The Market and the State in Economic Development:
Some Questions from East Asia and Australia

Ross Garnaut

Working Paper No. 48

Ross Garnaut is Professor of Economics at the Australian National University and Adjunct Professor at the Columbia University Graduate School of Business.

A version of this paper has been prepared as the 1990 Shann Memorial Lecture, University of Western Australia.

Working Paper Series
Center on Japanese Economy and Business
Graduate School of Business
Columbia University
October 1990
Amongst the great corpus of modern economic knowledge, a relatively small number of theorems are very important to understanding what makes the people in some countries rich and in others poor. Wisdom in economic affairs comes from understanding how these important propositions relate to the currents that shape national governance, the tides that rouse and tame human spirits, and the institutions that constrain and channel the energies of a community.

Students are introduced to most of the important propositions in their historical, political, and institutional context in the work of Professor Edward Shann. Shann winds the economic truths through the exciting history of a new country. I hope that he is still read widely on his old campus.

Shann's Economic History of Australia has much to say on the issues that beat upon our ears today: financial regulation; the origins and consequences of speculative boom; the moral basis of an effective market economy; the role of public enterprises in a mixed economy; and the political economy of protection. Following Marshall half a century before him, Shann even discussed ideas about protection for industries with economies of scale, which Boston economists relabeled and recycled in the 1980s as "strategic trade theory".

Shann thought and wrote that Australians would prosper most with open foreign trade. He was deeply sceptical about the contributions to prosperity of enterprises subject to public ownership and, therefore, in some sense and circumstances, to political control. With his main economic history published during the long high tide in Australian commitment to a large and interventionist state, he was dubbed a political conservative by many of his contemporaries and successors.
I do not believe that this is an accurate placement of Shann's published work in the excessively simple political spectrum that runs from libertarianism to social democracy, or from the left to the right of the political spectrum in this country. He was a conservative in the sense that he was wary of the enthusiastic departure from established and proven wisdom, in the way that any good student of history is wary of the practical men who think that here and now operates on its own rules, outside history. But in casting the eyes of economist and historian over the evolution of economic institutions in early Australia, he was as aware of the dangers of a weak, chaotic state, as of a state strong enough to enforce tyranny. In writing of the great clashes between capital and labour late last century that did so much to shape the Australia of the federation, no case is made against the labour cause. If there is morality as well as scientific history in his judgement, it is against the pragmatic man of capital, whose greed can in times of excitement and compliant government divert, capture, and destroy the growth of national wealth.

Shann attributed most of the greatest threats to common prosperity not to any evil from a known spot on the conventional political spectrum, but to simpler flaws in the human frame, or to accident. In telling the great and terrible story of David Syme and Victorian protectionism, he recalls with approval Trevelyan's memorable description of nationalism as "that simplest of all ideals which has in its nature no political affinities either with liberty on the one hand, or with tyranny on the other; it can be turned by some chance current of events or by the cunning or clumsiness of statesmen to run in any channel and to work any wheel".
Re-reading Shann reminds us that economic analysis and historical insight together stand guard against the tides of nationalist enthusiasm. They stand guard as well against the sense of their infallibility that grows around the short-term success of practical men; against the importuning of weak government by self-interested wealth; and against the whim and chance of error.

THE MARKET AND THE STATE

From the birth of modern economics with Adam Smith's *Wealth of Nations* two centuries ago, debate has continued in the West about the appropriate roles of markets and state intervention in co-ordinating economic activity. We have learned a great deal in principle from the concepts of *public goods* and *external economies*, and from the theory of public finance which relies so heavily on them. We have also learned that much depends upon the institutions and the ideas that shape the effectiveness both of markets and the state.

The economist and the historian have been provided with a rich new set of data on the big theorems by the success of the economies of East Asia in recent decades. Japan, Taiwan, South Korea, Hong Kong, and Singapore have expanded economic output faster for longer than any other in world history. The mainland of China between 1977 and 1989 experienced similarly rapid economic growth. The evidence is accumulating that several economies in Southeast Asia - Thailand, Malaysia, and recently Indonesia - are also revealing high capacities for growth.
Such an historic shift in the world's economic centre of gravity from the distant North Atlantic to Australia's own region, involving countries whose resource endowments are highly complementary to our own, has immense implications for Australia, through the opportunities it offers for productive exchange.

