CONFERENCE PROCEEDINGS

ECONOMICS '91

A NATIONAL ECONOMICS TEACHERS CONFERENCE

STRUCTURAL REFORM IN THE AUSTRALIAN ECONOMY

Peter Baldwin MP
Dr Dennis Mahoney
John Howard MP
Tom Dusevic
Dr David Clark
Carol Austin
Don Hunter
Michael Egan MLC
Peter Switzer
Braham Dabscheck
Professor Brian Johns
George Souris MP
Chris Burnup
Professor Wolfgang Kasper
James Cox
Virginia Frost
Mike Horsley
Max Walsh

Edited by Tim Riley

The Economics Education Resource Centre

The main purpose of the Economics Education Resource Centre (EERC) is to encourage a better understanding of the principles of economics and to promote their practical application. Secondary economics teachers are the main target group and they are encouraged to telephone, write, fax or visit the EERC for assistance with resources on a range of topics.

The major functions of the EERC include:

- Accumulation of a comprehensive resource base.
- Organisation of professional development days, seminars and conferences.
- Development of new resources for economics teachers.
- Liaison with other Australian economics teachers' associations.
- Publication of *The Economics Education Review*

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EERC The Economics Education Resource Centre

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EDITORIAL NOTE

This book records the proceedings of the ECONOMICS '91: A NATIONAL ECONOMICS TEACHERS' CONFERENCE held over three days (July 8-10 1991) at the University of New South Wales in Sydney.

The 17 conference papers are presented in three sections conforming to the themes for each day of the conference: **Macroeconomic Policy and Australia's Economic Performance; Microeconomic Reform in the Australian Economy;** and **Contemporary Issues in Economic Education.**

I am grateful to all of the speakers who gave permission for their papers to be published and trust that teachers and students will find the book a valuable resource in secondary economics courses.

Above all I wish to thank the 140 Australian teachers who attended the conference and participated in the discussion sessions, and Andrew Davies for his creative and technical assistance in shaping the conference papers into a coherent and readable form.

Tim Riley

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INTRODUCTION

TIM RILEY

The ECONOMICS '91 Conference served two purposes. First, it attempted to break down state barriers by bringing economics teachers from all Australian states and the ACT together to establish networks to facilitate an exchange of ideas, resources and experiences. Second, it was designed to cover a broad range of topics common to all Australian secondary economics courses by giving teachers access to a pool of high-profile economists, politicians, bureaucrats and educators.

Professional development of economics teachers is an essential part of the microeconomic reform of Australia's secondary education system. Economics is a popular and relevant subject in our schools. Since developments in economic theory and policy at both the domestic and international levels are occurring rapidly, it is imperative that teachers are given opportunities to update their knowledge of content, skills and teaching strategies. Despite the multiplicity of Australian economics syllabuses, ECONOMICS 91 proved that a national conference could break down state barriers and bring teachers together to discuss topics and issues of common interest.

The theme of ECONOMICS 91 was 'Structural Reform in the Australian Economy', which acknowledged the importance of structural change and policy revision in Australia's product and factor markets in the 1980s and 1990s. Controversy surrounds many of the policy proposals for economic reform (such as deregulation and privatisation) and teachers are charged with the job of simplifying the details for their students and giving an objective assessment of competing theories and policy prescriptions. For these reasons, differing points of view on the same topic were outlined at **Economics 91** by politicians and economists.

Labour market reform was discussed by John Howard MP who outlined the Federal Opposition's industrial relations policy based on voluntary work place agreements and enterprise bargaining. Peter Switzer and Braham Dabscheck from the UNSW were more supportive of the Accord process and the corporatist approach to incomes policy.

Similarly it was refreshing to contrast the approaches of George Souris MLA (NSW Greiner Government) and Mike Egan MLC (NSW Opposition) to the microeconomic reform of the public sector.

Aside from the contrast of viewpoints, conference participants gained an insight into the 'hands on' experience of experts such as Professor Brian Johns of the Trade Practices Commission who explains the contestability of markets and the procedures followed in framing Australian competition policy. Chris Burnup of the Business Council of Australia uses a logical and pragmatic approach in presenting an overview of the environmental debate in Australia. Carol Austin provides a fascinating discussion of the meaning of 'competitiveness' by drawing upon the conceptual framework of Michael Porter's *The Competitive Advantage of Nations*. Virginia Frost and Mike Horsley have outlined then theory of learning styles and given some practical hints on various approoaches to the teaching of economics and the use of textbooks in particular. Max Walsh discusses Australia's economic future in a humorous yet optimistic fashion.

Economics '91 Conference Proceedings is thus an exciting collection of readings on the Australian economy: its structural problems and the competing policy prescriptions. But the book is more than this. It summarises a professional development initiative by the Economics Education Resource Centre which exemplifies the important interface that is being built between educators, government, business, the media and academe.

PART ONE

AUSTRALIAN MACROECONOMIC POLICY AND PERFORMANCE

CONFERENCE OPENING:

THE ROLE OF HIGHER EDUCATION IN ECONOMIC REFORM

THE HON. PETER BALDWIN MP

FEDERAL MINISTER FOR HIGHER EDUCATION AND EMPLOYMENT SERVICES

Peter Baldwin is the Federal Minister for Higher Education and Employment Services. He was elected Member of the House of Representitives for Sydney in 1983 and served on a number of House committees before entering the ministry after the 1990 federal election. Before entering federal parliament, Peter Baldwin was a qualified engineer and computer programmer.

THE ROLE OF HIGHER EDUCATION IN ECONOMIC REFORM

PETER BALDWIN

In opening your conference today, I want to address two issues — the place of higher education in the government's economic policy and the process of micro-economic reform in higher education.

Considerable debate has occurred since the early 1960s over the contribution of education and training to economic growth. Initial optimism on the part of human capital theorists gave way to some scepticism and disillusionment as massive increases in educational expenditures during the 1960s and early 1970s were followed by low economic growth rates in the later 1970s and early 1980s.

In this climate of disappointed expectations, the political priority accorded to education in Australia and elsewhere suffered a general decline.

In recent years there has been a renewed interest in the contribution of education and training to national economic performance. This coincides with a heightened recognition of the limitations of macroeconomic policy and the increasing importance of microeconomic issues in addressing the fundamental sources of our economic problems.

Of particular importance is an adequate supply of skills to encourage long-term sustained economic growth. In his chairman's address to the 1988 OECD conference on education and the economy in a changing society, The Minister for Employment, Education and Training, John Dawkins pointed out that:

> if our industry is to be internationally competitive, it will need a highly skilled workforce not only possessing the skills currently required by employers, but also capable of responding quickly to the demands created by technological and structural change. To achieve a workforce of such calibre will require a more efficient and responsive education and training system which is more closely attuned to the needs of industry.

The emphasis here on the educational attainments and skill levels of the workforce is important. As many commentators have observed, in the changing world economy competitive economic advantage shifts increasingly towards labour whose value is based on quality, flexibility, precision and specialisation. More and more countries are gaining access to new technologies and the finance to turn them into products at about the same time and on roughly the same terms. The one factor of production that remains relatively immobile internationally, and on which future standards of living comes to depend, is people — their skills and competencies, and their capacity to work together productively.

Competitive Benefits of Higher Education

Economic success is determined more and more by our ability to transform ideas into high quality and competitively priced better and better goods and services. This continues to require changes in the workforce and fundamental changes in the way we organise work. The old hierarchical work model in which a few well-trained managers planned and maintained the production system from the top while the rest performed as single isolated cogs within the system is no longer adequate. The new system must prepare far more people to take responsibility for their continuing education and to collaborate with one another so that their combined skills and insights add up to something more than the sum of their individual contributions. This will require not simply more education but, also, a different sort of education.

We don't know the precise extent of these benefits — the true social rate of return to education is not quantifiable. But we do know that the estimated rates of return to graduates, which are themselves more than adequate to justify the investments, substantially under-estimate the social rate of return.

It is true, however, that the world's most successful economies over the past few decades have given a high priority to education, skills and training as part of a coherent strategy to achieve their economic goals. Importantly these economic benefits do not all accrue to the individuals concerned — there are important economic benefits to industry and the nation as a whole. This says nothing of the social benefits to all of us from living in a more educated and hence more diverse, more cultured and more tolerant society. This is why society as a whole, via governments, should play a major role in funding higher education, and why we are seeking a reasonable contribution from industry.

The boundary between education and other activities is also becoming less distinct. This change is most noticeable in the skills formation process which, more and more, is taking place in the context of labour market programs and education and training provided by and often within enterprises.

In addition, research and development is less and less an activity to be found only in higher education institutions.

Microeconomic Reform of Higher Education

Recognising these trends, the Commonwealth government in 1987 embarked on a program to reform higher education in Australia. While most of the debate since then has concentrated on the structural changes within the system, the government began the reform process by putting its own house in order. With the aim of achieving a better coherence and consistency between its various education and labour market policies and programs, the government, in mid-1987, amalgamated the traditionally discrete policy areas of employment, education and training into a single portfolio. In doing so, the government sought to combine the traditional values and objectives of education with closer links to industry and the labour market.

This reorientation acknowledges that education is but one of many factors which contributes to the performance of our economy and the labour market.

Increasing the level of participation in higher education was first on the government's list of priorities. The capacity of the system will be increased by over 70,000 Commonwealth-funded places over the period 1989-93. In comparison to 1983, the total student load — including places funded by state governments, the private sector and overseas students — will have grown from about 260, 000 to well over 400, 000.

In support of this growth the Commonwealth's higher education budget will climb to $4 billion by 1993, a real increase of 25 per cent over the 1988 budget. The need for such growth in the system is clear. Not only are there the economic pressures I have mentioned, but increased demand from the 17-19 year old population is also placing pressure on the system. In addition, the government has a firm commitment to improving access and equity within higher education.

Our policies, however, do not stop there — we must also address the efficiency of the high education sector itself.

The overriding requirement is for higher education institutions to focus more directly on responding to social and economic circumstances.

The government's 1988 White Paper on higher education set the scene for greater collaboration between higher education and industry and explicitly called for the development of closer links between higher education and all sectors of the economy.

It should be remembered in this context that higher education institutions are public authorities — mostly operating under state legislation. For the very good reason of academic freedom, universities must remain both public and autonomous.

This means that simplistic notions of 'deregulation', or 'let market forces operate', or 'corporatisation', or in particular, 'privatisation', have absolutely no applicability if universities are to fully perform their role.

The higher education system had not been the subject of any coherent set of reforms for over two decades. The system in place in 1987 was therefore, in many of its essential characteristics, that which had been put in place by the Menzies government during the 1960s.

Of course it would not be true to say that the system had remained stagnant during the intervening period. There had been significant growth in student enrolments, new institutions had appeared, course offerings were diversified, participation was spread more widely among the population, there had been shifts in the distribution of enrolments, and funding responsibilities had moved from students and state governments to the Commonwealth government.

Nevertheless by 1987 the government, along with many both inside and outside higher education, realised that reform was necessary.

There are a number of reasons why this was so, some of them to do with tensions inherent in the system and some relating to presures placed on the system from outside as the result of economic and wider social changes.

During the late 1970s and into the 1980s, the so called binary system of higher education itself had become increasingly unstable. Its two component sectors had developed so as to resemble each other in many aspects, for example number of students, type and level of courses, level of academic salaries and in their administration and management.

Some of the larger and more diverse institutions not previously permitted to offer higher degrees or funded for research had developed the necessary staff and resources to undertake both these functions, traditionally seen as the sole preserve of universities.

Some states had begun to redesignate the larger institutes of technology as universities, raising expectations of additional research funding which, if accepted without a thorough assessment of institutional potential and performance, would have dissipated the limited resources available to support these activities.

A number of other factors were also placing pressure on the system. Higher education had shifted from being an elite to a mass system of provision, and demand was continuing to grow for improved access and wider participation.

Although growth in higher education during the 1960s and early 1970s had allowed more Australians to be enrolled in higher education, access remained inequitably distributed.

The White Paper reforms resulted, then, from the need to address a whole range of tensions within, and pressures which had come to bear on, higher education.

The Unified National System

In 1987 the binary system was abolished and the Unified National System (UNS) established. This system provides greater flexibility and responsiveness by all higher education institutions, enabling them to adapt more readily to changing patterns of demand and to contribute more effectively to the establishment of a better educated, culturally enriched and economically secure society.

Within the UNS, institutions are now funded for teaching purposes on a basis determined by their respective educational profiles rather than according to institutional title. Funding for research is now on a more competitive basis throughout the system according to performance.

The UNS now has fewer, larger, and more broadly based higher education institutions as a result of amalgamations. These ensure that institutions are structurally less vulnerable and better able to respond to changing patterns of student and employer demand. Flexibility and the capacity to adapt to changes in demand are critical to institutions in the face of economic restructuring and rapid technological change.

Where managed well, the restructuring is resulting in a system of institutions offering a greater variety of programs, reaching more people and having a greater impact on their local communities.

Such diversity is crucial to the quality of our increasingly mass higher education system. Diversity is also necessary if the system is to have the capacity to adapt to change. There needs to be a wide variety of subjects available. There must also be available a wide variety of levels and modes of study.

Of critical importance to diversity is the system's own attitude to the status of teaching and the quality of that teaching.

The Higher Education Council (HEC), which is the national body charged with providing independent advice to the government on higher education, has argued that institutions should develop procedures to reward all high quality performance by academic staff, be that in teaching, research or other professional activities. As the HEC has pointed out, not all academic staff in the UNS will perform equivalent roles. Some staff concentrate, perhaps exclusively, on research, some on teaching and some are occupied with both. Provided that quality of performance is rewarded whatever the agreed balance of activities, both staff and students benefit.

Excellence in teaching is assessable and should be encouraged and rewarded in all institutions. For its part, the government is funding a number of institutional projects aimed at improving the quality of academic teaching, and has instituted a staff development fund which came into operation this year.

The government is also seeking to address inequities which existed in the provision of adequate teaching infrastructure in some institutions. Funds will be provided for libraries, computing and technological equipment, support staff and communications systems for teaching programs, and specialised centres for teaching, learning and evaluation mechanisms.

In the longer term, opportunities are emerging for institutions to improve their teaching effort through the adoption of advanced technologies. The full implications of these technologies, such as video-conferencing and other more advanced multimedia communications technology, for on campus as well as distance education have still to be fully explored. However, they clearly create as yet largely untapped opportunities for enhanced access, quality and productivity in the system.

As would be expected with such an expansion of the system, costs have risen dramatically. Research too is becoming increasingly expensive with the need in many disciplines for more and more sophisticated equipment.

The Commonwealth government took on full responsibility for higher education funding in 1973. Since then however, institutions have become more successful in attracting finance from other sources and in generating more of their own income. The dramatic rise in the cost of higher education provision makes it inevitable that institutions must diversify their sources of finance. Allowing a plurality of interests to influence institutions is also a good way of ensuring the relevance of higher education activities.

The relevance of higher education to community needs, and the need for higher education to further develop its responsiveness to the national economy have been important considerations underlying the government's higher education reforms.

To achieve this aim, the government considers it essential that, in allocating additional places, emphasis be placed on those areas providing the greatest economic and social benefit. At present these are in the areas of computer science, environmental studies, engineering, business studies and languages — reflecting both expected labour market developments and student demand over the longer term.

These priorities are implemented through the annual discussions with institutions on their educational profiles. A process of negotiation ensures that a balance is struck between the legitimate interests of the academic freedom of institutions, accountability to the tax-payers for nearly $4 billion of their money, and the demands of the ultimate consumers of higher education — students and industry.

Alternatives to Present Higher Education Policy

There are only two alternatives to our approach.

One is for a completely supplier-driven approach, with universities taking all the decisions with no thought to broader national interests. The pre-1987 situation — described by the Australian vice-chancellors' committee itself as a 'wish-list approach' — came dangerously close to this outcome.

The other alternative would be the voucher system, a version of which is being advocated by the Liberal party. This system claims to place all effective market power in the hands of the students. There are three problems with this:

First, it provides no scope for enhancing equity of access to higher education;

Second, it assumes too much about student knowledge of the labour market;

Third, it would lead to more and more students choosing courses according to short-term remuneration prospects. To put it crudely, Australia already has too many lawyers and not enough engineers (compared to a country like Japan). This policy would make the problem worse.

Future Directions in Higher Education Policy

The government is keen to foster closer links between industry and research in higher education.

One initiative aimed at making graduates' skills more relevant to the economy is the development of cooperative education programs between higher education and industry. The Commonwealth has provided funding to assist in the development of a number of such courses. Growth in the number of these cooperative programs can only serve as a positive influence on the quality and relevance of higher education offerings.

Perhaps the most visible of these developments in relation to industry is the Cooperative Research Centres Program which was launched by the Prime Minister last year. Under this program outstanding university, CSIRO and other research groups will be brought together to focus on research problems in areas of importance to existing or emerging industry sectors. This program encapsulates the government's three major goals for its research policy:

- excellence, which is captured by the program's emphasis on high quality research and strengthening the basic research infrastructure;
- cooperation, reflected in the program's aim to strengthen the interaction between government research organisations and the private sector; and
- application, which is implicit in the objective of the program to capture the benefits of research and strengthen the links between research and its commercial and other applications.

Another government initiative has been to introduce Australian postgraduate research (industry) awards to encourage postgraduate students in industry research.

There is no doubt that industry will increasingly contribute directly to higher education provision through, for example, providing funds for facilities, elements of courses, academic appointments, and research. It will also have a continuing role in advising on curriculum and teaching matters, as well as on more general higher education issues.

As the cost of maintaining the higher education system increases — by 1993 the government's higher education budget will be just under $4 billion — it is inevitable that industry will be called on for financial support for teaching programs and research in higher education. The incentives for industry to provide this support and to foster collaboration include access to graduates, to technology and research expertise, and to facilities and personnel for undertaking strategic research.

Industry's investment in education and training is increasing substantially following the introduction of the government's training guarantee legislation, which came into effect from 1 July 1990. The Training Guarantee is designed to encourage more employers to meet the national need to increase their training activities and to view training not as a cost but as an investment to improve the flexibility and quality of skills and hence to achieve more productive outcomes.

Award restructuring — linking wage and salary outcomes to broadbanding, multiskilling and career paths dependent on individual skills — will also offer new opportunities and pose new challenges for higher education into the 1990s. The requirements of employers and employees, and thus the community at large, will increasingly emphasise the need for skills and knowledge. Hence the demand for improved access to educational institutions will grow.

The long-term implications of award restructuring for higher education are as yet unclear. We can, however, expect a developing need for a greater emphasis on lifelong learning, and for greater flexibility in institutional admissions policies, curriculum and methods of delivery.

We can also expect a demand for higher education institutions to develop and mount short accredited courses for industry as well as industry trainers and technical and further education teachers. Institutions may also be called upon to carry out research into areas such as industrial education and skills acquisition.

