appointed Shadow Minister for Industry, Innovation Science and Research, Kim Carr has argued it is:

> Industry policy is about addressing market failure… Clearly the reliance on market fundamentalism is not working. In the last five years we've seen the loss of nearly 40,000 jobs in manufacturing.[2]

The Leader of the Opposition has similarly argued that Australia risks being relegated to the positions of 'China's quarry' and 'Japan's beach'.[3] In other words, the majority of Australia's prosperity may become dependent on as few as two industries, tourism and mining, with a single buyer for each. Such a situation, it is implied, will provide a poor base for Australia's future economic prosperity. Australia therefore requires a 'sustainable economy' buttressed by a diverse range of industries (a 'broad economic base.')[4]

The Shadow Minister has also targeted low-end service industries as an example of what ALP industry policy will avoid, arguing that Australian employment cannot be restricted to 'burger flippers' and 'cappuccino makers'.[5] This constitutes an extraordinary slight on those workers, and indeed on all low-skilled workers. This type of job-snobbery is entirely inappropriate for an elected representative. Such a view also ignores the fact that these jobs are typically entry-level positions, as employees go on to higher level, higher skilled and higher paid positions either internally or externally.

Reflecting on the claim that Australia's extractive industries provide an unsustainable base for economic prosperity, the Opposition Leader and Shadow Minister for Industry have signalled their intention to rejuvenate Australia's ability to 'make things'. This call for 'reindustrialisation' is a return to leftist ideas of the 1980s.

The term 'industry policy' refers to any active assistance given to economic production by government. These forms of assistance can range from the relatively benign—for instance, the legal protection of intellectual property—to the strongly interventionist—for instance, the imposition of protectionist tariffs, subsidies, or direct government control.

Australia has a long and disgraceful history of protectionism; high tariffs, the 'White Australia Policy' and highly regulated labour markets were some of the tools employed as part of previous industry policies. The state socialism, which characterised Australia's political economy for much of its history, drained the nation of much of its natural wealth.

Instead of these 'old-fashioned' measures of an industrial policy, the Federal Labor Party proposes a new brand of industry policy.[6] The Shadow Treasurer Wayne Swan says 'Industry policy means to me getting the basics right—skills, education, innovation, infrastructure and tax'.[7] Senator Carr has indicated a more expansive program, including measures such as utilising government procurement policy to provide a 'base level of demand' for Australian products.[8]

Seven Questions for Labor

1) What problem is 'industry policy' trying to solve?

Senator Carr argues that there is a demonstrable market failure that has created the current state of Australian industry. 'Market fundamentalism'—a tortuous concept, but which we will take to mean a *laissez-faire* approach to the political economy—is 'an old-fashioned view', as shown by the 'loss of nearly 40,000 jobs in manufacturing'.

This simple formulation does not seem to acknowledge the beneficial reallocation of resources—labour—to their most efficient use. Senator Carr seems to imply that the only result of these jobs losses is unemployment.

In the words of the Shadow Minister, the purpose of Federal Labor's industry policy is to mitigate against market failure, particularly in manufacturing. However job losses—the reallocation of labour across the economy—are not a typical indication of market failure.

The Shadow Minister may be referring to a market failure not strictly defined as an example of inefficient allocation of goods or services. Instead it appears that he defines market failure as being where the market has directed production contrary to some other criteria.

By adopting a definition of market failure that is ambiguous, and without a theoretical or empirical basis, the justification for government action is unclear. Nevertheless, Federal Labor policy appears to not be focused upon correcting market failure, but instead influencing the Australian economy in a particular direction.

2) What are Labor's objectives for Research and Development?[9]

The Commonwealth Government expects to spend six billion dollars on science and innovation in 2006-07, distributed, for instance, towards the higher education sector, federal agencies like the CSRIO and defence.

But should government fund science and innovation? It is self-evident that innovation and technological development provide a key bulwark of economic growth. Successful innovation increases productivity, allowing firms competitive edges above their competitors in domestic and international markets.