In this paper, I focus on a different type of implication - the implication of this new and powerful case of economic development for our understanding of economic processes. To the economist whose discipline is a social science, the emergence of this new case in a different cultural and institutional setting is as great a gift as a new hemisphere to an astronomer.

I have been encouraged to this subject by some of the public discussion of my recent report to the Australian Prime Minister and Foreign Minister - Australia and the Northeast Asian Ascendancy. In that Report, after analysing the postwar growth performance of Northeast Asian economies, I noted that Australia could perform better economically if it increased the international orientation of Australian production, raised savings and investment, including through investment in education, and embraced rapid structural change as an inevitable and necessary part of the process of growth. I noted the role of protection and other state intervention in some of the Northeast Asian economies, but, out of deference for the ambiguities, drew no strong and general conclusions about their contributions to rapid growth. Some academic critics have found fault in this caution, asserting that pervasive state intervention in economic activity has been crucial to East Asian economic success, and that we should emulate East Asia at least in these respects.
The question of the role of the state in East Asian development has also been raised in the discussion of policy. Practical men have called the protectionist mote in East Asian eyes to the defence of the beam in our own.

The concluding section of this paper addresses Australian policy discussion in the aftermath of my Report. But first, what do we learn about the ancient issue of markets versus the state from the recognition of East Asia as a second major locus of successful economic development?

GOVERNMENT INTERVENTION IN EAST ASIA

Milton Friedman in his Singapore Lecture ten years ago used the Singapore and Hong Kong successes to argue the case for economic libertarianism. "Singapore calls itself socialist", he said, "but much to the credit of its farsighted leaders, it has essentially followed capitalist principles. It has promoted a free market. That free market has enabled Singapore to thrive, despite extensive interventions of government."

Friedman's Singapore Lecture was a bold and, in retrospect, somewhat prophetic statement about the turning of the world intellectual tide towards libertarian economic values, after several decades of what he described as collectivist ascendancy. Singapore had done well, he argued, because it had relied upon the free market, and Hong Kong better because it had relied more on the market.
Other theologians of capitalism have not been so sure about the lessons that can be drawn about East Asia’s success. Berger, for example, states as one of his fifty propositions about prosperity, liberty, and equality, that the East Asia evidence falsifies the idea that a high degree of state intervention in the economy is incompatible with successful capitalist development.

One different and interesting attempt to bring the East Asian experience to account in answering the big questions of economics and economic history is the long-run historical work of Jones at LaTrobe University. In his recent book, Growth Recurring, Jones addresses perhaps the biggest issue in economic history. He looks back over a thousand years, and asks why Song China attained relatively high per capita productivity and incomes, without entering a period of sustained intensive economic growth as in Europe under modern capitalism. Song China was familiar with most of the inventions which had been thought to have been essential to the industrial revolution in Europe. Jones is led by the evidence to focus strongly on the role of government. Growth can occur, he concluded, only within an “optimality band”, where “factor and commodity markets are freed and the government is neither too grasping nor too weak”. These conditions came to exist in Europe a few centuries ago, but not in the Eurasian heartland, “where the main stumbling block was the centralised politic of conquest in its effect on incentives”.

Jones notes that the difference between the roles of government in the great empires of China, India, and the Ottoman, and in Europe under capitalism, was not simply that government was larger and more intrusive in Asia.
Every modern state in an advanced industrial economy has more control over the allocation of resources than any of the rambling despotisms of antiquity. Private agencies in Manchu China and Mughal India provided many infrastructural services to commerce that, in the age of capitalism, came to be made available by government in Europe. For growth to be sustained, government had to provide the institutions that were necessary to the effective operation of the market itself: enforcement of rights of property and contract; freedom of secure movement and exchange over large areas; the personal security that makes long-term investment in education feasible and worthwhile; and much else.

Scholars have drawn a similarly shaded and subtle picture of the sources of modern economic growth in East Asia. Krause notes the large presence of state-owned enterprises in Singapore production, and wonders why they seem to be more productive there than elsewhere. He notes the role of the high quality of recruitment into the public sector, and of a government-led ideology, built around commitment to economic development in a market context, that reduces the costs of enforcing market-conforming behaviour in public and private institutions. This suggests that the degree of reliance on government should depend on cultural and ideological circumstances in particular societies.