Closer links with the technical and further education sector will be necessary, especially in regard to admissions policy. Although progress has been made in improving arrangements for credit transfer between sectors, there will need to be a greater commitment from institutions to setting procedures in place.

Australian higher education institutions enjoy a deservedly high international reputation in the areas of pure and basic research, but are less well regarded for their achievements in applied research. Neither have they always been adept at marketing their research results. The other side of this coin is of course industry's poor performance to date in taking advantage of the commercial opportunities thrown up by higher education research. Industry support for the process of research and research training has been inadequate also. This is now changing and must continue to do so if, as a nation, we are to develop our productive capacity and maintain our still enviably high standard of living.

I am very pleased to have had this opportunity to speak to you about the place of higher education in the economic reform policies of the government as well the impact of our microeconomic policies within that sector. I believe we can point to a success story.

I would have liked to have stayed on to hear the following speakers but I have to attend budget cabinet deliberations in Canberra.

However, it is with pleasure that I open this conference.

AUSTRALIA'S ECONOMIC PERFORMANCE AND FEDERAL GOVERNMENT ECONOMIC POLICY

DR DENNIS MAHONEY

SENIOR ECONOMIST
WESTPAC BANKING CORPORATION

Dennis Mahoney completed a PhD at the London School of Economics in the early 1970s and subsequently lectured at Melbourne and La Trobe Universities. He is co-author of a first year university textbook *Positive Economics for Australian Students*. Dr Mahoney joined the Economic Department at Westpac in 1986 and is currently Senior Economist. He is the editor of the textbook, *Current Economics Made Easy* designed specifically for Year 12 students and is the co-author of the ACC/Westpac Discussion Paper 'The Asian Region by 2010: A Business Brief'.

AUSTRALIA'S ECONOMIC PERFORMANCE AND FEDERAL GOVERNMENT ECONOMIC POLICY

DR DENNIS MAHONEY

We begin with a review of performance and policies in the 1980s.

Australia entered the 1980s on a wave of optimism about international trade prospects. Foreign investment, mainly in the form of debt (borrowing) poured in to develop new coal mines, expand the aluminium industry, explore for oil and gas and investigate high-cost sources of energy such as shale oil.

Unfortunately, the resources boom never eventuated. Nevertheless, Australia had two years of rapid economic growth through 1983 and 1984. First, the drought broke in 1983, boosting volumes of rural products available for export. Second, policies were implemented which stimulated economic activity without being immediately inflationary.

The Mid-1980s: Painful Policy Awakenings

The resumption of low-inflationary growth in 1983 concealed the fact that Australia was living on borrowed time. The policy of expanding domestic demand was incompatible with a weak current account in the balance of payments.

In 1984/85, real GDP grew 4.6 per cent. This stimulated demand for imports, a major factor contributing to a blow-out in the current account deficit from $1.3bn to $10.8bn.

Under pressure from the huge gap between foreign exchange earnings and payments, the $A depreciated 25 per cent in 1985. The depreciation was welcomed by many exporters of rural and mine products. In time, they saw themselves capturing greater market share and bigger $A returns for their products.

Figure 1 is a simplified version of events that led Australia to its then record external deficit of $14.4bn in 1986/81.

The figure shows how rapid expansion of domestic spending (in 1983/84) and weak commodity prices (1985/86) combined to plunge the current account deeply into deficit. The deficit was financed by a rapid build-up of external borrowing. All of these factors finally took their toll on the $A. Higher-priced imports then flowed through into higher inflation.

Net external debt, which is total debt owed to foreigners (called gross debt) minus debt by foreigners owed to Australians, also expanded rapidly. Several factors affect the size of the net external debt: the deficit, borrowing, and the exchange rate.

Figure 1: **Macro problems in the 1980s**

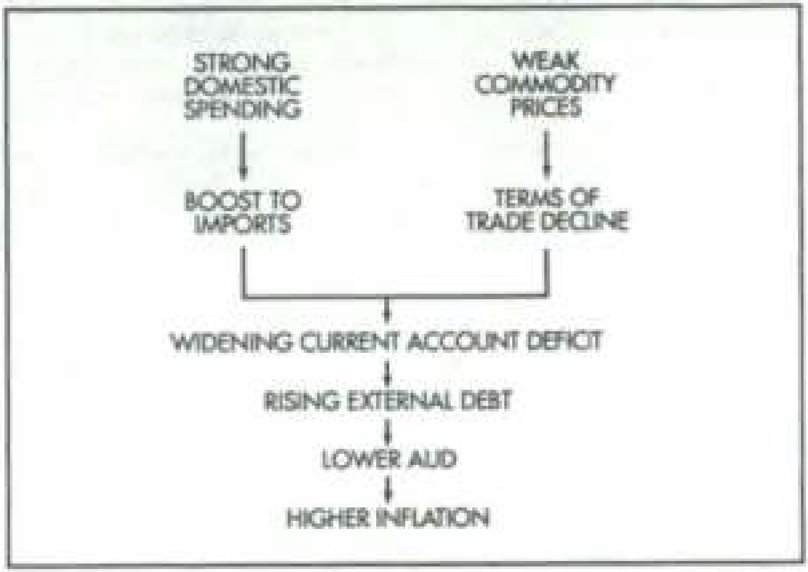
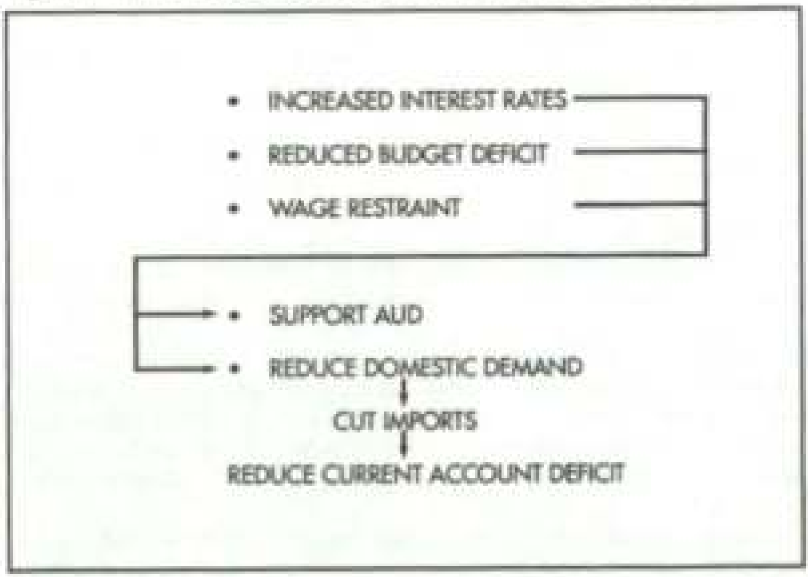


Figure 2: **Macro policy responses in the 1980s**



First, and fundamentally, the stock of debt is the accumulation of that portion of past current account deficits which were financed by borrowing (rather than equity inflows). Second, because 60 to 70 per cent of Australia's debt is denominated in foreign currencies, changes in the exchange rate directly affect the $A value of the foreign currency component of the debt.

The rate of increase in the $A value of the net debt slowed down after 1986. The debt also fell as a percentage of GDP. The $US value of the debt, however, continued to rise because a large part of the current account deficit is still financed by borrowing from foreigners.

Policy Responses

In response to the serious current account problem in early 1985, the government tightened monetary policy, both to support the $A and to suppress domestic demand and so dampen imports.

However, tighter monetary policy alone was insufficient to turn the balance of payments deficit around. With commodity prices clearly tumbling and the deficit rising, the currency came under renewed pressure late in 1985 and again in 1986.

The turning point came with the much-publicised remark by the Treasurer, Mr Keating, on Sydney radio on 14 May 1986, warning that Australia could become a banana republic.

Thus began the government's concerted attempt to encourage capital inflows and to tighten fiscal and wages policies.

Some of these policy responses and their intended effects are set out in Figure 2. (An important link between Figures 1 and 2 not included is an arrow from 'Lower AUD' in Figure 1 to 'Reduce Current Account Deficit' in Figure 2. The lower $A boosts exports and thereby helps to reduce the deficit.)

The policy shift to fiscal austerity first occurred in the 1986/87 budget, when the estimated budget deficit was reduced to $3.5bn from the previous year's outcome of $5.1bn.

Progressive cuts in the real value of outlays and extra tax revenues from a broadened tax base culminated in a $A5.9bn surplus in the 1988/89 budget. The boom in spending drove the 1989/90 surplus even higher — to $A8bn.

Prior to the 1986/87 budget, the government had distanced itself from the indexation-based Wages Accord which was introduced following its election in 1983. Late in 1986, pay increases were discounted (that is, they did not fully reflect past price rises). Then, in March 1987, indexation was replaced by a two-tier wage system which resulted in sustained real wage reductions.

Successive changes in the Accord agreement have been labelled Mark I,

Figure 3: **An overview of 1990 and 1991**

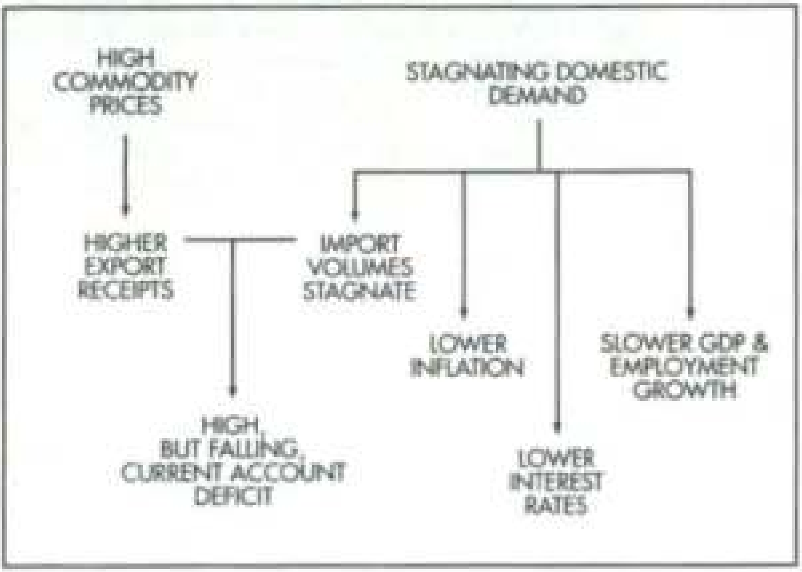
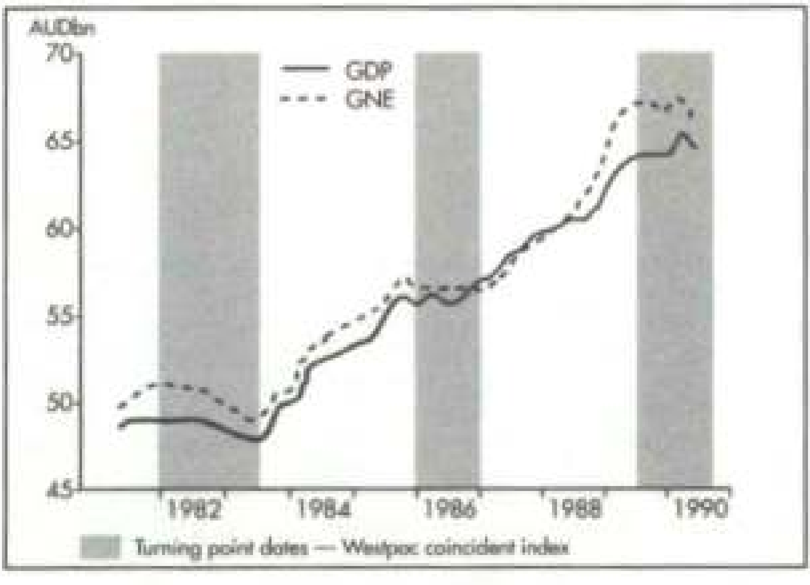


Figure 4: **Domestic spending and output**



Mark II etc. The last Accord, which involves wage increases in return for productivity gains through the restructuring of award rates of pay and conditions, is Mark VI. Under each Accord, wages rose more slowly than prices and average weekly earnings fell in real terms.

By early 1981, the three arms of policy had begun to reduce the current account deficit. The conjunction of falling inflation, rising commodity prices, improving trade data, and progressively tighter fiscal policy enabled the government to ease interest rates throughout 1987 and early 1988 while the $A gradually appreciated.

The Speculative Boom and Bust

In 1987 Australia's terms of trade began what was to be a dramatic turnaround. The rise in purchasing power caused some concerns about domestic spending, but the sharemarket crash confused all the commentators.

When post-October 1987 sharemarket concerns disappeared in the face of sustained world growth and lower oil prices in 1988, fears of recession gave way to concerns about inflation.

In Australia, no-one foresaw the size either of the speculative boom that was underway or the size of the domestic spending boom.

Stockmarket prices soared in 1987 before peaking in October, commercial real estate peaked in 1988 and house prices peaked in 1989. By the end of 1989, real domestic spending had risen 8 per cent and the external gains of the previous two years had been lost.

The government progressively tightened monetary policy until mid-1989 and maintained a high interest rate setting during the second half of the year in order to rein in domestic spending.

By early 1990, investment had crashed and the economy was slowing rapidly. Economists wondered whether the landing ahead would be soft or hard.

Figure 3 shows how Westpac thought 1990 and 1991 would work out a year ago. The direction was right in almost every case (except commodity export prices have fallen sharply in 1991) but the recession in domestic spending has been much worse than anyone expected. Figure 4 shows the big fall in spending by Australians over the past 18 months.

Uncertainty about the degree of severity of the economic downturn set in train by monetary policy (and fiscal restraint) was replaced by the reality of recession in the second half of 1990, and by the big shake-out in the labour market which accompanied it.

The economy has continued in the throes of recession despite on-going reductions in interest rates since early 1990 (as shown in Figure 5). The required pace of the reductions in interest rates was difficult to gauge. One objective was to avoid any early resurgence in demand — the other to

Figure 5: **Easing monetary policy 1990s style**

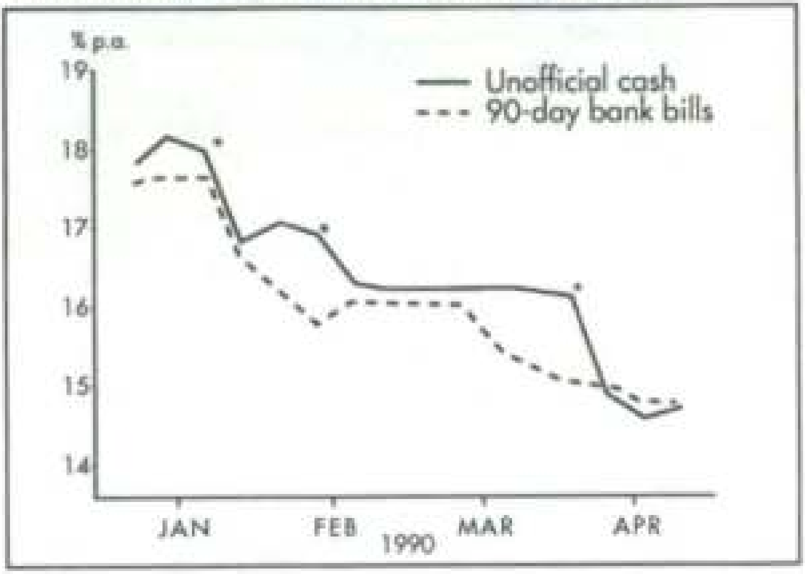
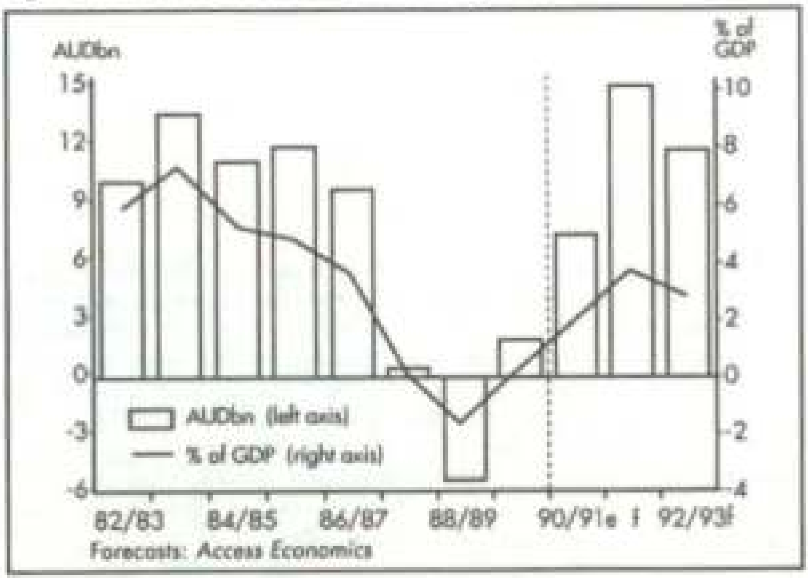


Figure 6: **Public sector borrowing requirements**



avoid a heavy and painful slow down.

Such a balance has always been difficult to achieve and confirms once again that the outcomes of monetary policy are by no means precise, either in terms of timing or impact.

In the end, no amount of monetary easing would have saved many over-geared companies, as asset prices tumbled and cash flows dried up.

The Way Ahead

The cost of recession has been high with rising unemployment, a decline in housing activity, increases in business failures. The continued relative tightness of monetary policy into 1991, falling asset values and reduced turnovers have generally exposed financial institutions and their customers alike to a process of painful and substantial adjustment.

No rapid recovery seems likely from the present recession, unless the government overturns its present fiscal and monetary policy stances and seeks to spend its way out.

But the drop in spending and rise in unemployment have already caused a major revision in federal government finances for the next few years. The loss of stamp duty arising from depressed share transactions and property sales has also caused state budgets to move sharply into deficit for the next few years. Figure 6 shows the inevitable result: an inevitable blow out in the net PSBR (on 'unchanged policy' assumptions) for the next few years.

Governments are unlikely to inject extra spending into the economy when the PSBR is running at levels creeping back to the mid 1980s.

Monetary policy is also likely to remain relatively steady until the recovery is clearly in danger of running too strongly.

Poor prospects for the rural sector, commodity prices and non-residential construction are likely to keep any recovery muted, at least until the end of 1992 (when the economic upturn and the political cycle come together).

The major policy unknown in the remainder of 1991 and 199 remains wages policy.

To its credit, the Accord delivered wage restraint during the boom of 1988/89. But it has been delivering higher nominal wage growth and real wage increases for the last two quarters. This is an ominous development because, if it continues, it implies wage increases for the employed at the cost of jobs for the unemployed. It also implies that the gains on inflation may be frittered away when the economy starts to recover in 1992.

As for the big picture, Australia is little further advanced on its current account deficit and net debt prospects than it was in 1985. These problems can only be solved if spending growth remains below growth in production, and that possibly for the next decade.