Profit seeking firms should eagerly pursue the competitive advantage provided by innovative business practices or products.

Nevertheless, many commentators perceive the characteristics of market failure in investment in research and development. Science and innovation has a 'public good' characteristic, which inevitably leads to under-provision in a laissez-faire marketplace. Anyone can use knowledge, once created; consequently the producers of science cannot earn a return for their efforts and would do less science than is socially optimal.

As the IPA Backgrounder *Back to Basics: Why government funding of science is a waste of our money* demonstrates, the characterisation of research and innovation as a public good and its subsequent under provision does not reflect reality.

Determining whether there is an underinvestment in research and development is an uncertain task. Private investment in R&D has grown rapidly since the late 1970s, from less than the government's expenditure, to roughly double. This is not entirely due to R&D tax concessions introduced in the mid-1980s. The Productivity Commission has investigated the growth in private R&D and argues that the acceleration in business R&D preceded the introduction of tax concessions by two years.

3) How could Labor facilitate 'Bottleneck' infrastructure investment?

It is in the area of infrastructure investment that there is demonstrable problem in Australian public policy, which a Federal Labor government would be able to correct.

Economy wide access regimes like Part IIIA in the *Trade Practices Act*, and industry specific regimes like Part XIB for telecommunications discourage investment by mandating infrastructure owners to share their investments with competitors. When firms are considering potential investments in infrastructure, this regulatory framework is even more pernicious.

In telecommunications, these disincentives have recently become obvious. Telstra's abandonment of its plan to construct a fibre-to-the-node network earlier this year was primarily caused by the firm's reluctance to open the network to competitors at a price set by the regulator. Telstra's subsequent rollout of ADSL2+ has been restricted to areas where there is similar competing infrastructure; a policy that the company maintains is to dissuade the regulator from mandating access.

For infrastructure built under government fiat, or built using public funds, access regimes are perhaps a reasonable approach to introducing competition. However, for infrastructure that is built in a competitive market, using private funds, mandatory access policies restrict the market from providing necessary infrastructure.

Alan Moran writes:

> Where there are no regulatory restraints on competition, we see the most promising conditions under which entrepreneurs seek out new needs or seek the meeting of existing needs more cheaply. The outcomes of new infrastructure built under such conditions epitomise the gains made by competitive processes. For, although mistakes in competitive strategies are inevitable from time to time and excessive or wrongly sited infrastructure will be built, the outcome of the process of free market decision-making offers us the best use of resources and the widest scope for the application of human ingenuity. If excessive building occurs, unless there is (illegal) collusion, the mistakes cannot be retrieved from the consumer.
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> Indeed, in such circumstances the consumer obtains windfall gains as the rivals seek to cut their losses by expanding their market shares and in the process driving down the price.[10]

If the Federal Labor Party intends to construct an industry policy that facilitates private investment in necessary infrastructure, it would be well advised to reform the *Trade Practices Act* to allow firms to do so.

4) What would be the measure of failure?

Interventionist public policy should always be coupled with a strong index to indicate whether the policy has been a success or not. As Jeffrey L. Pressman and Aaron Wildavsky argue in their classic study of federal programs in the United States:

> Policies imply theories. Whether stated explicitly or not, policies point to a chain of causation between initial conditions and future consequences. If X, then Y.[11]

Before constructing public policy, these theories need to have a clear idea of the desired future consequences of political action. For instance, as argued above, it is not certain that there is a case for government intervention in research and development. This is doubly the case when the measure of success is not clear.

The case that there is a market failure in Australian industry has not been demonstrated. (Australia's infrastructure investment problem is an example of government, not market, failure.) In the absence of a solid theory of causation, and without the ability to test the results of a policy against the results of a laissez-faire approach, it is hard to justify a policy's pursuit.

Even with clearly defined measures of success, implementation of an ambitious public policy program—in this case, the implied goal of rejuvenating the Australian manufacturing sector—is no simple matter.

5) What are the fiscal consequences of this 'new' industry policy?