The local Singaporean contributions to these discussions, including those of Lim Chong Yah and Associates, accept, in a matter of fact manner, that government has played a large role in Singapore success. In the event, it has been economically wise intervention, supporting and facilitating the structural changes that are being promoted by the international economy's interaction with Singapore through market forces.
Few interventions affecting prices have driven a wedge between incentives provided in international markets and those operating at home in Singapore. But while being frugal with price-distorting intervention, government has been important to human capital formation, to the distributional equity upon which political stability within a market economy depends, and to the promotion of high rates of savings and investment. Strong and decisive government has helped to provide an environment in which markets can work effectively.

Japan, like Singapore, has been used by both sides of the Western argument about the roles of state and market. Japan has, proportionately, by far the smallest public sector amongst industrial economies. It also has a highly competitive and, today, internationally open industrial sector. Some analysts see this as the key to economic success. Others, like Johnson in his influential definition of the "development state", have emphasised the strategic interventions in corporate decision-making of a powerful Ministry of International Trade and Industry.

There is not much doubt about the role of markets in the prodigious growth performance of Hong Kong over these past four-and-a-half decades. The debate over Hong Kong's success has been about whether its role as the recipient of people and capital from communist China has made it a special and advantaged case or, as Friedman would have it, a victim of unfavourable circumstances that was able to absorb in its stride hordes of unskilled immigrants because it used so intensively the productive power of markets.
The pervasive government interventions of Stalinist central planning have failed as emphatically in East Asia as in Eastern Europe, the Soviet Union, and Cuba. It took some decades for China to face this reality. Vietnam, diverted by military goals, took longer. North Korea has not yet done so.

The explosion of growth in the Chinese countryside from 1978, following the greater reliance on markets and smaller and more varied forms of enterprise, tells a powerful story, despite the wider framework of the Leninist state and the continuing, if diminished, role of central planning. In China, the failure of growth over the past year is substantially the result of the reforms not having proceeded far enough, making a further, eloquent case against the old system.

South Korea and Taiwan have powerful states, supported by military establishments that absorb high proportions of their national output. They have been linked intimately into international markets for industrial products, increasingly so in the process of rapid growth. State enterprises have played major roles in investment, especially in Taiwan. Attempts at strategic intervention in corporate decision-making have been important, especially in Korea.

What general conclusions can we draw from this kaleidoscope of East Asian experience?

The first conclusion is that not much can be said simply about an overall effect of government intervention on economic development. It depends on the nature of the intervention and of the society and polity within which it operates.
IDEOLOGY AND MARKET-CONFORMING BEHAVIOUR

The experience of East Asia underlines the old truth from the economic classics that the provision of the institutions of the market itself represent the irreducible minimum of state intervention for economic growth to proceed.

Adam Smith was much more aware than later economists who promoted the virtues of his "invisible hand", of the political, moral and ideological basis of the market economy.

Individuals have incentives to break the rules that are necessary to make a market economy work - to corrupt the legal basis of market exchanges, to collude in anti-competitive ways, to misrepresent the nature of assets which are the subject of contracts. Enforcement costs of market-conforming behaviour are extremely high unless the operators of the state, and powerful participants in markets, operate within an ideology that values market-conforming behaviour as a virtue, or which at least values the national benefits to economic development that flow from the honest and effective operation of markets. As we know from the failed development experience of many countries, these costs can be prohibitively high in a society in which there is no ideological basis for national development or acceptance of market rules.

There are significant insights into these relationships in earlier theories linking the rise of capitalism in the West to the pre-capitalist ideologies of Europe, and contemporary theories linking East Asian success to a Confucian moral legacy. This is not the singular, ethnocentric and, for the rest of humanity, depressing conclusion that success in economic
development is possible only when it is built, in the old case, on North Atlantic Protestantism, or in the modern cases on Neo-confucian ideology. Rather, the lessons are about the types of constraints on personal and social behaviour that are favourable for economic growth, whatever their particular cosmogenic justifications.