Keeping domestic spending growth below production growth implies no more booms in spending and hence requires relative tight fiscal, monetary and wages policies.

In that constrained setting businesses will seek to lift their sagging profitability by slashing their workforce and restructuring their employment patterns such as shifting from full-time to part-time workers.

There are two ways the government can ease the spending constraint. First, it can reject the idea that spending growth must stay below production growth. That is, it can 'lurch to the left' by spending up big on say, infrastructure projects. This will certainly pump-prime the economy out of recession but the cost will be another serious deterioration in the current account deficit and, ultimately, higher wage and price inflation. In short, more of the same expansionary demand policies of the 1980s.

The second alternative is to lift production growth by working smarter and working harder. This way forward is summarised in the term microeconomic reform which is designed to lift Australia's productivity, efficiency and international competitiveness across a broad range of industries, many of which are in the transport and distribution chain (road, rail, ports, sea) and public sector (placing government business enterprises on a commercial footing, deregulation of airlines and telecommunications etc.)

Microeconomic reforms in all their guises are the high road out of Australia's debt morass . . . but that is another story, about politics as much as economics.

MACROECONOMIC MANAGEMENT IN AUSTRALIA: TOWARDS A BETTER INDUSTRIAL RELATIONS SYSTEM

THE HON. JOHN HOWARD MP

SHADOW MINISTER FOR INDUSTRIAL RELATIONS, EMPLOYMENT AND TRAINING

John Howard was elected MHR for Bennelong in May 1974. He was Treasurer in the Fraser government from November 1977 until March 1983. John Howard was elected Deputy Leader of the Opposition in 1983 and became Leader of the Opposition in 1985, a post he held until 1987. Following the March 1990 federal election, Mr Howard was appointed Shadow Minister for Industrial Relations, Employment and Training. He also assists the Leader of the Opposition on public service matters and is chairman of the Manpower and Labour Market Reform Group.

MACROECONOMIC MANAGEMENT IN AUSTRALIA: TOWARDS A BETTER INDUSTRIAL RELATIONS SYSTEM

JOHN HOWARD

This seminar is very much about challenges to macro and micro economic management in the vastly changed economic circumstances Australia faces in the 1990s.

It has become a weary cliché to say that Australia must endure painful economic adjustment if she is to remain competitive and if our living standards are to be maintained in the longer term.

Those of you who have carefully followed economic and political debate in Australia will know that over the last six to eight years I have been the most strenuous political advocate of radical reform to our industrial relations system.

It was not long after the election of the Hawke government that I came to the realisation that decades of bipartisanship on industrial relations should end.

In August 1983 I addressed the National Press Club as Deputy Leader of the Opposition and said that the time had come to turn Mr Justice Higgins on his head.

That attack on the citadel of centralised wage-fixation was greeted with howls of derision from the unions, many employer groups, the Labor Party, and a sizeable segment of my own party.

Deregulating the labour market was a very unpopular cause in the early 1980s. The Accord-style consensus approach was all the rage then.

When I became Leader of the Opposition in 1985 I specified labour market reform as the most crucial economic challenge facing Australia. That remains my view.

The 1986 industrial relations policy of the Coalition broke completely new ground.

For the first time in Australia's history a major political party was advocating that individual employers and their employees should have the right to make direct workplace bargains without the supervision or intervention of anybody else provided certain minimum wage, health and public safety conditions were observed.

To the electorate of only five years ago it was seen as a radical prescription. It evoked a lot of scepticism. Some state Liberal leaders either ignored the policy or, even worse, denounced it.

Yet today one has a real sense that it is a policy whose time has come.

Perhaps the best evidence of this is that many now clamour to receive the credit for being amongst the earliest advocates of the policy change.

The Industrial Relations Debate

Success has been achieved in the industrial relations debate because the two essential preconditions for selling major economic change have been met.

First, the national benefit of a changed industrial relations structure has been constantly advocated.

That benefit is the one of higher productivity.

There is common agreement that Australia's crying economic need is enhanced national productivity. By demonstrating that free bargaining at the workplace level will lift individual workplace productivity, those of us who argue for radical change are able to make a powerful case in the national economic interest.

The second precondition for selling radical economic change to the community is that the burden of that change must be fairly and evenly spread.

This also has been demonstrated in respect of labour market reform.

As the SPC and Power Brewing examples have so eloquently displayed, free workplace bargaining ultimately benefits the worker more than anyone else.

Higher productivity and profitability are the real foundation of higher real wages.

We have no hidden agenda on industrial relations. The Australian public will know full well the industrial relations system it can expect if it elects a Liberal/National Party government in 1993.

We stand for a radically changed industrial relations system for this country.

I am conscious of the mixed views that this audience here today probably has of our industrial relations philosophy.

There are some of you who will be utterly opposed to it. There are others of you who will remain profoundly sceptical as to whether the policy will work or, alternatively, whether we really intend to introduce the full gamut of what is contained in our current policy. Of course I am certain that a significant number of you support the full thrust of the policy.

I do not deny for a moment that when implemented our industrial relations policy will affect institutional power in the Australian community.

There will be a lesser role for the Industrial Relations Commission. Some power now wielded by trade unions will disappear. Likewise the influence of employer organisations will be diminished.

None of this is said vindictively. The agenda is not one of political or industrial revenge.

I have long believed in the need for major change to Australia's industrial relations system through the introduction of an approach putting maximum emphasis on workplace bargaining.

This is because I believe that an industrial relations system built on workplace bargaining is more likely than any other system to boost enterprise productivity and hence national productivity.

Whatever credit the Accord can claim in restraining real wage growth is overwhelmed by the abysmal failure of the Accord years to deliver higher productivity.

Therefore the litmus test of any industrial relations system for the 1990s must be its potential to deliver more productive outcomes than those achieved in the 1970s and 1980s.

The Opposition's Industrial Relations Policy

The essential elements of our industrial relations approach are well known. Today I shall briefly rehearse them and then deal with a number of specific concerns which may be entertained by some of you here today.

The policy is built on four major principles:

- firstly, the absolute right of individual employers and their employees to make voluntary agreements at a workplace level without the intervention of organisations or industrial tribunals subject only to the observance of a minimum wage calculated at an hourly rate and statutory requirements relating to safety and health matters;
- the absolute right of individuals to join or not to join trade unions. This means an end to the closed shop;
- the maintenance of the principle that the conduct of all Australians should be subject to the ordinary laws of Australia administered by the ordinary courts of this country; and
- the right of trade unionists to associate on an enterprise, industry or craft basis without arbitrary restrictions of any kind.

It follows from the above that the Coalition strongly supports the right of employees to form enterprise or company unions if that is their wish.

I used to believe that the solution to all our demarcation problems was to effectively force the creation of large industry based unions. I no longer believe that.

To me it is a grievous contradiction to argue on the one hand that what Australia needs is a bargaining system based on the workplace and yet deny Australian workers the right — if they so choose — to associate exclusively at a workplace level.

In any event, the demarcation myth about industry unions was effectively demolished by the Business Council enterprise bargaining survey published two years ago which showed that even if the total number of unions were reduced to 20 then this would result in the average number of unions operating in the very large enterprises falling from only five to four.

Our commitment to the rule of law means that we are totally opposed to the creation of a specialist labour court.

One of the mammoth changes to the industrial relations scene in the 1980s was the ascendancy of the principle that certain forms of industrial conduct which did great damage to companies could be made subject to adjudication and penalty by the ordinary courts.

Section 45(D) of the Trade Practices Act has proved remarkably effective in bringing to a prompt end predatory conduct by irresponsible unions.

In my view there is no need to attempt any codification of the right to strike in Australia.

As the Prime Minister himself correctly observed in the wake of the pilots' dispute in 1989, 'there is a right to strike in Australia and it is exercised'.

If the abortive 1987 industrial relations legislation is any guide, a revived attempt by the Hawke government to resuscitate the concept of a labour court which would assume jurisdiction over Section 45(D) and common law remedies would amount to nothing more than the effective destruction of these hard won protections now available to Australian employers.

Therefore the federal Opposition will fight any attempt to establish a separate labour court or to codify the right to strike.

There is no shortage of myths surrounding the industrial relations debate in Australia.

The 1981-82 Wages Breakout

One of the greatest myths is that our present policy is bad because it is a re-run of the wages policy of the Fraser government after the then Conciliation and Arbitration Commission abandoned the wage fixation principles in July 1981.

That claim is totally false. The wage break-out of 1982 did not result from the pursuit of an enterprise based wage fixing system of the type now proposed by the Coalition.

There were no voluntary agreements in the early 1980s.

The wage policy pursued by the Fraser government after July 1981 was not based on enterprise agreements.

Much of the difficulty which arose in the early 1980s was caused by the fact that as one system collapsed or became inoperative no mechanism existed to take over from the former system.

Ironically — particularly in the light of the Hawke government's frequent attacks on the Coalition over what happened in 1981 — the present no man's land of wage-fixation created by the government/ACTU rejection of the recent national wage case bears remarkable similarities to the situation which occurred in 1981.

The government and the ACTU have combined to undermine the centralised system which has existed for the past eight and a half years but have no viable alternative system to put in its place.

This is because the only viable alternative to the system followed for the past eight and a half years is the policy espoused by the Coalition. Under no circumstances will the Hawke government fully embrace that policy.

The circumstances and policies of 1982 are light years away from what the Opposition now proposes.

Our policy provides that voluntary agreements will have the status of awards and, to the extent that a voluntary agreement replaces or varies an existing award, the product of that variation or replacement becomes the new award.

Crucially, that new award only applies to the individual enterprise. Under our policy the Act will be amended to prevent the Commission having any jurisdiction over those matters covered by a voluntary agreement.

The policy further stipulates that the Act will be amended to exclude the provisions of a voluntary agreement from the matters the Commission may have regard to when it is hearing and determining an industrial dispute.

To buttress this stipulation, the policy further states that should a trade union take industrial action designed to have the provisions of a voluntary agreement granted or incorporated into an award of the Commission to which the union is a party, the taking of that action shall be a ground for the Commission suspending or cancelling the award so far as the award applies to, or is in favour of, the union or its members.

These provisions are all designed to quarantine voluntary agreements to the individual enterprises in question.

The policy specifically commits a future Coalition government to legislatively prevent the application of comparative wage justice where voluntary agreements are involved. That is the effect of paragraph 2.20 of the policy.

To those cynics who might well yawn at such legalisms, mutter darkly about the real world and simply assert that any powerful union will 'take in the field' any juicy item of a voluntary agreement which catches its fancy, let me say that the real world of the 1990s is a millenium away from the real world of the early 1980s.

First, union membership has continued to fall through the 1980s.

The tide of history is clearly against the organised trade union movement as we have known it.

As already noted, union membership has declined sharply over recent years despite the unparalleled political influence of ACTU leaders.

The dramatic surge of married women returning to the workforce — often part-time — is bad news for traditional trade unionism. Many of them are suspicious of unions. Some see themselves as only temporarily in the workforce.

Add to this the innate disinterest of the young in joining any organisation, least of all a union movement, they often see as fighting long distant battles of no relevance even to their parents, let alone themselves, and you have a recipe for continued decline in union membership.

Second, as I have already indicated, employers today have a much keener sense of their common law and other legal rights than was the case ten years ago.

The change on this front has been momentous. In 1985 the members of the Hancock Committee could still state with a collectively straight face that unions could not be made subject to the ordinary courts because they could not be expected to obey the directions of those courts. Such a proposition would not seriously be advanced today. In six short years there has been something close to a revolution of thinking and attitude best encapsulated by former ACTU President Hawke, at the height of the pilots' dispute last year, exhorting the airline companies to sue a union.

Third, the mass unemployment in manufacturing industry in 1981/1982 and the current high levels of unemployment have been etched on the consciousness of the broad labour movement.

It was after all a Labor Treasurer, Paul Keating, who told George Campbell at the 1986 Hobart conference of the ALP that he 'had 100,000 dead men around his neck'.

All of us have been mugged by the realities of the 1980s and early 1990s.

Future Industrial Relations Reforms

Against this background I must say that some of the wage increases awarded by some Australian companies to their senior executives are excessive and have done nothing to encourage the vast bulk of the workforce to believe that there has been a completely fair sharing of the burdens of the current recession.

I speak only of a minority. Many executives have been subject to either severe salary restraint or reduction. Many in middle management have lost their jobs. The recession has absolutely devastated small businesses throughout the country.

Nonetheless, there is an obligation on the very highly paid in the corporate and financial community to understand the impact of unreasonable wage adjustments on the capacity of those seeking wage restraint in the generality of the community to achieve that goal.

The industrial relations policy I have spoken of today is essentially a development of that put in place early in 1986 when for the first time the Liberal and National Parties departed from the basic bipartisan consensus in support of centralised wage-fixation which had existed for decades in Australia.

The industrial relations debate has moved rapidly in recent months. There is now much greater support for the concept of workplace bargaining.

In particular, I have under review the whole question of whether it is any longer appropriate for Australia to have a national wage case.

In an environment where enterprises have the option of remaining within the award structure, entering into an enterprise agreement under Section 115 or alternatively concluding a voluntary agreement outside the ambit of the existing industrial relations system, the question must be asked as to whether a place really does exist for a national wage case.

Finally, there remains the vexed but fundamental question of the federal/state dichotomy which has afflicted industrial relations as much if not more than any other section of Australian economic activity.

At heart I believe in a single Australia-wide jurisdiction. I am not a centralist but I am an economic nationalist.

A nation of only 17 million people can ill afford the economic provincialism which is often the product of divided legal and jurisdictional responsibility.

Rapid change on this front would be difficult. If Commonwealth and state power could be pooled then giant strides could be made towards eliminating many of the overlapping problems which now exist. For this to be achieved, however, there would need to be widespread common agreement on policy goals and objectives — no mean task in the area of industrial relations.

I have said before — and repeat it today — that as part of an overall re-apportionment of power between the Commonwealth and the states I would support a transfer of the industrial relations power to the federal government.

In other words, if the Commonwealth were to surrender to the states some responsibilities more properly belonging to them then as part of the package the states ought to hand over the industrial relations power to the Commonwealth.

I do not imagine any of this is going to happen overnight but if we are serious about radical, lasting change on the industrial relations front then it must be put on the agenda.

AUSTRALIA AND THE WORLD ECONOMY

TOM DUSEVIC

ECONOMICS WRITER
THE AUSTRALIAN FINANCIAL REVIEW

Tom Dusevic holds a BA and a BEc from the University of Sydney. He undertook postgraduate studies in journalism at the University of Southern California. Since 1988, Tom has been working at *The Australian Financial Review* covering banking and finance, the Australian and international economies and the Gulf War. He is a regular editorial writer with a weekly column on the state of the world economy and with Michael Stutchbury, prepares the widely read 'The Economy This Week' section of the *AFR*.

AUSTRALIA AND THE WORLD ECONOMY

TOM DUSEVIC

My topic today is Australia and the world economy. Semantically that wording may have been fine in the Menzies era, but these days it just won't do. John Donne's 17th Century maxim that no man is an island applies equally to insular medium-sized economies in the 1990s. Contemporary economic and political thought is rooted in the concept of Australia in the world economy.

Australia is firmly integrated in a changing world economy where capital flows move rapidly between national boundaries and where economic crises in the giant economies and market gyrations (such as oil shocks, commodity price slumps and sharemarket crashes) can quickly spread around the world. All this means that managing the Australian economy is akin to sailing a small boat in huge seas — you tend to get bumped around a lot.

Today I would like to look at a few issues facing the Australian economy as it battles to earn its way in the world: first, trade and industry policy; second, the balance of payments and foreign debt; third, the state of play in the world economy, commodity prices and the $A.

Trade and Industry Policy

Protectionism effectively died in March this year, when the Prime Minister announced that most tariffs would be cut to 5 per cent by 1996 (see fig. 1). The exceptions were motor vehicles (15 per cent by 1999) and textiles, clothing and footwear (a maximum of 25 per cent by 1999). The bottom line is that the effective rate of assistance (the extent to which domestic value added in a particular industry is boosted by protection) will have fallen from around 35 per cent in the early 1970s to 5 per cent by the end of this decade.

There is now a broad free-trade consensus in the Australian polity, which is aimed at cutting import protection, boosting foreign competition in domestic industry and further integrating Australia in the international economy.

The intellectual impetus for this view largely comes from Professor Ross Garnaut's October 1989 report, 'Australia and the North-East Asian Ascendancy', which principally called for the elimination of all protection by the year 2000. As well, Garnaut stressed that Australia must take advantage of the rapidly growing opportunities for trade with the dynamo Asian economies to our north. Australia is rich in natural resources, while Asia lacks resources. As Asian countries such as Japan, South Korea, Singapore and Taiwan become more middle-class, they will

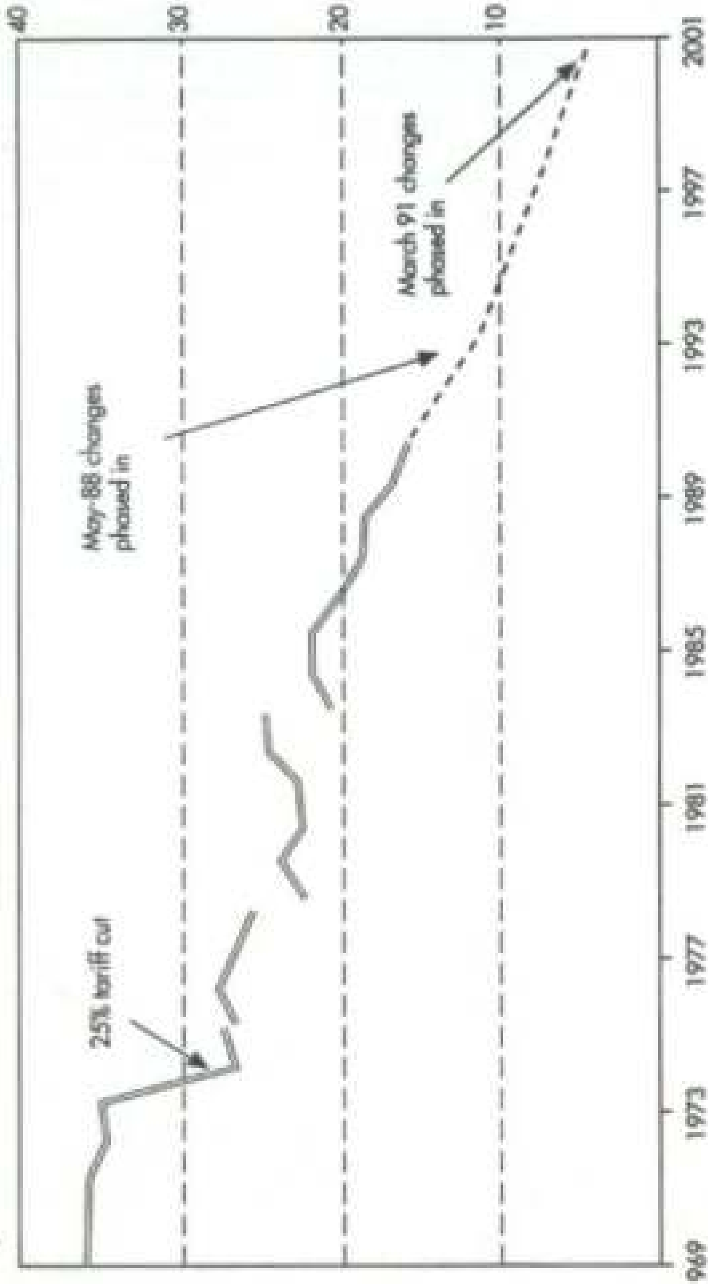


Figure 1: **Effective rates of assistance for manufacturing**

Source: Industry Commission (breaks due to industry reweighting) increasingly want western-style consumer products.