Craig Emerson has described the Howard government as a 'conservative administration that parades itself as the champion of free enterprise and small government is, in truth, heavily interventionist and the highest-taxing government in Australia's history'.[12] If, by implication, we can expect the tax burden to decrease under a Labor Government, it is hard to reconcile such sentiments with a desire to reintroduce an interventionist approach to economic management.

Senator Carr has indicated that 'ship building, automotives, pharmaceuticals, information technology and greenhouse abating technologies' were all sectors worthy of policy consideration.[13]

These industries all require massive financial investment. Where will the money come from? The tax burden is already very high, and the budget surplus already under some strain. Will a Rudd government take money from middle-income families and give it to industrialists?

Will a Rudd government take GST money from the states for its industrial policy? The IPA Backgrounder *Opportunity Squandered: How the States have wasted their reform bonus* shows how the states, having been granted through the introduction of GST a massive revenue windfall, have not used this unexpected money well. If Federal Labor is looking for a source to fund significant government investment, reform of the federal tax system would seem a natural place to start.

6) Will the old-style Industrial Policy be abandoned?

Labor's proposed policy continues to pick winners

The fallacy that government's can adequately pick winners, let alone pick winners more reliably than the decentralised market has been well dealt with in the popular and technical literature.[14]

Kevin Rudd has indicated that Federal Labor's industry policy is not about picking winners—that is, not picking winners amongst individual firms.[15] But Senator Carr's distaste for the typically entry-level coffee shop and fast food jobs, and his nomination of industries like shipbuilding and 'greenhouse abating technologies' seems to contradict this position, indicating a willingness to pick winners, albeit out of industries, rather than firms.

This is of more than academic interest. As the source of finance for industry policy is taken from a broad base through taxation, directing those finances to certain favouring industries penalises the industries—and their employees - which do enjoy political support. Any advantages conferred upon ship-builders by government action are at the expense of burger-flippers.

If the 'picking winners' accusation remains a slight against proposed economic policies, then it is hard to see how picking winners out of industries, rather than firms, constitutes a dramatic departure from traditional protectionism.

An opportunity for Labor: final abandonment of protectionism in Australia

Senator Carr has told us that Labor will pursue an 'interventionalist but not protectionist' industry policy. Does that mean that those elements of current government policy would be abandoned under a Rudd government? Australia still applies a whole raft of trade barriers that inhibit trade and provide protection to local industry. If the Labor Party is to finally abandon traditional industry policy to focus on less orthodox methods of national economic management, then this could fruitfully be coupled with a reduction of all barriers to trade as close to zero as possible.

7) How can Industry Policy be reconciled with Climate Change policy?

In 1998-99, the energy-intensive manufacturing industry accounted for 26% of primary energy consumption and 34% of electricity consumption. Greenhouse gas emissions from the sector had grown 8% in the preceding decade.[16] All else being equal, it seems likely that the artificial stimulation of manufacturing will have a corresponding increase in greenhouse gas emissions, both directly from the processes of 'making things', and indirectly, from the increases of electricity use in these sectors.

If, as the Opposition Leader has stated, 'the science is in' on climate change, this government-stimulated increase in greenhouse gas emissions would seem to be counter with Labor's climate change policy. Conversely, if industry policy is to be coupled with explicit measures to reduce harmful emissions, such as carbon taxes or trading arrangements, or mandatory emission reduction technologies, then this added burden on manufacturing would seem to be against the desire to encourage Australian industry.

It is beholden to Federal Labor to detail how these two seemingly disparate and irreconcilable policy areas can coexist under a Labor government.

Conclusion

Those mindful of the havoc which previous state and federal governments wreaked on the Australian economy have rightly greeted the announcement of a new-look industry policy with scepticism. Whether this scepticism is deserved remains to be seen as Federal Labor prepares its policy. This document has tried to outline some key questions which need to be answered, and provided a few possible recommendations to help the Opposition Leader and Shadow Minister prepare a policy which has the best chance of allowing Australians to grow their economy.

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