Hirsch has observed that the declining moral legacy of the West has created problems for successful continuation of capitalist development. The weakening ideological support for self-restraint in maintaining the rules of the market place has required more explicit, extensive and expensive enforcement of the rules by a strong state. These observations take us back to Adam Smith in his historical setting. "Laissez faire" did not then represent withdrawal of government. In the eighteenth century, "laissez faire, laissez passer" alluded partly to the demand for a strong central state to enforce freedom of movement and contract against the local powers of other interests.

The effective operation of the "invisible hand" required a state strong enough to keep at bay the vested powers that would always be seeking to conspire against freedom of trade and the public interest.

As more East Asian states found their ways into Jones' 'optimality zone' in which sustained growth becomes possible, more of the essential conditions of growth became apparent. Everywhere a strong state is required to enforce the rules and maintain the integrity of the institutions that are necessary for the effective operation of markets. Within this context, markets must play an important role in allocating resources. Amongst much else, markets must facilitate close integration into international sources of goods, services, capital and technology.
The public good of an effective domestic market can be provided by a strong and wise state acting alone. But, as Rattigan and Carmichael have reminded Australians in their recent paper on Australia and the Gatt, modern economic development also requires access to an effective international market - an international public good. In the early decades of rapid, internationally oriented East Asian growth, this essential international public good was provided gratis by the leadership of a self-confident and expansive United States of America. United States' commitment to keeping its own markets open, and to enforcing the rules and liberalising potential of the General Agreement for Tariffs and Trade, underpinned rapid expansion of international trade under clear and stable rules. However, in the 1980s, for a number of reasons that I have discussed elsewhere, the United States polity has ceased to be willing to lead the international system alone. Effective contributions to maintaining the open international trading systems now must be part of the irreducible minimum role of the state in any significant trading economy.

Everywhere in high-growth East Asia, except Hong Kong, the state has been active in the promotion of growth-oriented ideology. The state's definition and assertion of the national interest in economic growth, together with close interaction between political leaders and interest groups (although the latter less in Hong Kong and Singapore), have created a favourable environment for living by the rules of the market, accepting the inconvenience of structural change, and reducing business uncertainty by generating shared perspectives on the directions of structural change.
This has been the substantial content of Johnson's "development state". This role of the state sometimes encompasses "picking winners", but for the most part not backing them, when assistance to a particular industry is assessed net of the industry's contributions to assistance elsewhere. The celebrated role of Miti in influencing resource allocation in Japan, much less important today than in the sixties at an earlier stage of economic development, was never so powerful that it constrained the strategies of corporations which thought they knew better. It should also be noted that the Japanese government, when it moved from the form guide to the betting ring, backed as many losers as winners. The losers were by no means confined to the notorious case of agriculture.

The biggest temporary failures of growth in Korea, in the late 1970s, and in Singapore, in the mid-1980s, were associated with the largest postwar direct interventions of those governments respectively in the course of industrial investment and structure. In Korea and Singapore, however, governments quickly recognised mistakes and declined to send good money after bad.

The encouragement of market-conforming structural change in East Asia, therefore, has sometimes encompassed picking winners, but more rarely backing them consistently with a net transfer of resources. Most importantly, with the important exceptions in agriculture, it has encompassed the prompt dumping of losers as industries have lost international competitiveness, whether or not they had once received official support.
GETTING THE PRICES RIGHT

Rapid economic growth requires continuing far-reaching structural change in response to changes in economic opportunities at home and abroad. Beyond the earliest stages of economic development, it is impossible to achieve the required flexibility unless markets are used extensively to allocate goods, services and factors of production, and to set the prices which govern exchanges.

Price distortions in goods, services and factor markets powerfully influence growth performance. Statistical analyses reported by the World Bank indicated that over one-half of variations in growth performance amongst developing countries was explained by differences in the degree of price distortion in markets. The distortions related to exchange rates, the degree of protection in manufacturing industry, the degree of protection in agriculture, the rate of inflation, and to interest rates and electricity pricing. The East Asian economies which have sustained high growth have relatively low degrees of price distortion. As the World Bank would put it, to a considerable extent, they have "got their prices right".

The evidence shows that the most important prices to get right are those governing incentives for production for export, relative to production for home markets. All of the East Asian economies in their periods of high growth have had high and increasing international orientation in their manufacturing sectors. Hong Kong, and Singapore have achieved this with free trade. Korea and Taiwan early in their rapid industrialisation, and China today, have achieved this outcome with assistance to exports to offset the assistance to imports provided by protection. In a few instances, there has been over-compensation in favour of
export production, although as Rodan has demonstrated in the case of Singapore, this has not converted easily into upgrading the value of manufacturing production in the process of growth.