Just on comparative advantage it seems there are tremendous trade opportunities here. Garnaut sees Australia's best opportunities in boosting mineral exports (such as coal, iron ore and natural gas), agricultural exports (such as beef and wool) and services (such as education, health and tourism). Further processing of natural resources (such as bauxite into aluminum and agricultural products into food) is vital, says Garnaut.

But before these trade gains with Asia can be realised, Garnaut says that microeconomic reform in a variety of areas such as transport (particularly the waterfront), the tax system and power generation needs to be implemented to boost Australia's international competitiveness.

Well competitiveness and micro-economic reform are indeed the latest economic buzz words. But what do these over-used terms mean and how far have we gone to make them real beyond the rhetoric? The next speaker, Dr Clark, will flesh out the latter, so I will take a closer look at international competitiveness.

Competitiveness is far more than the conventional definitions which simply look at wage costs and exchange rates. These two things play a part, but I prefer to use the concept of competitiveness in the way two Swiss bodies look at it. They define it in terms of how conducive or detrimental a country's environment is to the domestic and global competitiveness of enterprises operating within it. So competitiveness is a matrix of virtues and vices.

Each year since 1981 the World Economic Forum and International Institute for Management Development have prepared the 'World Competitiveness Report', looking at over 300 quantitative and qualitative criteria, ranking the industrialised countries in terms of the attractiveness of its competitive environment for investment and aggressiveness of its enterprises in world competition.

Despite the recent hype and federal government initiatives, Australia is slipping behind the pack in the competitiveness stakes. Australia was 16th in this year's report. Last year it was 13th and in 1988 it was 10th.

According to the latest report the recession, business failures, suspect corporate credibility and the perception that Australia is still plagued by industrial relations problems makes Australia an unattractive place for foreign investment. While a volatile $A, a lack of management initiative and an insular mind-set emasculates Australia's performance on world markets, the report found.

Looking at Australia's industrial structure and exports, the report placed the nation in the catching-up category, with a small export portfolio, characterised by a weak competitive position due to low market growth and low market share.

The weighted-average growth of Australia's leading 10 export industries between 1985 and 1989 was 12.2 per cent — only Norway showed slower export growth. In the 1990 report Australia's weighted-average share of world markets was 7 per cent. This year Australia's market share has been squeezed to 6.2 per cent.

The report also showed that in terms of geographic diversity, Australia's exports were heavily concentrated in the Asia-Pacific region. Although if the much heralded 'Pacific Century' actually lives up to its PR potential, then this may not be such a bad thing.

Turning now to the international arena, one must ask how well Australia can (or is allowed to) compete in world markets and assert its comparative advantage. Australia is hampered by the agricultural protectionism of Europe, the United States and Japan. By subsidising their own farmers and pushing down commodity prices, these countries make it harder for efficient producers like Australia to compete. The main hope for Australia lies in a successful resolution of the current Uruguay Round of trade talks being held by the General Agreement on Tariffs and Trade (GATT). The current round is the eighth such round since the GATT was established in 1947 and is the first to include barriers to agricultural trade.

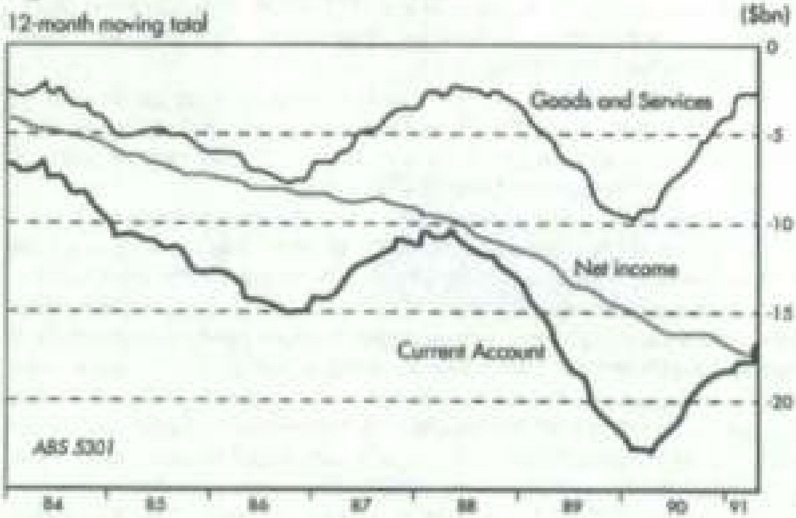
The Uruguay Round is almost five years old now. The talks broke down in December last year when the European Community could not agree to demands from the US and the Cairns Group of countries (including Australia) for large cuts to farm export subsidies, internal support and increased market access. The talks started up again in March and it is important for countries like Australia to keep the pressure up and make sure the parties stay at the negotiating table.

Clearly for Australia the GATT-talks represent big dollars. If subsidies are not cut, more Australian wheat and dairy farmers will go broke and successful producers will be forced to the margin. Removing agricultural barriers in OECD countries would boost real farm incomes by 11 per cent in a single hit. According to Westpac economists a continued drift to protectionism and trade blocs could lower the level of GDP by 3.5 per cent (or $16 billion) by the mid-1990s. Australia is too small to fight trade wars and must rely on trade diplomacy.

Balance of Payments and Foreign Debt

Perhaps the biggest economic story of the 1980s was the sharp deterioration in Australia's current account deficit (see Fig. 2) and the rise in Australia's foreign debt from 5 per cent of annual GDP to almost 35 per cent. The slide in the external accounts led to Paul Keating's oft-quoted Banana Republic remark, the rise of the gloom merchant economic commentators and panic and mayhem in Australian dealing rooms at 11.30 on the morning of an ABS monthly balance of payments release.

Figure 2: **Current account deficit**



What were the reasons for this deterioration?

- The surge in borrowings to finance the much-vaunted (but failed) resources boom of the early 1980s.
- The era of large Budget deficits preceding the 1982-83 recession.
- The collapse in commodity prices and, of course, the terms of trade, which devastated the nation's export income in the mid-1980s.
- The surprising spending boom ignited by the relaxation of monetary policy after the October 1987 sharemarket crash which sucked in a poultice of imports.

So how did this translate into the growth in foreign debt?

One way of looking at the current account deficit is as the excess of domestic investment over domestic saving. The extent to which domestic investment (such as in plant and equipment, roads, bridges, airports and housing) exceeds domestic saving (the part of national income not consumed) must be financed by the savings of foreigners, or capital inflow. And that's how you get the two sides of the balance of payments — the current account and capital account. By definition, the current account deficit is equal to the capital account surplus or vice versa.

From this starting point we can tell the story of the rise in the foreign debt. The initial widening of the goods and services deficit in the early part of the decade was financed by increased foreign borrowings on the capital account, helped by financial deregulation and the removal of capital controls (see Figures 3 and 4). This increased stock of foreign debt had to be serviced, which showed up as an increase in the net income

Figure 3: **Composition of net non-official capital inflow, proportion of total**

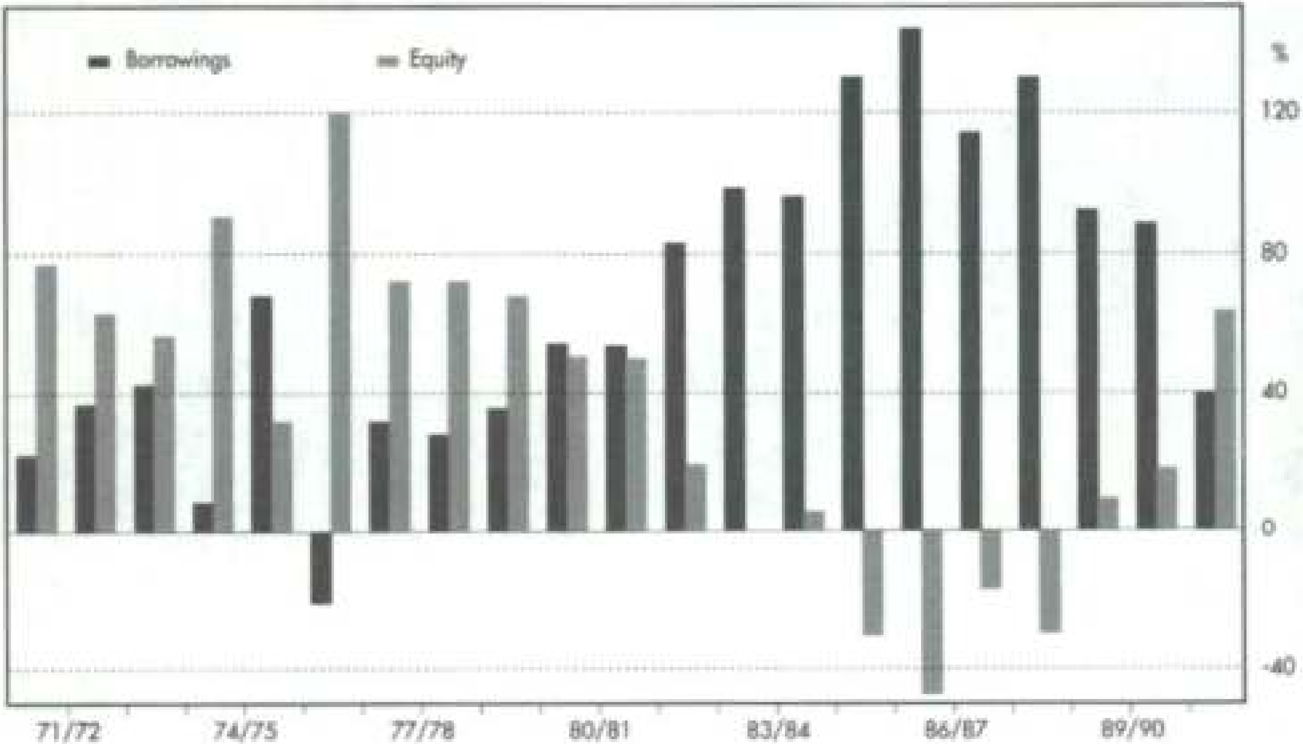
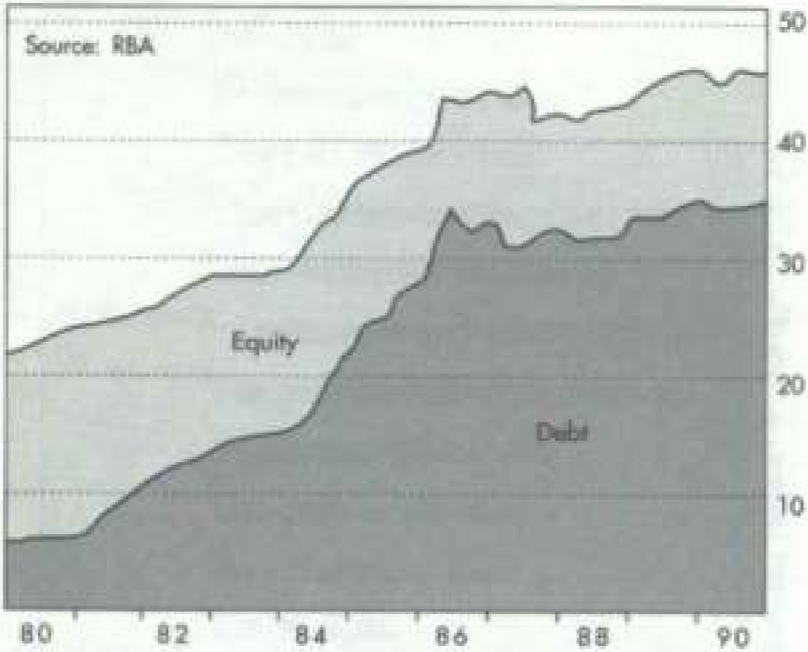


Figure 4: **Net foreign liabilities**
Per cent of GDP



deficit on the current account. In turn, the larger current account had to be financed by increased capital inflow and so on in a process that took on the character of an increasingly nasty debt trap.

Indeed, with a marked improvement in the goods and services part of the current account, the interest payments on past borrowings (shown in the net income part) now account for more than the whole current account deficit. True, the bottom line on the current account has improved by 30 per cent in the first 11 months of the 1990-91 fiscal year and looks like coming in at around $16 billion — less than the government's forecast of an $18 billion deficit. But the improvement has largely been cyclical in nature, with import spending reduced by the recession.

The danger is that when the economy picks up in the second half of this year, the current account deficit will worsen again. The only way to stabilise the foreign debt then is for the goods and services part of the current account to move into a big surplus.

In opposition to the ruling foreign debt 'doom and gloom' school has emerged a group of economists who argue that foreign debt is not worth worrying about. Led by the Australian National University's Professor John Pitchford and the University of Queensland's Tony Makin, these economists say the build-up in foreign debt has allowed the domestic economy to expand its productive capacity and, in the end, generate more income.

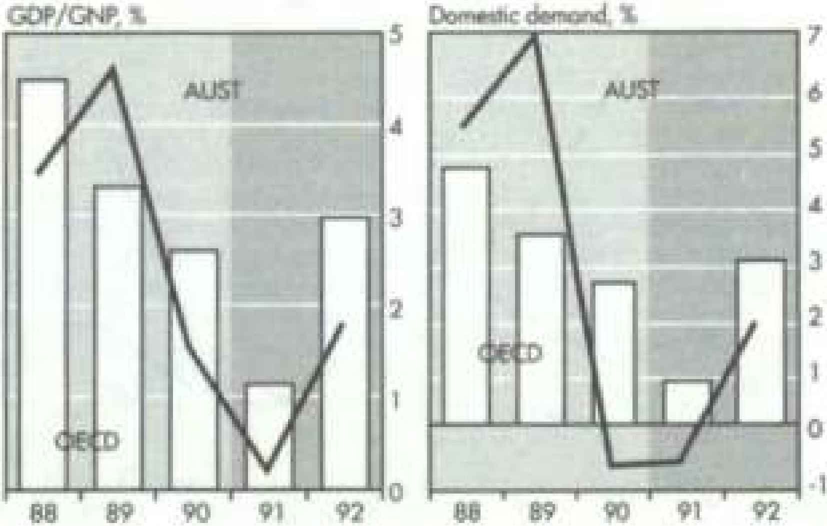
They argue that the balance of payments is being driven by a benign capital account (of productive investments), and not a deterioration in the trade account, or as some argue, by a damaging capital account (speculators attracted by high interest rates). Foreign savings are being attracted to investment opportunities in Australia, allowing the economy to live beyond its means through the widening of the current account deficit, they argue. But the increased investment will deliver profits and export earnings, allowing the nation to service the increased foreign debt.

This *laissez faire* argument asks governments to keep out of the process. The investors will either make money or go broke, based on the prudence of their decisions. Why should government's attempt to wreck these investment opportunities with high interest rates to improve the balance of payments, they ask. The self-regulating nature of markets (with correcting mechanisms such as exchange rates) means they are more likely to get it right than governments.

This debate still rages, dividing academics and professional economists. Nevertheless, whatever the final outcome, the so-called Pitchford line has tempered the alarmist concerns surrounding the foreign debt. Even some of the doomsayers are now questioning the conventional wisdom that Australia's current account deficit and foreign debt problems

Figure 5: **OECD forecasts** — Australia and the industrialised world

Figure 5a: **Output** Figure 5b: **Spending**



should be tackled through government macroeconomic policies.

One other important new development in this area, as chronicled by my *AFR* colleague, Michael Stutchbury, is the great foreign-debt-for-equity swap going on in the Australian economy (Figure 4). Much of the rise in Australia's foreign debt in the 1980s comes back to the rise in foreign borrowings by Australian companies to finance takeovers, here and overseas. Capital inflow can appear in the form of either foreign borrowing or equity inflow (that is, increased foreign ownership).

In the 1950s and 1960s, most of Australia's capital inflow came in the form of equity, raising concerns about selling off the farm. But in the second half of the 1980s, more than 100 per cent of capital inflow came from foreign borrowings (the bit above 100 per cent financed the offshore exploits of Australian companies, like Bond, Elders and TNT in their quest, as one could put it, to Fosterise the world). Australia briefly became an exporter of equity capital. But with the collapse of what *The Economist* called *homo entrepreneuris australiensis* (risk-taking, debt-carrying, southern man), the debt boom has gone bust. The high-flyers are trying to pay off their debts by selling their assets to foreigners. Once again, equity comprises a large part of Australia's capital inflow.

Although the foreign debt should level off, Australia's foreign liabilities will keep growing as foreign ownership increases. Like debt, foreign ownership has its downside. Instead of interest payments, it is overseas dividend payments which will show up on the current account's net income deficit.

Figure 5c: **Inflation**

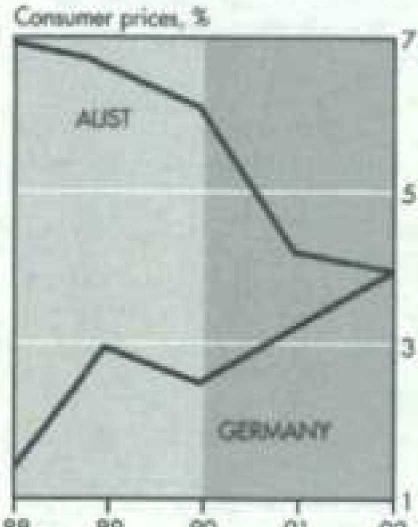
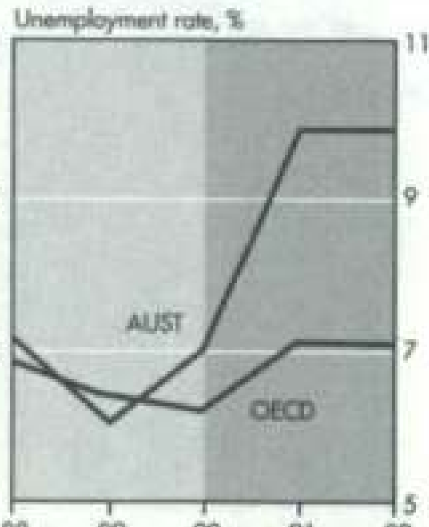


Figure 5d: **Jobless**



But the government's sense of urgency over the balance of payments has subsided over the past year. Inflation is the number one policy target (fig. 5c). Part of this change in direction (and rhetoric) has been the amazing resilience of the $A in a climate of falling interest rates, falling commodity prices and only modest improvement in the external accounts. I now turn to the likely course of these factors in the coming 18 months.

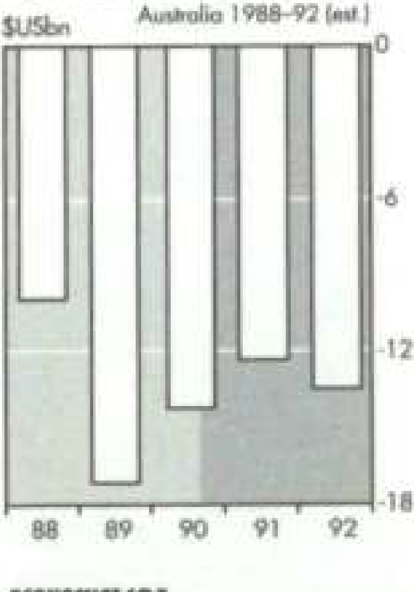
State of Play in the World Economy

Despite an 11 per cent drop in Australia's terms of trade (the ratio of export to import prices) in the past two years and short-term interest rate cuts (from 18 per cent to 10.5 per cent) since January 1990, the $A has been remarkably steady. Some economists argue that the $A will have to fall to improve exporters' price competitiveness and thus help the balance of payments. There have been attempts to talk down the currency (most notably by Reserve Bank chief, Bernie Fraser). This so-called 'jaw-boning' may not be necessary if you consider the latest forecasts on commodity prices from the Australian Bureau of Agricultural and Resource Economics.

ABARE describes the short-term outlook for commodities as very weak due to the slowdown in the world economy. With further falls expected in commodity prices in the current 1991-92 financial year, the drop in the terms of trade will put downward pressure on the $A.

As well, the forecast fall in export earnings will make it harder for Australia to service its $133.5 billion net foreign debt. Weaker terms of trade, and therefore lower national income, should keep the current account deficit stuck at around 4.75 per cent of GDP next year, according to the Federal Treasury's latest forecasts.

Figure 5e: **Current A/C**
Australia 1988–92 (est.)



But the ABARE forecast for commodities and the world economy is distinctly more pessimistic than the growing consensus among private sector economists, who see a pick-up in commodity prices, support for the $A and a sustained revival in the world economy in the second half of 1991.

In its latest semi-annual 'Economic Outlook', the Organisation for Economic Cooperation and Development paints a rosy picture for a solid recovery in the world economy. The deeply-recessed Anglophone economies such as the United States, Britain, Canada, Australia and New Zealand are expected to bounce back in the last six months of this year, while the looming slowdowns in Japan and Germany are seen as being only moderate.

The optimism is based on a rebound in business and consumer confidence after the Gulf War; falling global interest rates, particularly short-term rates; inflation has been controlled, despite the crude oil shock to prices; fiscal policies have remained structurally tight; and, better management of the business inventory cycle, which means a rise in demand will translate quickly into higher output.

Although Australia's major trading partners are tipped to grow by 3 per cent in each of the next three half-years, Australia's growth will be more modest, rising from a dismal 0.2 per cent in 1991 to 1.8 per cent in 1992. Consumer price inflation in Australia is tipped to fall to 4 per cent next year, but the unemployment rate looks like being stuck at around 10 per cent (see Figures 5a–5e).

Our proximity to the rapidly developing Asian region, however, should help exports. But weak commodity prices and rising import penetration will see a deterioration in the current account deficit and, by implication, an increase in the ratio of foreign debt to GDP. That's why the government is being more modest in its forecasts these days. Keeping a lid on expectations, while our neighbours enjoy better times, will be a challenging exercise.

STRUCTURAL PROBLEMS FACING THE AUSTRALIAN ECONOMY IN THE 1990S

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STRUCTURAL PROBLEMS FACING THE AUSTRALIAN ECONOMY IN THE 1990S

DR DAVID CLARK

Despite the impression given by syllabuses and most textbooks, Australia's external account problem is not something which can be divorced from domestic policy issues.

Indeed, at the very root of our high current account deficit and foreign debt is a failure of policy-makers to encourage three things:

- higher savings by governments, households and business.
- more investment
- greater productivity growth.

The first two of these are best discussed in tandem; the third separately.

Recent media focus on the unemployment rate has obscured an even greater problem plaguing the Australian economy — the fact that both savings and investment have fallen to their lowest level for many years.

Without a sharp pick-up in both these key variables, Australia has no chance of returning to a more socially acceptable unemployment rate, let alone solving its current account and foreign debt problems.

Each month, our current account deficit reminds us that we prefer to spend for today, rather than save and invest for tomorrow.

Every deficit figure tells us that once again we have relied on foreign savings to help pay for our imports and to cover the fact that we save less than we spend and invest.

Thus to achieve a long-standing improvement in both our current account deficit (CAD) and foreign debt requires urgent measures to increase both domestic savings and the level of investment.

The Hard Facts on Australia's Savings and Investment Problem

Savings:

- In the late 1970s, the average Australian household saved about 11 per cent of its after-tax income. By the end of the March quarter 1991, this ratio had fallen to a mere 4.0 per cent (see Figure 1).

  While business savings increased over the same period, with the exception of the early 1980s recession and the current one, and government savings improved for a while in the late 1980s, these rises were far from sufficient to compensate for this dramatic long-term fall in household saving.
- Over 1990–91, two key measures of business savings — the profit share

of the national cake and business margins (pre-tax profits to sales) — have fallen sharply and are likely to, at best, remain flat over 1991–92. J.B. Were's May 1991 'Profit Monitor' showed that the ratio of net profit to turnover for 103 of our largest industrial companies has fallen to 4.4 per cent, compared with a boom peak of almost 6 per cent in 1988.

- Government savings have also fallen dramatically. Indeed, the public sector is now back to being a net borrower. In 1988/89, the public sector as a whole repaid debt equivalent to some 1.5 per cent of GDP. However, over 1990/91, it borrowed more than $7 billion — equivalent to 2 per cent of GDP. Worse, over 1991/92, borrowings are likely to be about $14 billion — or 3.5 per cent of GDP.

Investment:

- Between the June quarter 1989 and the March quarter 1991, business investment in plant and equipment fell by 20 per cent in real terms. Over the same period, investment in buildings and structures (other than dwellings) fell 19 per cent in real terms, with the biggest falls in both categories occurring in Victoria.
- The biggest falls in investment have been in the services sector, particularly in hotels and resorts, and in financial services. Mining investment, at least until very recently, kept growing but further declines in key mineral prices could send it downwards over 1991–92.
- As a result, the ratio of business investment to GDP, after reaching its highest level for many years over the first half of 1989 — 14.2 per cent — has fallen sharply since and the latest figures show it running at only 11.8 per cent.

  Both these figures are unimpressive by international standards. At the height of the late 1980s boom, our peak ratio was still way below the 22 per cent OECD average and it has fallen much more sharply in the early 1990s than most other OECD economies.
- Looking forwards, the latest Australian Bureau of Statistics survey of business investment intentions suggests that business investment will continue falling, with a fall of at least 10-15 per cent in real terms likely over 1991–92. A similar private survey, conducted by the Business Council of Australia, suggests a similar decline.
- As a result of the downturn in investment, real growth in our plant and equipment capital stock has fallen sharply and is likely to continue falling. Access Economics expects it to grow at under 2 per cent per annum over 1991–92, compared with a growth rate of over 6 per cent in 1988–89. This will send this key variable to a level below even that reached in the mid 1970s and early 1980s, suggesting that we will not even have enough investment to cover depreciation of existing plant and equipment, let alone produce the productivity improvements that can only come from installing the very latest capital goods.

Figure 1: **Household saving ratio**

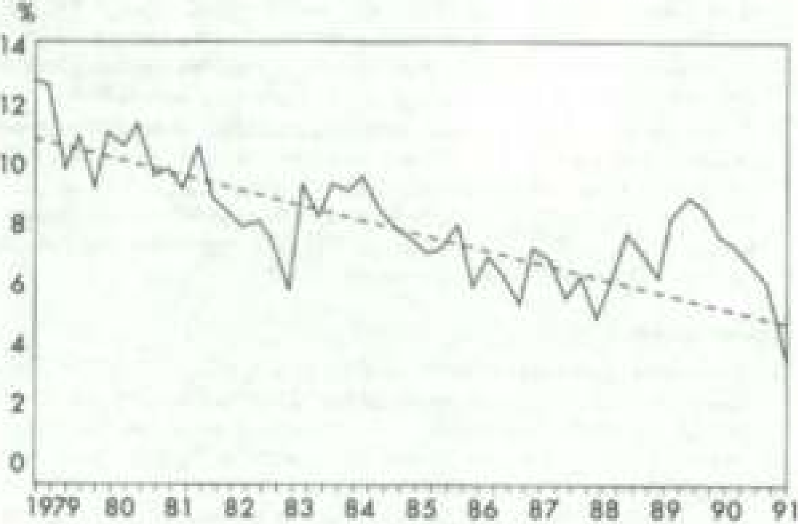
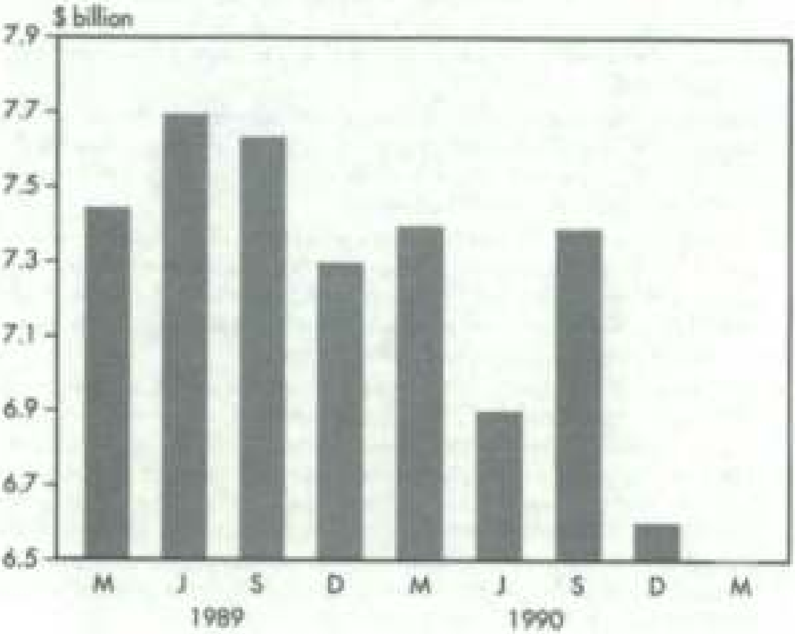


Figure 2: **Business investment slumps**



While the current recession has sent both savings and investment into a free-fall (see item above and Figures 1, 2, 3 and 4) average savings and investment levels were not very impressive over the past decade and are unlikely to pick up again sharply unless crucial policy changes are made as soon as possible.

Or to put this problem in simple arithmetic, EPAC estimates that to achieve capital stock and output growth of 3 per cent per annum over the next few years, total fixed investment has to rise to about 25 per cent of real GDP. Yet, over 1991–92 it is expected to come to only about 21 per cent of GDP.

Moreover, even if fixed investment does recover markedly and rises to 25 per cent of real GDP, if savings do not increase over the same period, the CAD will blow-out to 8–9 per cent of GDP, compared with its current recession level of between 4–5 per cent of GDP.

In other words, our savings and investment problem should be seen as two sides of the same coin.

Saving

Three groups save in Australian society: households, companies and governments.

Household savings usually fall in recession as unemployment rises and two-income households become one income ones. Business savings also usually fall, as demand and profits fall. Finally, government savings fall, as revenues decline, the demand for government services and welfare payments rises and government budgets go into deficit.

Unfortunately, the 1990–91 recession has proved no exception to these three rules. All three groups are saving less, as a result of the recession. Indeed, governments are once again net borrowers, rather than net savers.

Fifty years ago the prevailing community ethos was that you did not borrow money to buy things you could do without. You saved first. The ethos now seems to be — buy whatever you want provided you can borrow the money.

The main factors which determine the household saving ratio — the percentage of after-tax income saved by households — are:

- The experience of savers, their social attitudes, and acquired life-styles. For example, the 'Depression generation' — persons who suffered the tribulations of the Great Depression — were much more likely to save than persons currently in their 20s and 30s.
- The standard of living and distribution of income and wealth. For example, Australian household surveys have shown that higher income groups save more than lower income ones.
- The age structure of the population. An economy with a younger population than other economies is, all other things being equal, likely to have a lower saving ratio than one with a much older one.

Figure 3: **Savings and investment** (% GDP)

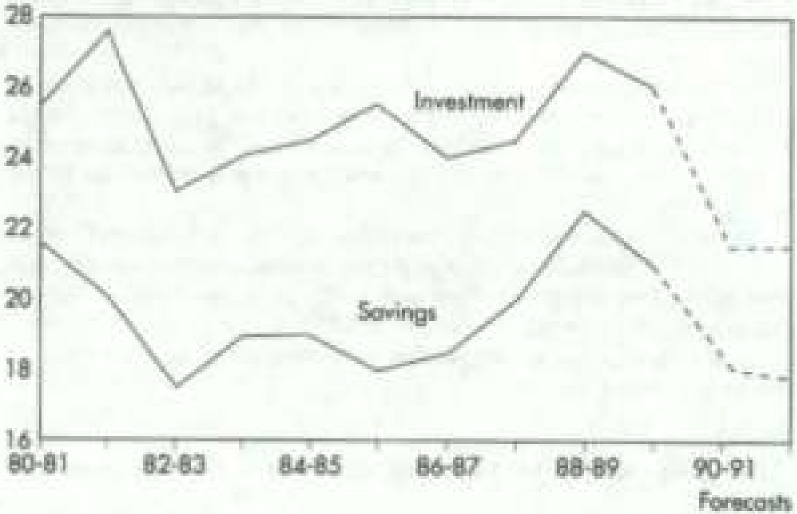
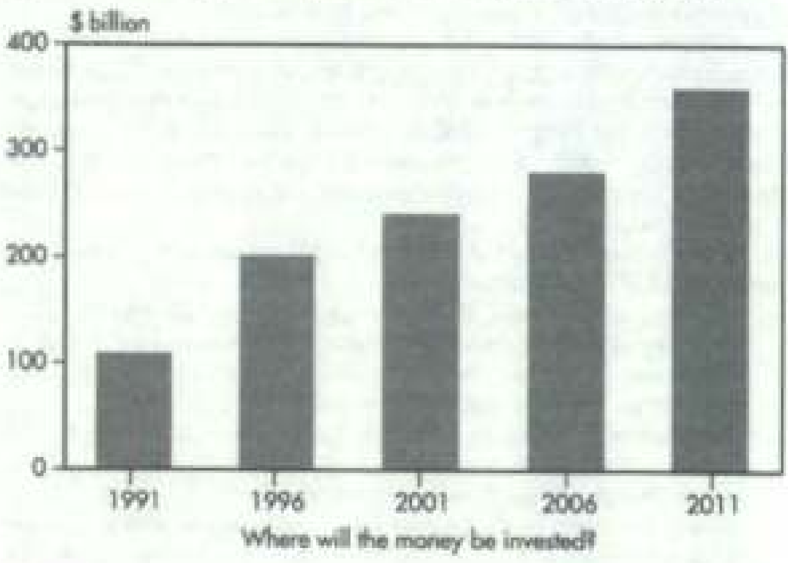


Figure 4: **The super explosion** (Likely total asset growth)



- The extent of government support available to the aged. There is more incentive to save in an economy with little government assistance for retirees, than in one with far more generous support. This is one reason, for example, why the Japanese saving ratio is very much higher than most other economies.
- The current and expected rate of inflation. For example, if you expect a high rate of inflation over the years ahead, you might be encouraged to save more for your retirement than if you expected a low or declining inflation rate, so as to protect yourself against the effects inflation will have on the real value of your savings. Alternatively, you might conclude that it is simply not worth saving.
- Taxation arrangements. For example, an increase in income tax rates leaves wage and salary-earners with less disposable income to either save or consume.

The incentive to save can be greatly reduced by taxation of the income gained, particularly if the saver is first taxed on his or her income via income tax, then taxed a second time on any income they may earn from saving part of their disposable income. Interestingly, the savings ratio was at its highest when income tax as a proportion of total household income was at its lowest — in 1978–79 (see Figure 1).

The recession has also hit business and government savings very hard. The former have been cut by the fall in demand and profits (see item on pages 44–5 for more details) and the latter by increased demand for social security payments and reduced government tax revenue.

The forecast for 1990–91 was for a Public Sector Borrowing Requirement (PSBR)/GDP ratio of 0, meaning that the public sector was intended to be neither a net saver or borrower. However, the 2 per cent forecast for 1991–92 means that it will go heavily into the red.

This is particularly disturbing, given that it took from 1961-62 to 1988–89 to get the public sector into a saving mode. That mode has now ended, as tax revenue has collapsed and the dole queues have lengthened.

The drain on local capital markets from the rise in government borrowing is likely to total about $7 billion over 1991-92. This increased demand for funds from the public sector means that interest rates will be higher than they otherwise would have been.

With Australia in recession and likely to experience lower growth in savings over at least 1991–92, it is crucial that we take urgent steps to raise our savings ratio. There is also a crucial international development which adds to the urgency.

In the early 1990s, the slowdown in the Western economies has temporarily hidden the growing gap between growing demand for investment funds and falling savings but when the upturn begins again the gap will place upward pressure on international interest rates. Over the 1980s, the great supplier of foreign capital was Japan but outflow from it is likely to moderate, as the Japanese take advantage of higher interest rates at home and savings levels fall.

This means that economies like Australia which rely heavily on capital inflow are likely to find themselves facing stiffer competition for the available funds and higher interest rates over the 1990s. Governments will also find it difficult to increase their savings at the same rate as they did over the 1980s, as the easiest steps in fiscal tightening have, in most countries, already been taken.

The options available to encourage Australians to save more include:

- Further reductions in personal income tax and/or reductions in tax on income earnt in savings accounts etc.
- Further encouragement of superannuation schemes. The more Australians who contribute to such schemes, the greater will be our savings level and the greater will be the pool of local investment funds. However, while industry superannuation schemes will certainly increase funds for investment purposes their full impact will not be felt until well into the next century (see Figure 4).
- Campaigns to get Australians to put more funds in government bonds.
- Introduction of Tax Exempt Special Savings Accounts, based on a system already in operation in Britain. This is advocated by the Left of the ALP. Such accounts would encourage small savers to invest a limited amount for a fixed period and offer tax-free interest earnings to depositors. It argues that they would boost domestic savings, without providing a tax concession to wealthier Australians who already do most of the saving.
- A re-assessment of the current trend towards early retirement.
- The introduction of a broad-based consumption tax, accompanied by further reductions in income and company taxes.