Krueger, amongst others, has observed that movement towards internationally-oriented trade policies has contributed more to growth than standard economic analysis would suggest.

We will return to this important phenomenon in our later discussion of Australian policy.

Significantly, all of the rapidly expanding East Asian economies which had earlier relied on balancing protection with export incentives have found it expedient to move towards open regimes, without distortion on the export or the import side, as productivity and incomes have risen towards the range of advanced industrial economies.

Open foreign exchange policies and regimes have been important to getting the foreign trade prices right. This has required convertible currencies at exchange rates that do not generate black markets, and liberal rules on access to foreign exchange. China continues to run a controlled and distorted foreign exchange regime and this has been an important source of economic instability and underperformance.

It seems that economic development becomes increasingly demanding over time of flexibility, free communications and openness to ideas and technologies from the international economy, all of which depend on extensive use of effective markets with correct prices. Within a single country, growth has been able to proceed for a while within
rigid and internationally closed structures, as in China in the first decade of communism, or in North Korea for a bit longer. But growth under these circumstances peters into stagnation and eventually political and economic instability. Changes in the structure of the world economy have made it increasingly difficult for one country to succeed without intimate integration through markets with others. These factors represent Krueger's "shifting bottleneck", in which liberalisation of economic institutions is required to go further and further over time if growth is to be sustained.

THE SIZE OF THE PUBLIC SECTOR

The extent of government involvement in the economy is sometimes measured by the share of national output provided directly to the community through government administrative structures, or sold through state-owned enterprises.

Direct spending on administrative and other non-commercial services has tended to be relatively low in East Asian economies experiencing rapid growth, and this has been associated with relatively low taxation shares of national income. If there is a general conclusion to be drawn, it is along the lines that smaller public sectors are associated with stronger growth. But there are exceptions and ambiguities which blur the messages. Certainly the high-growth economies have not skimped in provision of public education or economic infrastructure, although the efficiency with which the latter is provided has been enhanced in several cases by potential and realised competition from private investors. In the more advanced economies in recent years, there has been a strong trend towards sale of infrastructure into the private sector.
The role of state-owned commercial enterprises has varied through East Asia - being prominent in Singapore and Taiwan, and relatively unimportant in Hong Kong and (in recent decades) Japan. The key to successful performance of state-owned enterprises has been the high quality of recruitment into public enterprises, and the establishment of a strong commercial orientation, often with competition from other enterprises, and with high expectations of commercial performance.

THE STATE AND INCOME DISTRIBUTION

Rapid economic growth in East Asia has been associated with relatively equitable distribution of income. This has been important to maintaining political support for and social cohesion around high growth, in the face of massive strains associated with structural change and associated churning of the relative political and economic standing of various groups in society.

Historically, tough action by a strong state, sometimes externally imposed, was important to establishing the conditions for equitable income distribution: the Japanese-administered reform of feudal land ownership in Korea and Taiwan in colonial times; the Chinese land reforms after the communist victory on the mainland; the imposition of land, education and taxation reforms by the American occupying forces in Japan; and the far-reaching reforms of a wiser and (locally) stronger Kuomintang in Taiwan after its retreat from the mainland.
Everywhere in rapidly growing East Asia, a large, hard, competitive public education system provides relatively open access for high talent to elite positions. This has contributed to perceptions of equality of opportunity, as well as directly to growth performance.

In the densely populated economies of East Asia, the equitable distribution of incomes and wealth, and the associated social cohesion around growth-oriented policies, has been challenged by the disproportionate increase in property values, especially urban real estate prices as incomes increased. High levels of public investment in housing has been one important response. This has been supported in Hong Kong and especially Singapore by forthright use of the power of the state to control the use of land, with compensation sometimes at levels that would be seen as confiscatory and unacceptable in our own society.

GOVERNMENT INTERVENTION IN AUSTRALIA

The experience of East Asia does nothing to contradict the older lessons from the economic texts and from our own experience.