While none of these moves in isolation would guarantee a marked rise in our savings ratio, we must reverse its 1980s downwards trend over the 1990s, if we are to ever escape our current account deficit and foreign debt traps and get interest rates down to levels closer to those of other developed economies.

Investment

Turning to the other side of the savings/investment coin, investment is the engine of economic growth. It is the major source of productivity growth and hence of rises in income and living standards. It creates jobs, raises demand for goods and services, and increases profits.

Investment levels are determined by a whole host of factors. Four factors, though, are given special emphasis by modern economists:

- The level of interest rates. These can be a very important influence on the cost of borrowing and hence expected profitability.

  High interest rates, particularly high real interest rates — nominal rates less the expected rate of inflation — discourage investment by raising the cost of investment funds (see Figure 5).

  However, under particular tax regimes high rates can also encourage some forms of investment. For example, a Reserve Bank study suggested that if interest rates rise entirely because of expectations of higher inflation, housing investment may increase, rather than decrease. This is because with higher inflation, the value of the tax deduction for nominal interest costs rises, whereas only the real portion of the capital gain is taxed (see Figure 6).

  Still, investment is generally regarded as the most interest rate sensitive component of aggregate demand, with the real (after tax) interest rate being the key one. In formal language, one would expect to see a negative relationship between investment and the level of real interest rates.

  However, in recent years this textbook logic has been confounded. When investment was higher, real interest rates were not lower but higher. Indeed, investment was higher over the second half of the 1980s, despite the fact that the real interest rate was generally higher than over the first half of the decade.

  This may have been a product of the demand for investment funds driving up interest rates but it still casts serious doubt on textbook discussion on investment and interest rates.
- The level of demand. If demand rises, then producers are forced to invest in new capacity.
- Technological change. New techniques require new investment.
- What Keynes called the 'animal spirits' — unmeasurable factors which can be very important influences on investment decisions. For example, if exchange and interest rates are highly volatile, decision-making is more difficult and investment is likely to be discouraged. These 'animal spirits' will be especially critical over the 1990s.

Our biggest investment booms have been associated with the mining booms of the early 1970s and early 1980s. With the depreciation of the $A in the mid 1980s came hopes of a massive and sustained investment boom, which would assist import replacement and export diversification. However, much of the plant and equipment investment that did finally occur in the late 1980s went into the non-traded goods sector or merely replaced worn or outmoded plant and equipment.

This reminds us that simply more investment over the 1990s is not enough though. We have to get much more investment in our traded-goods sector. To achieve this will require:

Figure 5: **Real interest rates** 90 day rates minus inflation

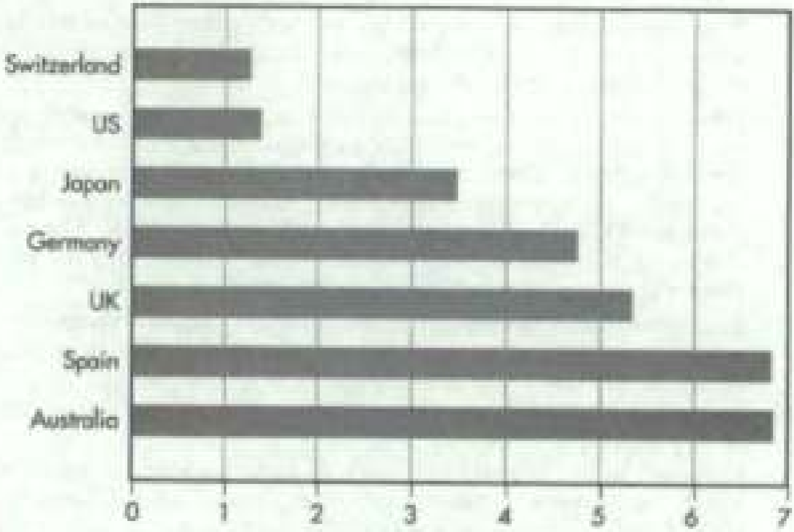
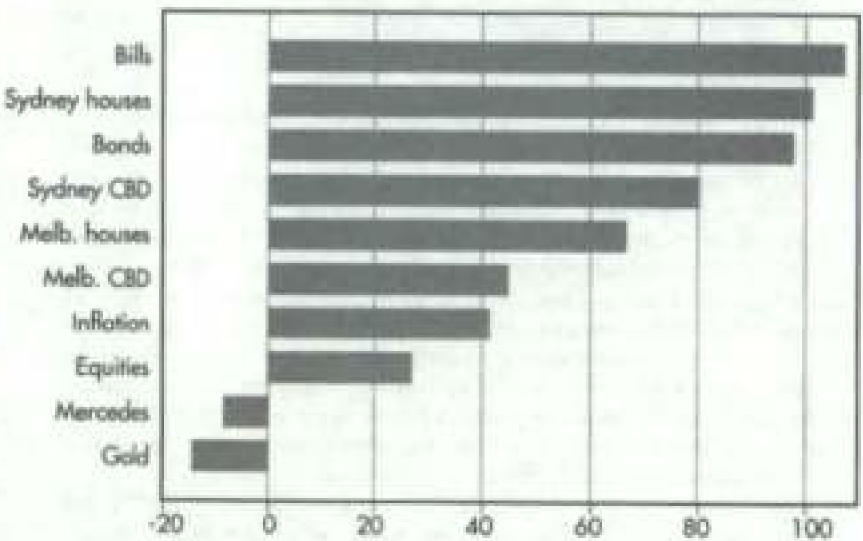


Figure 6: **Returns on assets** 1985–86 to 1990–91, % change



Source: *Access Economics*

- Increased domestic savings — as discussed above.
- Good company profits over the 1990s.
- Reduced reliance on high interest rates, as the major economic policy tool.
- More stable growth in domestic demand.
- Measures to encourage more foreign investment in our traded-goods sector.
- Changes in our tax system to discourage speculative investment and encourage investment which will help expand exports and stimulate import replacement.

For example, a study done for EPAC (Freebairn, 1990) found that investment in productive activity is taxed most, while property speculation is taxed the least. It found that assuming an inflation rate of 7 per cent, an individual on a marginal tax rate of 48.25 per cent and a real rate of return of 5 per cent who invests in their family home pays no tax on its capital gain. If they invest in commercial property they face a tax rate of 33.7 per cent. However, if a corporation invests in plant and equipment it faces an effective rate of about 60 per cent for between five to 25 years.

The Left faction of the ALP has also called for the establishment of a National Development Fund to provide capital to small and medium-sized firms who are unable to raise funds from other sources. However, this was the approach was tried by the Victorian government and State Bank in the late 1980s, when they tried to pick 'winners'. The only trouble was the 'winners' picked were largely those which private sector lenders had rejected. As a result, hundreds of millions of dollars of taxpayers' money was lost and Victorians will be paying for these losses via higher State taxes and charges for many years to come.

Australian Productivity Trends

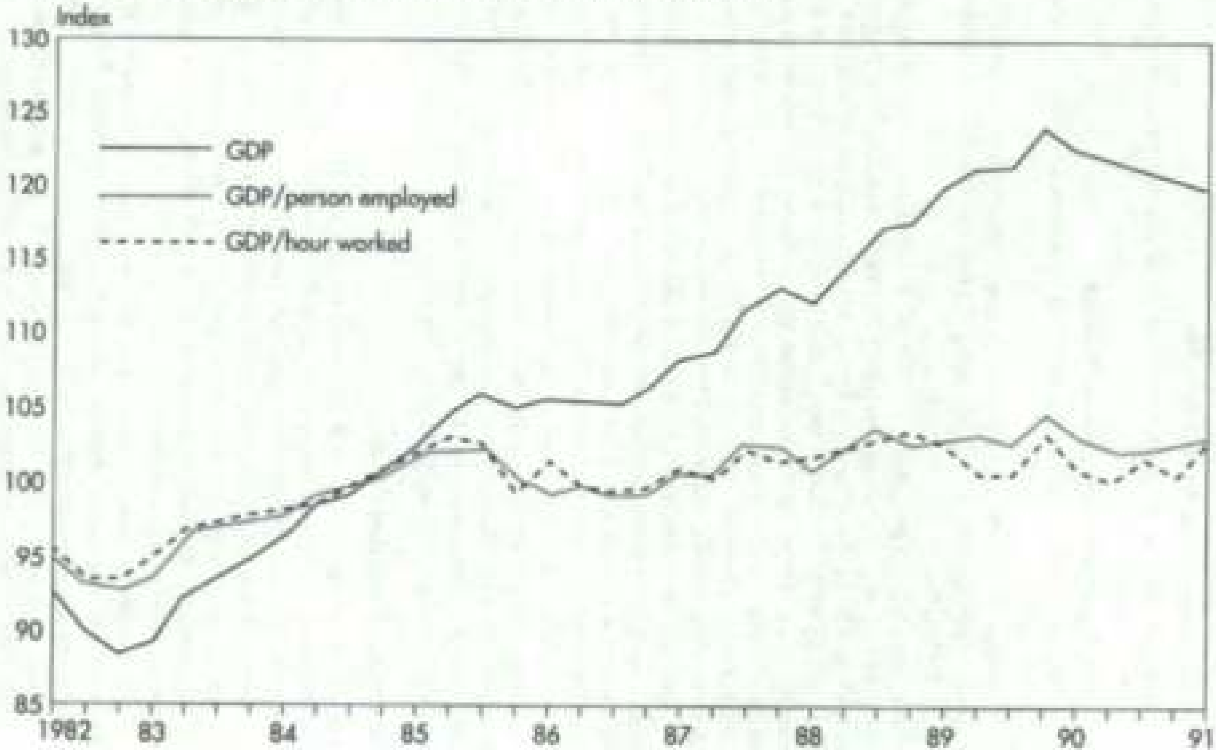
Finally, there is the related problem of our appalling productivity performance in recent years (see Figure 7) despite all the talk about structural change and restructuring of our industrial relations practices.

Australia needs to make much greater effort to raise the productivity of its workforce. Over the late 1980s, employment growth was very high by world standards but growth in real output per employee and the inflation rate were far less impressive.

Unfortunately, productivity is like love — a many splendoured thing. Attempts to measure it usually use GDP at constant prices divided by man-hours worked over the same time period.

This approach gives the impression that it is a measure of the contribution of labour to output growth but it is nothing of the sort. In fact, labour productivity growth can also be a product of: an increase in output from the introduction of superior machinery which requires less

Figure 7: **Productivity** (1984/85 prices; seasonally adjusted)



productive, less skilled labour; improved supervision and management of the same workforce; or the discovery of new materials or energy sources.

Should, for example, the introduction of a labour-saving piece of machinery, which raises output per worker by, say 6 per cent, result in a 6 per cent rise in pay for that worker — or a 0, 1.0, 2.0, 3.0 or 5.0 per cent rise?

With most modern technology, it is impossible to quantify the precise respective contributions of labour and capital to increased productivity for one cannot measure the value of capital independent of the rate of profit.

It is also especially difficult to measure accurately the productivity of the two-thirds of our workforce who work in the services sector. For example, if a teacher or an academic has to lecture to classes double the size of previous ones, is he or she doubly productive?

Unfortunately, progress with basing wage rises on genuine productivity increases has not been as successful as was hoped when the principle was agreed to in 1987, under the Accord Mark III.

Indeed, productivity-based wage rises have shown two interesting characteristics:

- Industries with the highest ratios of government employment, such as communications, electricity, gas and water, and public administration and defence, have passed on these national wage increases faster than other industries with less government involvement.
- Industries more subject to competitive pressure have not passed on such increases as quickly.

For example, the mining and basic metal products industries have not passed on these wage increases as rapidly as the more highly protected textiles, clothing and footwear or transport industries. Hence the key promise of the Accords Mark V and VI to encourage much more 'award restructuring' (ARS).

ARS has four main aims:

- To increase employee productivity.
- To create more interesting and challenging jobs by encouraging employees to increase their training and skills and to acquire new skills in industries undergoing rapid structural change.
- To streamline awards by reducing the number of different job classifications, thereby enabling employers to make more efficient use of their employees and employees to be more flexible in their job choices.
- To encourage 'multi-skilling' more suitable to late twentieth century technology than to the nineteenth century arrangements on which many of our current awards rest. In other words, to break down the rigid barriers between the various trades which cause demarcation disputes and hinder productivity growth.

An excellent example of the need for ARS was the ridiculous situation in many factories until recently where only electricians were allowed to change light bulbs, even in the administration areas.

Another was the fact that only members of the Waterside Workers' Federation were allowed to pack and unpack certain containers, even if it was done kilometres away from the docks. Farmers, for example, were not allowed to put their export produce directly into their containers on their farms.

The need for urgent ARS is confirmed by the results of a Business Council of Australia survey, entitled 'Enterprise-Based Bargaining Units: A Better Way of Working', released in late 1989. It found:

- There is considerable talk in Australian enterprises about increasing productivity but relatively little action.
- Very few enterprises are experimenting with alternative remuneration methods such as profit-sharing, bonuses or share ownership.
- There has been little progress in reducing the number of unions which individual employers have to deal with in their plants and struggles between unions to represent employees in a plant add to employers' difficulties.

The survey found that almost 80 per cent of workplaces have more than one union; more than 50 per cent have four or more unions; 29 per cent have between six and 10 unions; and about six per cent have more than 10 unions.

- The average workplace had one industrial incident a month. Since half the plants were incident-free, this means that many workplaces averaged at least two incidents per month.
- Productivity of both labour and capital could be improved by up to 25 per cent if there was significant reform in our workplaces. In fact, the report found examples where productivity in Australian plants was between 20-50 per cent lower than in comparable plants overseas.

The Business Council suggested we have no choice but to:

- Reduce the number of awards covering employees in a workplace by amending the industrial relations act to allow employers and employees the option of entering into 'comprehensive enterprise agreements'. This would be purely voluntary and provide a parallel stream of work regulation to the general award stream.
- Work towards a situation where one union could represent all the employees in one workplace and with the Industrial Relations Commission (IRC) being given the power to order secret ballots among workers to approve one union representation where negotiations to achieve such an arrangement fail.

The federal Opposition's industrial relations policy supports such suggestions and has particularly emphasised the need to decentralise our whole industrial relations practices by encouraging much more enterprise level bargaining.

Neither the IRC nor the ACTU can guarantee that there will be wage rises based on genuine productivity increases under the ARS process.

The Workplace Reform Centres set up by the Department of Industrial Relations to foster award restructuring can only assist employers to do an industrial relations deal with the unions. They cannot guarantee that a genuine productivity trade-off will be realised. In fact, in many industries the agreed trade-offs will be very much a product of the respective bargaining power of both employers and unions, rather than a reward for a genuine productivity rise.

The IRC commitment to only rubber-stamping industry agreements based on genuine productivity increases downplays the great difficulties in measuring productivity change in a modern economy.

Indeed, the whole ARS package rests on the assumption that increased training automatically produces higher productivity from the employee.

More fundamentally, it assumes that each grade of employment has a measurable level of skill attached to it and that once employees have mastered that particular level of skill, either on the job or by attendance at off-the-job courses, they automatically increase productivity and thus deserve to be in a higher wage bracket.

But the mere attainment of a certificate, diploma or degree does not guarantee that the holder is automatically more productive.

In fact, the most successful modern industrial nations, Japan and West Germany, have never stressed certificated, off-the-job training but a judicious mix of on-the-job training plus off-the- job training if necessary.

Indeed, some of the biggest companies in both countries run their own in-house colleges which achieve results more than comparable with off-the-job institutions.

Business and the public sector need more people with quality basic skills — who can calculate, read and write proficiently — rather than merely more and more persons who, because of their paper qualifications, believe that much work that needs to be done is below them.

In mid 1991, critical discussion of the whole Accord process was accelerated by an interesting new book on Australian industrial relations, *Labor and Prosperity and the Nineties*, written by two Labor Council of NSW employees.

Its authors, Michael Costa and Michael Duffy, argue that:

- the Accord Mark VI is 'a nonsense';
- the ACTU's policy of union amalgamation is fundamentally flawed;
- the union movement is becoming increasingly irrelevant;
- the manufacturing sector based model of award restructuring 'just won't work' if imposed on other industries; and

- a market-orientated, free bargaining style of unionism that promotes diversity and flexibility is essential.

Only a few years ago, arguments of this kind were simply dismissed as 'New Right'. Clearly, the whole industrial relations debate in Australia is becoming much less ideological and much more rational and interesting.

In April 1989, the then Minister for Industrial Relations, Mr Peter Morris, laid down the principles according to which award restructuring must occur:

> Negotiations at the industry and award levels need to be complemented by discussions at the enterprise level: it is, ultimately, at the enterprise level that restructuring agreements will be implemented and the benefits derived.

The statement of principles is one thing; their application another. Workplace reform in Australia is too important to be left solely to industrial tribunals, employers' organisations and trade unions.

It can only succeed if it is done from the bottom up, rather than the top down, thereby involving ordinary Australian employees in the whole restructuring process.

Indeed, some commentators have argued that the whole deal reinforces the already insidious Australian belief that increased productivity is 'their' — i.e. the employers' — sole responsibility, when in fact what Australia really needs is a joint employer-employee campaign to raise our productivity levels.

In sum, whichever party runs Australia over the rest of the 1990s will have no choice but to provide more incentives to Australians to save and remove many of the current disincentives against business investment. It must also take urgent steps to improve our productivity performance.

Otherwise, we have no chance of permanently reducing our current account deficit and foreign debt, except by keeping the economy in permanent recession.

Further reading

Clark, D. (1991) *Economic Update 1991*, Sydney

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THE CHANGING ECONOMICS: AT HOME AND ABROAD

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THE CHANGING ECONOMICS: AT HOME AND ABROAD

CAROL J. AUSTIN

I was very pleased to accept this invitation to address the National Economics Teachers' Conference.

I have been asked to talk this evening about the subject of international trade. The issues of international trade were once the preserve of economists, but now there is much wider interest in the topic.

A decade ago few were familiar with the concept of the 'balance of payments' or 'current account'. This is certainly not the case today. These days, such terms are part of the lexicon of the wider community.

What lies behind this surge of interest in the 'dismal science' is the parlous state of our balance of payments, and the seemingly endless 'red ink' of the current account deficit, rather than the thirst for knowledge.

Numbers such as the monthly balance of payment figures are but one measure of Australia's international trading performance. Yet even if we take a broader view, the picture is equally bleak.

We tend to think of ourselves as a great trading nation — as we once were — but the facts sit awkwardly with this perception.

Our share of world exports has contracted from 1.7 per cent in 1960 to 1.3 per cent in 1990. Our ratio of exports to GDP is only about 16 per cent. A nation our size should have a very high proportion of its output exported, yet we do not. Nations of a similar size — such as Austria, Switzerland, the Netherlands and Taiwan have a far higher proportion of exports to GDP.[1] And remarkably the city states of Singapore and Hong Kong have exports the value of which exceed their GDP!

Logic would suggest that Australia should be an exporter on a scale similar to those nations, but instead we are predominantly domestically-oriented like the economic giants of Japan and the US. The popular view of Japan as almost obsessively export oriented is quite inaccurate. In truth Japanese exports account for a small percentage of that country's GDP.[2]

Observing differences is one thing — making judgements about their relevance is another, quite separate matter. For that reason it is legitimate to ask whether it really matters that we have a relatively small exposure to world trade.

On this occasion, both theory and practice are in agreement! An open trading system allows small economies such as ours to specialise in a limited range of goods and services. Sweden, Switzerland and the Netherlands are good examples. In these countries intra-industry trade is very important. Sweden for instance is both a large exporter of cars and

[1] For this and subsequent references, see footnotes on page 66.

simultaneously a large importer of cars. By contrast Australia is largely an exporter of primary products and importer of the sophisticated manufactured products of countries such as Sweden.

We need to turn this around, so that the reality becomes a better match with our view of ourselves as a strong trading nation.

However the degree of openness of an economy is quite separate from the health of its balance of payments. Australia could run conceivably a current account deficit of 4 per cent of GDP with exports running at 15 per cent or at 50 per cent of GDP. In either case one is faced with either reducing imports or expanding exports. It is pretty clear which is the less painful route for the economy.

Creating Competitiveness

So what is involved in increasing our export penetration ratio?

International competitiveness is today constantly cited as the answer. The term has become the buzz word of the 1990s. It is embraced with enthusiasm from Wollongong to Washington. But I should register a warning. There are no simple, painless means to address structural rigidities and to resolve deep seated underlying problems. In my view it is very much a matter of no pain, no gain.

This having been said, there are some challenges being laid down to the prevailing orthodoxy. The prevailing wisdom of the links between factor endowments and industry structure have been shown to be temporary at best. In the same way, the resilience of Japanese exporters in the face of massive swings in the yen exchange rate has turned much competitiveness theory on its head.

If we are to make sense out of these apparently unusual developments, we need to be prepared to consider alternatives to the conventional wisdom and also look outside the narrow confines of economics for new insights into the sources of competitive advantage.

Some years ago, Mikhail Gorbachev wrote a book called *Perestroika — New Thinking for the USSR and the World*. In my view there is also a need for some 'new thinking' in the area of competitive advantage.

A valuable contribution has been made by Professor Michael Porter in his challenging work, *The Competitive Advantage of Nations*. He talks about a need for:

> . . . new tools — an approach to competitiveness that grows directly out of an analysis of internationally successful industries, without regard for traditional ideology or current intellectual fashion. We need to know, very simply, what works and why. Then we need to apply it. [3]

Porter concluded that competitive advantage is *created* not inherited. In the sophisticated industries which form the backbone of any advanced economy, a nation does not inherit but instead creates the most important factors of production – factors such as a skilled human resources or a strong scientific base.[4]

Strikingly, the creation of competitive advantage is the result of 'innovation' by **companies**, not countries. Such innovation, in its broadest sense, builds strong brands, a reputation for superior customer service or product customisation, superior technology, or marketing and so on.

Innovation sees 'disadvantages' transformed into new means of competitive advantage, through the application of human drive and ingenuity. For instance, in Japan with its premium on the availability of land, companies have come up with developments such as 'just in time' production and miniaturisation.

Trying to explain 'competitiveness' at the national level then is to answer the wrong question. To find useful answers, we must focus not on the economy as a whole, but on specific industries and industry segments. We must understand how and why commercially viable skills and technology are created.

This can only be fully understood at the level of particular industries. Competitiveness is the outcome of struggles in particular segments and industries for competitive advantage against rivals at home and abroad. This day to day struggle in particular segments and industries, in which products and processes are created and improved, underpins the process of upgrading national productivity. [5]

Industries obviously do not exist in a vacuum — competitiveness is a result of the relationship between individual firms and the wider economy.

Professor Porter has made telling contributions to understanding the determinants of national competitive advantage. His studies of major trading countries point to the range of factors that determine whether a particular country provides a good environment for creating strong, world class enterprises.

He has identified four factors that are the underlying determinants of competitiveness. They are:

1. Factor conditions: factors of production such as skilled labour, infrastructure and the availability of natural resources.
2. Demand conditions: the nature of home demand for an industry's product or services.
3. Related and supporting industries: the presence or absence in the nation of supplier and related industries that are internationally competitive; and
4. Firm strategy, structure and rivalry: the conditions influencing how companies are formed, organised, managed and compete with each other.

As you can note, with the exception of natural resources, all other factors are created. Strength in all these factors may not be necessary for successful firms to exist. For a country such as Australia with her very rich natural resource endowments, it is not surprising that there are some successful firms operating in the primary industry sector.

The disconcerting thing for Australia is that despite the success of these industries, the overall value of our exports has grown more slowly than the value of world trade over the past two decades. Our commodity-based successes are in areas of diminishing, not rising international growth.

Australia is the only industrial country that has not increased its proportion of merchandise exports to GDP during the last 30 years,[6] and it is this area which has grown fastest in the post war years. Our lack of commitment to export in this area, was borne out in a study by the Bureau of Industry Economics which suggested that, the proportion of manufacturing firms which regularly export 10 per cent or more of their turnover is only about 10 per cent of the industry![7]

However competitiveness in secondary and tertiary industries is more heavily dependent on created, rather than inherited factors. We have failed to nurture the appropriate conditions and attitudes that will encourage the growth and development of more sophisticated value added industries.

Instead we in Australia have relied almost entirely on our natural advantages, rather than gone on to develop input industries like agricultural machinery, mining equipment and explosives which could have flowed on from this base.

Making Australia More Competitive

Expanding the range of activities in which Australia is competitive will require fundamental changes.

We have to tackle the underlying determinants of competitiveness. That means changing the goals firms set themselves, the way firms operate and the environment in which they operate.

The 'Hughes Report' of 1989 spoke cogently about the absence of an 'export culture' in Australia. With few exceptions only primary producers have been concerned with efficiency and international competitiveness [8] and these people constitute a very small proportion of our workforce.

The complacency and misconceptions that abound are illuminating. Over half the plant managers who were surveyed by the Institute of Labour Studies believed that labour productivity in their plants was 'equal to or better than' that in comparable operations overseas.[9] Sadly this is not the case.

While there has been much public rhetoric in recent years about being export oriented and outward looking, a report prepared for AUSTRADE by the Australian Graduate School of Management found that only 9 per cent of Australian firms could be described as having a 'global orientation'.[10]

Many areas have been able to get away with this type of outlook for a long time, but as Graham Greene once wrote, 'There always comes a moment in time when a door opens and lets the future in'.[11]

As we all know for Australia that time is now. A number of recent initiatives have changed the operating environment for Australian firms.

The Prime Minister's March 12 Industry Statement included the announcement of the phased reduction of general tariffs to 5 per cent by 1996. This move has made reform even more urgent.

Like many others in the private sector I was disappointed that the government did not dovetail this with a set of comprehensive initiatives to rid us of impediments in the supply side of our economy — the much talked about micro-economic reform. However, regardless of that, the competitive pressures that will be brought to bear will not leave any sector of our economy untouched.

Even those firms which are not exporters themselves, will feel the pressure to improve their performance. The interdependency of the economy is such that substandard performance in one area can have severe consequences for others. When this was perceived to be 'costless', people turned a 'blind eye', but this will surely change.

The Role of Education

As the work of Professor Porter shows, and as we can observe in the most successful economies today, a skilled labour force lies at the heart of competitiveness. Ultimately it is the skill, the talents and the motivations of people that determine competitiveness.

Education reform and vocational training must therefore become major priorities if we are serious about becoming internationally competitive. There is no doubt that in both these areas we have much to do.

The Australian Manufacturing Council has said that 'without major changes in the ways schools and firms train workers over the course of a lifetime, no amount of macro-economic fine tuning or technological innovation will be able to produce significantly improved economic performance and rising living standards'.[12]

Industry will play a far greater role in shaping education than has been the case in the past.

Already such initiatives are taking place. Recently the Industry Education Forum, an organisation which brings together Australia's major business groups under one umbrella on education issues issued a 'Declaration of Goals for Australia's Schools'.

In a nutshell, the reforms suggested in the declaration are designed to put our schools at the front ranks of international performance by the year 2000. Today it is the standards set by the best in the world that matter, not our own.

To complement education reform, industry will have to devote much greater resources to employee training. Earlier this year the Chairman of Samsung, Mr Hyon-Hwak Shin came to Australia to address the National Business Summit. One of Korea's largest companies, Samsung spends on employee education approximately twice that spent by the average Japanese business, and three and four times the amount spent by the average American and European businesses, respectively.[13]

The Appropriate Role of Government

I have concentrated on what changes must take place within the private sector to make Australia more competitive and thus enable us to trade our way out of trouble. This attention upon the private sector is quite deliberate — once a nation opens its economy as Australia has done, governments' ability to control economic activities diminishes correspondingly. But as global industries look to find new areas to invest in, the policy decisions of governments and investments by government in economic infrastructure remain critical tools.

In this area, economic orthodoxy will still have its place!

The Economist recently suggested that the best thing governments could do to promote an environment for competitiveness was to:

> . . . keep inflation low, real interest rates gently positive and exchange rates stable. After this the most important initiatives will be to invest in human capital: a well educated labour force, able to acquire new skills and adapt to changing demands, is the most valuable asset an economy can have. And governments will need to invest adequately in economic infrastructure, because there are good reasons for thinking that private businesses will not.[14]

In discussions about international competitiveness and international trade, one invariably encounters suggestions that governments should do more. The suggestions usually run along the lines that governments should 'intelligently target assistance'.

Such 'intelligent targeting' has at best a spotty record world wide, and none more so than in Japan. Japan's Ministry of International Trade and Industry (MITI) lead some to believe that 'strategic intervention' is the way forward. Yet MITI's 'success' is somewhat exaggerated, and has really been in facilitating exits,[15] rather than at 'picking winners'.

The most telling evidence against overemphasising the role of MITI comes from successful Japanese entrepreneurs.

Akio Morita, the Chairman of Sony, recounts in his memoirs the difficulty Sony had in obtaining clearance from MITI to purchase transistor technology in the 1950s. Many years on Morita was moved to write that, 'MITI has not been the great benefactor of the Japanese electronics industry that some of its critics seem to think it has'.[16]

Such intervention is extraordinarily difficult for governments to perform successfully — but intervention can take a number of forms.

The removal of 'impediments' to competitive pressures is more reliable than 'targeted assistance'. This sort of intervention is more concerned with ensuring that the broad infrastructure for economic development is in place, than with prescribing the method and outcome of development. It builds the road and allows people to choose their own destinations.[17]

Conclusion

The factors and conditions that will make for an internationally competitive Australia are not unique. The difference is that today we are trying to create competitiveness rather then relying on our inheritance.

Footnotes

1 'Developing Australia's National Competitiveness' A report prepared for the Business Council of Australia by Access Economics and the Allen Consulting Group, p34

2 SRI International, Business International Program, 'New Directions for the Global Economy: Shaping the transition to the twenty-first century' report No 794, Fall 1990, p5

3 Michael E Porter *The Competitive Advantage of Nations* Harvard Business Review, March-April 1990, p74.

4 Ibid, p78

5 Ibid, p85

6 'Australian Exports — Performance Obstacles and Issues of Assistance'. Report of the Committee for the Review of Export Market Development Assistance. July 1989. p xix

7 'Developing Australia's National Competitiveness' Op cit p35

8 'Australian Exports — Performance Obstacles and Issues of Assistance' Op cit, pxxiii

9 'The Global Challenge: Australian Manufacturing in the 1990s'. The final report of the study by Pappas Carter Evans and Koop/Telesis for the Australian Manufacturing Council, p72

10 'Australian Management and International Competitiveness'. A report prepared by the Centre for Export Marketing and the Australian Graduate School of Management October 1990, p8

11 From Charles Handy's *The Age of Unreason* Harvard Business School Press 1989, p ix

12 'The Global Challenge', p74

13 Hyun-Hwak Shin, 'The Samsung Group: Past, Present and Future' Address to the National Business Summit. 1 March 1991, p5

14 *The Economist*, June 8, 1991, p13

15 'Developing Australia's National Competitiveness' Op cit p69

16 Michael Costa and Mark Duffy, *Labor, Prosperity and the Nineties: Beyond the Bonsai Economy*' The Federation Press , Sydney 1991, p179

17 Ibid, p179

AUSTRALIA'S EXPORT OPPORTUNITIES

DON HUNTER

ACTING MANAGING DIRECTOR, AUSTRADE

Mr **D.H. Hunter** is a senior government official with experience in the Department of Treasury, the Departments of Minerals and Energy and Trade and Resources, the Australian Overseas Projects Corporation and as General Manager, Operations Group, Australian Trade Commission (AUSTRADE). In the latter position he was responsible, inter alia, for the development of overseas markets through the operations of some 64 AUSTRADE posts in 51 countries. Don Hunter was appointed Deputy Managing Director of AUSTRADE in November 1989 and has been Acting Managing Director since December 1990.

AUSTRALIA'S EXPORT OPPORTUNITIES

DON HUNTER

Your conference today has dealt with key issues to do with the management and development of the Australian economy — or about the big picture and our capacity to manage our national future. Or — what governments can and should do. And what they can't and shouldn't do. Tonight I'm going to talk about something complementary to this. About where our export opportunities lie. And what companies — for it is companies not economists or politicians who write the business — should do about these opportunities.

The foundations of our international business performance are built upon the responses we make to two fairly broad questions:

- First — do we know where our best potential markets lie?
- Second — how do we exploit them?

Australia's Export Opportunities

The first question we can answer without hesitation. The answer is: **Asia**. If anybody here today has any doubt that we are now living in the 'Age of Asia', let me share some figures with you. These figures have been put together by AUSTRADE as an estimate of the incremental export business Australia can capture. We estimate that by the end of 1994, our annual national export sales will have increased — in real terms over a 1989 base figure — by $4.5 billion to North America and all of Europe combined while our sales to Asia should increase, over the same period, by more than **$13 billion**. And most of that – more than $10 billion worth – will go into North Asia.

What is so obviously striking about these figures is the proportion of the increase which will occur well away from the European and American markets we have tended to concentrate on in the past.

Look at it this way:

- more than 53 per cent of these new opportunities for export growth will be in North Asia;
- something like a further 14 per cent will be in South East Asia.

In other words, more than two-thirds of our potential export growth is in Asia. So, if this is where the opportunities exist, what are they?

AUSTRADE projections indicate that the major opportunities for trade expansion in North Asia are going to lie in:

- manufactured products to Japan, Korea and Hong Kong;
- energy products to Japan, Hong Kong and other North Asian countries;
- raw materials into Korea and Taiwan; and

- foodstuffs into Korea, Japan and Taiwan.

But at the same time, let me make it clear that we are not suggesting Australian exporters abandon more traditional markets. We are, however, suggesting we need to look for the big new chances in export growth to Asia as we come out of the recession.

Let us focus a little further on the opportunities we see emerging for Australia in 'The Age of Asia'.

The United Nations estimates we can expect to see regional annual GDP growth rates in Asia by 1994 of:

- 5 per cent in North Asia; and
- 7 per cent in South East Asia.

These compare with those 'traditional' markets we have talked about where the U.N. expects GDP growth rates up to 1994 to reach just:

- 3 per cent in Europe; and
- 2.5 per cent in North America.

Based on figures for 1989, these GDP rates translate into opportunities for increases in sales of our Elaborately Transformed Manufactures — or ETMs — in real terms of:

- 28 per cent a year to North Asia
  — or from $1 billion in 1989 to $3.8 billion in 1994
- 20 per cent a year to South East Asia
  — or from $1 billion in 1989 to $2.4 billion in 1994
- 16 per cent to Western Europe
  — or from $1 billion in 1989 to $2 billion in 1994
- 12 per cent to North America
  — from $1.2 billion in 1989 to $2 billion in 1994

  [constant $1989 terms]

If these figures sound overly optimistic, I would note that comparable results have been achieved in recent years — for example Australian manufactured exports to Southeast Asian countries in the last few years have grown annually by 21 per cent to Singapore and 41 per cent to Indonesia and Thailand. *[note in current $ terms]*

There is also significant anecdotal evidence supporting these growth estimates. The Chairmen of the Industry Groups that work with AUSTRADE have expressed a view that in fields such as:

- infrastructure projects,
- environmental control,
- engineering and allied services in Asia,

our challenge is not so much finding the demand — but our ability to meet it.

Capitalising on the Opportunities

These opportunities, however, will not be realised through some form of economic osmosis.

It will be the drive, knowledge and instincts of company executives that identify and nail down these opportunities. But — to do this they will need a sustaining economic environment that allows them to take the calculated risks involved in doing business in a foreign market.

At the macro level it is helpful for:

- Treasury to continue to pursue a more competitive macroeconomic environment;
- the Industries Commission to expose microeconomic reform opportunities ;
- and for AUSTRADE to push open doors in these vital markets to give Australian exporters a 'hand up' in seizing these opportunities.

But this only takes us so far. Australian company managers still have to physically sell their products — they still have to close the deals. We, therefore, also need to consider business attitudes to internationalisation.

A recent study conducted by the Australian Graduate School of Management (AGSM) for AUSTRADE showed that many senior Australian executives feel the cost of capital, labour costs and infrastructure problems restrict their ability to compete internationally.

Australia's economy, it would seem, is often a very harsh environment in which to try to cultivate international business success. But more significant than this, is the volatility of the economy which has made many senior managers extremely cautious about making the sorts of long term commitments required.

The AGSM survey showed that many of these senior managers were cautious because they feared the economy would turn against them, eroding their competitiveness once they had committed themselves to an overseas market.

The upside of the argument is that this environment has bred some rather tough international competitors amongst the ranks of Australian business.

If we expect more companies to join them we must consider not just the pure economics of the situation; we need to look at the psychology of business decision making as well.

Our business decision makers need certainty. And they need clear, unambiguous signals in the direction of economic policy. We must not lose sight of this while we are pursuing the important but often turbulent process of micro-economic reform.

Neither must we ignore the importance that senior managers themselves place on international business.

The AGSM survey told us that Australian managers were generally aware of the urgent need to build on our export economy. But it also revealed a considerable lack of interest in acquiring the tools to participate in significant export trade. Very few had any language skills or international business experience — and those who did tended to have them in European, not Asian, cultures.

It also showed that students do not have great enthusiasm for developing these skills — and in fact see little incentive to pursue careers in international business.