It underlines the importance of getting the prices right, and especially of avoiding government intervention through protection to raise incentives for domestic production over exports. It urges a firm approach to maintaining structural flexibility and to being prepared to accept the decline of industries which lose competitiveness in the process of economic growth.
It reminds us of the importance of macro-economic stability in general and price stability in particular. It urges that care be taken to provide a competitive economic infrastructure and to invest heavily in hard, formal education. It does not make a strong case against state-owned enterprise, but it tells us that any state-owned enterprises should operate in a thoroughly commercial and competitive environment, with high expectations of financial performance.

In the remaining part of the lecture, I will focus on one important set of government interventions in economic activity, which have been the subject of much public discussion and some contention following the release of the Garnaut Report. These are issues relating to "getting the prices right" or, in nomenclature used more often in Australia, to "levelling the playing field".

"Getting the prices right" is not the same as minimising the role of government, let alone weakening the state.

The improvement of Australian economic performance requires strong state action to enforce honest practices in commercial law, to reduce inflation and with it interest rates and the real exchange rate, to provide a competitive economic infrastructure, and to increase the flow of resources to the education and training of Australians for productive roles in an advanced economy. We need an active and effective state to secure access for Australia's most productive industries to expanding international markets. We need a strong state to build political support for reform, and to resist vested interests' requests for special favours.
None of this will be possible politically without the efficient delivery of social security to poor Australians, and without the integration of environmental and other objects into economic perspectives.

This is a big and demanding agenda of state action.

There is some doubt as to whether the Australian state is strong enough for the task. Australian governance is constrained constitutionally by short parliaments, the veto powers of a permanent opposition majority in the senate, and the diffusion of sovereignty through the federation. It is constrained politically by the Australian tradition of openness to pressure from sectional and vested interests. It would be impossible for the constrained Australian state to implement the radical reform programs of the Thatcher government in Britain at the height of its zeal, or of the Lange-Douglas government in New Zealand. There is good and bad in the constraints on state initiative in Australia. But, on balance, I would see advantages in the strengthening of Australian governments, at least through the lengthening of parliaments and the building of more co-operative federalism along the lines proposed recently by the Prime Minister.

Australia and the Northeast Asian Ascendancy argued for greater international orientation of the Australian economy in this wider context of a strong, focussed, and effective state. It noted the progress that had been made through the 1980s in foreign exchange liberalisation, reduction in protection and removal of other distortions in foreign trade in several commodities. It observed that the continuation of reduction in protection at the overall rate of the current program would achieve free trade by the end of the century for all commodities except textiles, clothing, and footwear. It recommended the removal of all
protection by the end of the century. Acceptance of this recommendation would cause Australian producers to see themselves as operating in a world market, like those in the small, high-wage economies of Europe. When a country’s markets for industrial products are mainly outside its own borders, its leaders soon come to the view that it is appropriate to remove or to minimise anti-dumping arrangements as well.

The recommendation on protection was one of many in a long Report. It captured the public imagination more than others, and diverted attention from other matters of high importance. At the risk of further diversion, I will take a few moments to explain the recommendation on protection in the light of the public discussion.

The recommendation was not for sudden removal of Australia’s remaining protection. Eleven years is not a short period for adjustment. Eleven years is longer than it took for the Japanese textiles industry to move from being the world’s largest exporter to a net importer. It is twice the time that it took the Japanese aluminium industry to move from being the world’s second largest producer, in the late 1970s, to barely being a producer at all. It is over twice as long as it took over half a billion Chinese farmers to replace the people’s communes with a system based on household responsibility, and longer than it took them to double their production. Ten years is the time that Singapore has given itself to move from the top ranks of developing countries to a standard of living equal to Switzerland, at the top of the European tree.
Reduction in protection would not proceed in isolation, but in the context of a range of reforms to reduce production costs in Australia. The removal of inflation would contribute to lower capital costs and a lower and more stable real exchange rate. The ending of inflation would also remove the taxation bias against long-lived capital-intensive investment. Cost reduction in transport, communications, and electricity generation, including through potential private competition for public enterprises, would improve the competitiveness of Australian production. An effective economic diplomacy would secure the continuation of the recent expansion of foreign markets for our most productive industries. Realistic, soundly based and stable rules for environmental approval would remove uncertainty which in recent years has been an important impediment to expansion of raw material processing.

The wider context of the report encompassed strengthening of the Australian skills base through education and training, and a stronger economic focus in the immigration program. Each individual industry would gain directly, and indirectly through lower costs of living and therefore wage levels, from the reduction of protection for other industries. Each industry would be spared the deadweight cost of representations to government, public affairs departments and Canberra offices and lobbyists, that must be met for each to get its share in a protectionist polity.

Within the Australian economy that would emerge from this approach, those Australian industries that export profitably in current circumstances would do much better. Any industry that is within striking distance of international competitiveness at present - any industry which now survives with low protection - would have its costs reduced enough to compete with foreign producers for the Australian market.
The most productive parts of Australian industry would expand into export markets. Some but not all of these parts would then enjoy lower costs from larger-scale production, and be provided with opportunities for further expansion.

This is not abstract theory. The potential for operating competitively in an international environment, if artificial, cost-increasing restrictions were removed, can be confirmed by talking to many Australian producers, carrying a bewildering array of unnecessary Australian costs on their backs as they battle, and sometimes win, in international markets.

Australia has hitherto been excluded from the expansion of intra-industry trade based on fine specialisation that was a principal source of North Atlantic growth from the 1960s and East Asian from the mid-1980s. It has been excluded mainly by the high costs imposed on trade at the border by protection and international transport costs. With the shift of the world's industrial centre of gravity towards our region, we can expect the removal of artificial border costs to be reflected in opportunities to join the fine economic specialisation that characterises the modern industrial world.

The international including East Asian experience with trade liberalisation tells us that the greatest gains come from the way it causes every enterprise to know that it has to compete in an open international environment. This makes the enterprise sensitive to developments elsewhere in technology, management and market trends, and encourages rapid adaptation
to change. Firms know that to survive they must adopt the world's best practices, and so take care to inform themselves on and compare themselves with the world's best practices. Workers quickly learn the realities and make similar adjustments.

For all of these reasons, those Australian industries which have been operating in an open, competitive, environment - for example our pastoral and mining industries, some mineral processing, and banking since deregulation - operate at the frontiers of world performance levels. Our protected manufacturing and service industries operate a long way from these frontiers.

My recommendations have been contrasted in public discussion with the Australian Manufacturing Council (AMC) Report, *The Global Challenge: Australian Manufacturing in the 1990s*, that was presented to government and released in July this year.

The contrast has been overdone - partly because the AMC Report itself highlighted differences on protection. The AMC programme overlaps with the earlier recommendations of my Report in many important areas: the need to expose Australian industry to international competitive pressure through further reductions in protection; the need to integrate the Australian economy more closely into economic opportunities in Asia; the need to invest more heavily in relevant education and training; the need to commit Australians to world class work practices and productivity performance; the need to reduce the cost of capital by reducing inflation; the need to remove cost-raising inefficiencies in transport and energy infrastructure and the need for stream-lining and settling policies and procedures on
environmental approvals for resource processing. The two Reports therefore embody a large agreed agenda for reform to improve the competitiveness of Australian industry.

But the differences remain important. The AMC proposals - implicit in the econometric analysis embodied in the report but not explicit in the report itself - have tariff protection falling to a maximum of 10 per cent by the end of the century for all industries except passenger motor vehicles, which would be protected at 25 per cent.

In addition, suppliers of a small number of products from "global" industries would be required to sponsor some production in Australia under "offset" agreements: computers, telecommunications equipment and aerospace hardware, but not pharmaceuticals. The AMC Report would retain indefinitely anti-dumping arrangements, research and development taxation concessions and old and new export subsidies. Large-scale resource processing export projects would qualify for accelerated depreciation of capital expenditure for taxation purposes.

The AMC Report has emerged from a consensus process involving a number of large manufacturing unions and producers. It represents a substantial step towards commitment to international standards of performance within the sector. It supports the virtual removal of Australia's most costly and damaging protection, for textiles, clothing and footwear. From these perspectives, it is to be welcomed.
The AMC Report eloquently describes the damage to Australia of past protection, including the legacy of an inward-looking and uncompetitive manufacturing sector. But it argues that Australia would benefit more from partial removal of protection than from moving all the way to "getting the prices right".

The AMC Report presents the results of some economic modelling, purportedly to demonstrate the superiority of "nearly getting the prices right" over a policy of removing all protection by the end of the century. Only the results derived from the Orani model need to be taken seriously. These results are presented in a manner which, to say it gently, is not very honest.

The Orani model only measures the gains from reallocating resources from protected industries to other industries operating at their current productivity levels - the gains commonly described as "static" by economists. In the exercise for the AMC, it does not bring to account economies of scale from greater specialisation. It excludes the spurs to world class management, technological and marketing performance that both the AMC and Garnaut Reports argue are the main sources of gains from trade liberalisation.

The Orani exercise suggests that the AMC proposals yield the greater part of the static gains that could be obtained from removal of all protection, for the good reason that the proposals encompass the removal of the greater part of protection. The AMC Report says that the difference in the static gains from its own and my position is zero, although the working sheets from the modelling exercise demonstrate the difference to be about one billion dollars per annum in today's prices.
The AMC Report excludes the dynamic benefits from trade liberalisation, but includes these same benefits as part of the very large gains that would be obtained from moving towards world class work practices and productivity.

But even the Orani model's static gains from removing the last protection from cars and other items, beyond the AMC recommendations, are far from negligible. There are not many single micro-economic reforms that can yield the Australian economy one billion dollars per annum.

There is a more fundamental problem in the political economy of the AMC position. Shann observed sixty years ago that a protectionist polity's work is never done. The protectionist polity is forever busy with the representations on this or that new special case. If Australia removes almost all assistance measures, but leaves car producers with half a billion dollars per annum in assistance from protection, and raw material processors with several billion dollars per annum in unique tax concessions, why would we expect the political economy of the rent seeking society to stop to draw its breath? Every other industry would pay for motor vehicle protection in its cost of labour and materials, and for processing assistance in higher interest rates and inflation. Some of the other industries which would carry the costs would be battling in international markets, or at home without protection. How to explain to the farmer shooting sheep at Katanning, or to the Perth exporter of solar heaters, that he or she has no similar case for assistance? Certainly the AMC does not make the case for the difference in terms of external benefits to the wider Australian economy.
If we keep the Australian polity busy with the political economy of industry assistance, we will lack the energy and time to right the other wrongs of the Australian economy. There will be less effective pressure and less political capacity to remove inflation, to strengthen our education, training and economic infrastructure, and to reform the legal basis of our securities and financial markets.

Economics has a theory of the second best, in which the impossibility of removing one distortion may justify the retention of others. Hence my own Report envisaged retention of the existing structure of export subsidies, to compensate exporters, albeit imperfectly, for the cost of protection pending its removal. It contemplated the case for comprehensive indexation of the taxation system in recognition of the inflation-induced bias against long-lived capital intensive investments. It rejected the latter because of its administrative costs, and its inferiority in these and other respects to a committed effort to remove inflation.

Australia's history teaches us that the second best is often not good enough.

CONCLUSIONS

My Report was cautious in the lessons for Australia that it drew from the Northeast Asian economic success. The Northeast Asian experience varies a great deal from country to country and, in any case, as we have seen, the historical and institutional environment has a large effect on what will work and what will fail. Australia has its own history, institutions, values and hopes.
The assertions by others that the East Asian experience provides compelling evidence for us to move in certain ways drew me to this evening's subject, linking the East Asian lessons about markets and the state with contemporary Australian discussion of trade and industry policy.

The East Asian economic success has transformed the world economy and our own economic choices. It has not forced the transformation of our understanding of the important relationships in economics and economic history.

Our survey of the East Asian story has not given us new reasons to demand a larger and more important role for the state in economic development. Neither has it provided a new confirmation that a libertarian reality shapes the choices of humanity. It has, however, brought into sharper focus some of the ways in which an effective state and the power of the market must work together.

Australia will be the richer if all sides of politics claim as their own the simple truths that come from the systematic study of economics and history, including in East Asia. This will build in all of us, amongst other things, a regard for the strength of the state in its core activities, and wariness about any restriction of trade and rigging of prices to benefit one group of producers over others.
Agreement on these basic truths would liberate our political society to focus on and to achieve the things that a strong state must do well for a nation to prosper. We could then save our disagreements for those other great issues, on which it is possible for wise Australians to hold different opinions, because they believe different things about what is good.

For all of these reasons, I have been glad this evening to honour the work of Professor Shann at the University of Western Australia.