However, as we progressively establish the necessary 'positive' economic environment, I am confident we will see an equally more positive outlook from business and students alike.

To be successful internationally, Australian companies need to apply the same rigour and the same level of energy to analysing opportunities and servicing their overseas customers as they do for their clients at home.

To put it briefly, you have to *be there* to make it happen.
There really is no substitute to being on the ground. Our competitors are keenly aware of this and so must we be.

And like most areas of human endeavour — familiarity breeds success. Familiarity with the many emotional, intellectual and cultural barriers is an all too frequently underestimated component of the recipe for international trading success. In this recipe, one ingredient will continue to be critical — Australian bums on aeroplane seats, more of them, more frequently.

We learn by doing things. And we will learn about Asia and the new opportunities in our other major markets by being there. Only by being there will companies develop the networks of contacts that will enable them to learn of the opportunities, the potential local business partners and how best to close the deal.

The Next Step

You will not have been surprised tonight to hear me talk about:

- the opportunities in Asia
- the need for clear economic signals to business, and
- the importance of integrating business into the Asian region by living and working in the countries in which we do business.

Much of the debate over the last several years on what economic policies Australia should pursue has recognised all these points. And we have had a welter of reports on how the institutional and policy framework should be structured to achieve this.

But from AUSTRADE's perspective, at this point in time, it is being there — having many more executives from many more companies living and working in Asia and our other markets which will make the difference. I believe, quite firmly, that we know what to do, our policy makers know what policy settings are required and many of our companies know what they have to do to be successfully internationally. There is no secret formula, no international marketing lodestone which we have yet to discover — it is simply a matter of doing it — of getting on with the job — with utmost diligence. This is not a short term commitment. Certainly we need early success, but it is the long term effort which will reap the big reward.

As teachers, you have a unique role to pay in ensuring that we have capable and confident managers in the future, who understand the international business challenge, and are ready and able to meet it.

AUSTRADE is committed to aiding in this process. Through our support for projects such as the 'Overseas and Undersold' television series, and the education resource kits produced with it, we hope to spread the message of the importance of export throughout the community.

I hope that my comments tonight have helped you to assess the skills your students will need to succeed in international business. Because, succeed they must, if we are to keep pace with the region we inhabit.

PART TWO

MICROECONOMIC REFORM IN THE AUSTRALIAN ECONOMY

MICROECONOMIC REFORM OF FEDERAL-STATE FINANCIAL RELATIONS

MICHAEL EGAN, MLC

LEADER OF THE OPPOSITION,
LEGISLATIVE COUNCIL,
SHADOW MINISTER
FOR FINANCE AND ECONOMIC REFORM

Michael Egan was elected as Member for Cronulla in 1978 to the Legislative Assembly of the New South Wales Parliament. He was Chairperson of the Public Accounts Committee in 1981–84 and from 1984–86 Senior Policy Adviser to the Hon. Barrie Unsworth. In 1986, Michael was elected to the Legislative Council and became Chairperson of the Opposition Waste Watch Committee in 1990. His work in this latter position has led to greater public scrutiny and awareness of the costs to tax-payers of government services, spending and resource management and use. In June 1991, Michael was elected Leader of the Opposition in the Legislative Council and made Shadow Minister for Finance and Economic Reform.

MICROECONOMIC REFORM OF FEDERAL-STATE FINANCIAL RELATIONS

MICHAEL EGAN

Before looking at reform of federal-state financial relations, I propose to briefly examine the history of this relationship. Most peoples' exposure to federal-state relations is watching news reports of bleating Premiers as they walk away empty-handed from each year's Premiers' Conference. This ritual has occurred in some form or other for 90 years, since Federation in 1901. Federal payments to the states have usually been in two categories — General Purpose Payments and Specific Purpose Payments. In addition, since 1927 the federal government has determined the level of borrowings that the states can raise each year, although today I don't propose to touch on this particular aspect of financial relations.

General Purpose Payments to the States

Turning first to General Purpose Payments, these were provided to the states to reimburse them for the loss of customs and excise duties which were taken over by the federal government on Federation. The major change in financial relations occurred in 1942 when for war purposes, the federal government assumed the sole right over income tax powers. Of course, as most things which start as temporary in the area of public finances, this became a permanent feature. It is a feature which for much of the 50 years has significantly disadvantaged New South Wales. When the federal government took over income tax collection, it introduced a system of tax reimbursement payments to the states. These continue in some form today, although their basis has changed. Indeed, the present Financial Assistance Grant is still the largest recurrent budgetary receipt in this state. This is despite federal government cutbacks in both the size of the grants pool to the states and continued discrimination against New South Wales and Victoria. I will return to this aspect later.

There have been four main phases since World War II in the history of General Revenue Payments. First, the Tax Reimbursement Grant, which lasted from 1942/43 to 1958/59. In 1959, the basis of the grant changed when the federal government introduced the States Grants Act. This introduced a second system of payments called Financial Assistance Grants to replace the Tax Reimbursement Grants. The new system did not have regard to income tax collections for each state, nor relative state expenditure needs. The grants after 1959/60 were calculated by escalating the previous year's grant with a factor taking into account population increase, national wage increases and a so-called Betterment Factor.

In 1975/76 a third system of grants was introduced under Fraser's failed 'New Federalism'. The system was generally designated as tax sharing arrangements. Between 1976/77 and 1984/85, general payments to the states were based initially on a percentage of personal income tax collections. Then in 1980–81, until 1984/85, the grants were based on a proportion of total Commonwealth tax collections. The fourth phase, the current period, has seen a return to a system of Financial Assistance Grants. However, like the tax sharing grants, these are not related to federal tax collections in any form. Instead their size is subject to the whim of the federal government as to the increase, if any, they decide to give to the overall grants pool. In the first three years of the operation of the new Financial Assistance Grants, there was a guarantee by the Commonwealth government to index the grants pool for inflation. As well, the Commonwealth guaranteed to provide a further two per cent growth in years two and three of the period. This growth factor was arbitrarily cancelled for the third year. So despite a Commonwealth guarantee to the states, entrenched in legislation, the system was changed. It's little wonder the states have problems with forward planning. However, for the next three years, there was no guarantee to index the pool for inflation, let alone provide a betterment factor. Fortunately, for this financial year and the next two years, the Commonwealth has agreed to index the pool in line with inflation. This is of at least some assistance to the states.

To sum up the history of general revenue grants, it can be seen that the period, particularly since World War II has evolved dramatically. It has changed from one where states where compensated for handing over their income tax powers, to a system where general revenue grants from the Commonwealth are not related in any way to federal tax collections or a system of tax reimbursement. General revenue grants are now determined by the federal government at its will. You can observe that the system has been particularly ad hoc. It has generally allowed no forward financial planning by the states because of the uncertain and erratic nature of federal payments. Before examining the implications of that approach and the best way to reform the system, we need to also briefly examine the other major arm of federal-state financial relations. We have just discussed the system of general purpose payments, which I might add in passing, largely covers recurrent payments. There are some capital payments made but these have virtually become insignificant. The other major payments are specific purpose payments, for both recurrent and capital purposes. These commenced in 1923/24 when the first payments were for road purposes. Since the Second World War, the importance of specific purpose payments have increased significantly, both in terms of the number of different grants and the level of funding. The major period of growth in this type of payment occurred under the Whitlam government.

Specific Purpose Payments to the States

The legitimacy for specific purpose payments is entrenched in our Constitution under Section 96. This allows the Commonwealth to make payments to the states for certain purposes. In other words, it allows the federal government to impose national priorities on the states. You will have heard these grants described by the more common term 'tied grants', because they are tied to a specific expenditure purpose.

These grants can take two broad forms. First, payments direct to the states, such as payments for schools, hospitals, roads and housing. Alternatively, the payments involve the state as a 'post office', as they are paid to areas that are not state responsibilities such as private schools or universities. In 1972, specific purpose payments accounted for 26 per cent of all Commonwealth payments and borrowing allocations to the states. This rose to 49 per cent three years later, but declined to 41 per cent in 1981/82 as the Fraser government discontinued a number of Whitlam programs and started to absorb some specific payments into the general purpose payments. By the mid 1980s this trend started to change again, particularly due to increased funding in the hospital area under Medicare as well as education, community services, roads and housing. In 1985, specific purpose payments represented 45 per cent of all Commonwealth payments and allocations to the states. In the last few years specific purpose payments have increased in real terms, particularly for capital purposes. This occurred at a time when, you will recall, general purpose payments were subject to no inflation guarantees and were cut significantly in real terms. As a consequence, the relative importance of specific purpose payments to the NSW Capital Budget increased slightly to 17.9 per cent in 1990/91, compared to 17 per cent five years ago. Although recurrent specific purpose payments have increased in money terms by nearly 39 per cent in the past five years, as a proportion of New South Wales recurrent Budget revenue, they have fallen from just over 14 per cent to 12.4 per cent in the same period. This is due to the greater importance of state taxation in recent years, partly reflecting increases in state taxation rates.

Outcomes for NSW: The Need for Reform

So while specific purpose payments have in some respects become more important, the squeeze on general revenue grants has collectively hurt all states, particularly the larger states. This is borne out by these simple figures for New South Wales:

- In 1942/43 New South Wales received 42.7 per cent of the general revenue grants from the federal government. This was above our population share of 39.6 per cent.
- In 1959/60 our share of the grants had dropped to 33 per cent which

was below our population share of 37.6 per cent. We have continued to be below our share even though our population share has also continued to fall.

- In 1976/77 we received 30.4 per cent of federal grants compared to a population share of 36.1 per cent.
- In 1990/91 New South Wales received an estimated 28.2 per cent of federal payments to the states and the Northern Territory, compared to our population share of 34.6 per cent.

In the current year, it is anticipated we will receive 26.3 per cent of our share of general revenue grants compared to our population share of 34 per cent.

That means that in nearly 50 years, although our population share has fallen from around 39.6 per cent to around 34 per cent, our share of general revenue payments from the Commonwealth fell from 42.7 per cent to 26.3 per cent, or from being around 3 percentage points above our population share to now being nearly 8 percentage points below our population share.

It would be hard to find any rational citizen of New South Wales who would not argue that rectifying this imbalance must be part and parcel of any reform of federal-state relations. Clearly the system is one in need of reform, both in terms of the general and specific purpose payments. The means of reform and the desired outcomes are areas of disagreement, not only between states but also between political parties. In relation to general purpose payments, I indicated how New South Wales had been disadvantaged by the system which replaced the initial tax reimbursement grants. I repeat, in 1991/92 it is expected that New South Wales will receive 26.3 per cent of general revenue grants compared to our estimated population share of 34 per cent. In other words, if we received our fair share of general revenue grants, New South Wales would be more than $1 billion a year better off.

We propose that general revenue grants should be made on the basis of population share, and not on the basis of the Grants Commission's academic formula which determines the relative needs of states. A number of other payments or allocations are now moving towards being calculated on population share, if they are not calculated on that basis already. For example, local government general revenue payments, housing payments as well as the global borrowing allocation are based, or to be based, on per capita shares. Our solution is to move to population share for general revenue grants, as well as a guarantee of a real increase in Commonwealth payments each year. This latter aspect would enable long term planning. We reject the alternative proposal of allowing states to have access to a major new revenue source such as a consumption tax. The last thing the Australian economy, Australian business and the Australian people need is a consumption tax. Or, for that matter, any new tax. But, especially a consumption tax. Not only will it have a disastrous, albeit one off, impact on inflation at a time when we are starting to break the inflationary cycle, it is inequitable as low income earners and social security recipients cannot be properly compensated. As well, it is an unnecessary burden on business with the extra red tape that many businesses would have to endure. For New South Wales the answer is clear. No new tax — just a fair share of federal funding. After all, why should a person living in Tweed Heads attract a federal payment of $633 in 1990/91, while a person living in Coolangatta attracted a federal payment of $860 — $227 more for living just over the border. This situation is purely the result of some arbitrary lines drawn on a map. It is a position that is anachronistic in 1991. I am not going to get into the complicated theoretical reasons for and against the principles of fiscal equalisation. In practical terms the system is wrong for the outcomes I have just outlined. And New South Wales continues to be disadvantaged by it.

Indeed, in the current year the Grants Commission's latest report has cost New South Wales another $120 million. Queensland was again a winner this year. Yet Queensland continues to have a lower level of taxes and at the same time gets subsidised by New South Wales to maintain that level. In other words, New South Wales tax-payers continue to pay the highest level of tax per capita, a feature that has been entrenched in recent years, in order that Queensland can maintain a lower level of taxes. It is discriminatory to say the least. And just to reinforce this point, I will detail all the per capita Financial Assistance Grants for 1990/91 for all states:

New South Wales	$633
Victoria	$618
Queensland	$860
Western Australia	$942
South Australia	$996
Tasmania	$1143
and Northern Territory	$4309

That is the break up of the federal funding pie. All New South Wales and Victoria seek is a fairer slice. Instead, what we have had to date is a burnt crust. Queensland, on the other hand, has had a decent slice; Western Australia that again plus a few more plums in the pie; South Australia cream on top; Tasmania that again plus a cherry — while the Northern Territory has all that served on a Royal Doulton plate with silver tea service, served by a butler who asks when they have finished 'would you like another slice, sir?'. As you can appreciate there is something fundamentally wrong with a system which results in New South Wales and Victoria subsidising the other states to the tune of $1,900 million a year.

Proposals for Reform

There are many problems with the Grants Commission methodology. Two spring to mind:

First, the Grants Commission's methods do not reflect current financial and economic circumstances of the states. As a consequence, Queensland receives a major increase in funding at a time when its economy has been hit least by the recession.

Second, the Commission's assessment of the taxable capacity of the states is on the basis of the taxes that are levied rather than the capacity of a state's citizens to pay higher taxes. The Queensland problem again.

Our proposal for a federal revenue payments system based on population share does not mean that differences within the state borders can not be addressed. If every state received a payment according to its population share, it is then up to each individual state to allocate what it thinks is a fair distribution of funds within the state. It may be that a state would determine there are immediate problems to be addressed in city areas for a few years and another state may determine remote areas should receive a higher priority for the immediate future.

The federal government has now given some recognition to the unfairness of the current system by agreeing to New South Wales' suggestion at the recent Premiers' Conference to show the clear cost of the New South Wales and Victorian subsidies to the smaller states and Territories.

In future, Financial Assistance Grants will be separated into two categories. The first payment will relate to an equal per capita payment to all states and Territories. The second component will be an equalisation payment made to smaller states and Territories. That is at least one small step in the right direction. For the first time the subsidy to the other states and Territories will be explicitly detailed. It is interesting to note that given the continued cuts in federal funding, the benefits from the property boom on state tax collections and increases in state tax rates particularly in recent years, the importance of Commonwealth revenue to state budgets has declined. This has been one unintended outcome of federal cuts. For example in 1983/84, total state sourced revenue accounted for around 54 per cent of all New South Wales Budget recurrent revenue, with the Commonwealth accounting for 46 percent. So eight years ago, it was nearly half and half. In 1990/91, state sourced revenues were estimated to account for 64 percent of all New South Wales Budget recurrent revenue, with the Commonwealth payments accounting for around 36 percent. In other words, the ratio became nearly two-thirds state versus one-third Commonwealth. While this has allowed New South Wales to have more control over its own finances, it is not an argument for ignoring the present discrimination between the larger and smaller states. I appreciate that this conference is a national conference. But I make no apologies for giving a New South Wales slant to my speech because this is fundamental to the argument for reform. I have talked today about the difference in funding levels between the states. That is generally termed **horizontal imbalance**. A lot of discussion in the last twelve months has been about reforming the allocation of functions between the Commonwealth and the states. This comes into the category of **vertical imbalance**.

Labor's Approach to the *Microeconomic* Reform of Federal State Financial Relations

The need to restructure the Australian economy to create a more efficient and internationalised economy is the challenge of all governments in the 1990s. The goals of micro-economic reform are to produce a more competitive, more productive and lower cost outcome. Public sector reform is an essential element, with the major feature being the streamlining of government functions. In this way we can cut waste, restrain the taxation burden and enable emerging expenditure pressures to be addressed without resorting to higher taxes.

In my view, the size of the public sector has reached its limits measured in terms of expenditure, taxation, borrowings and employment relative to the economy. As I said, there are strong pressures facing state governments in the 1990s. In NSW these include:

- the aging of the population and the associated increased pressure on hospital budgets for example;
- higher demands for environmental quality;
- addressing the sub-standard services in Greater Western Sydney and the Central Coast;
- the cost of law and order, particularly the cost of meeting the community's demand for increasing police numbers and the flow-on costs for the court, prison and welfare systems;
- immigration pressures, with NSW accommodating 40 per cent of the migrant intake;
- land constraints in Sydney. It presently costs the tax-payer around $40000 to service a block of land in the growth areas of Sydney; and
- renewal of infrastructure, particularly public transport, roads, water and sewerage. In the case of water and sewerage, the existing systems are up to 100 years old and will require hundreds of millions of dollars to upgrade.

All these will create pressures on the state government this decade. As I said, cost savings will be required from all areas of government. Hence the need to reduce duplication.

Two principles govern Labor's approach to reviewing federal-state relations in the broader sense. First, state governments exist primarily to provide basic services. Of the three tiers of government, it is the state government level where the bread and butter services are provided. The most important are health, education, transport and law and order. The federal government should not have largely parallel and wasteful bureaucracies, especially in education and health. State government authority in this area of basic services should be strengthened. In return, the federal government should have stronger powers relevant to its basic responsibility for managing the national economy. Hence, the Labor Opposition's commitment to ceding state powers in industrial relations, business and consumer regulation, vehicle registration, the freight network and ports. It is impossible for Australia to trade its way out of problems on the external account unless businesses can rely on cost-effective communications, transport and electricity generation. The current inefficiencies in infrastructure provision arise partly from the irrational allocation of responsibilities in Australia's federal system of government.

States' rights have been the real enemy of micro-economic reform. The farcical delay in the establishment of a proper national companies and securities system is a case in point. Actually, the states have a lot to answer for, as their scandalous obstruction of the new scheme allowed our corporate crooks to cause unnecessary damage to our economy and our international reputation. The administration of company laws, industrial relations and consumer protection through each of the state parliaments has produced unnecessary litigation and inefficiency. If the federal government is to govern in the interests of national economic growth, it must generally take responsibility for Australia's leading economic institutions and infrastructure provision. In April last year, Bob Carr released a major statement on improving federal-state relations. He proposed a working party on federal-state powers, reporting direct to the Premiers' Conference. Subsequently, the Prime Minister announced in July a major review of federal-state relations including the special Premier's Conference last October, the first of a series. The following areas of state administration were initially proposed by the Opposition for inclusion in the work program to reduce duplication and achieve greater uniformity:

- administration of universities;
- overseas skills recognition;
- credit legislation;
- administration of non-bank financial institutions (building societies, credit unions, co-operatives, trustee companies and friendly societies);
- packaging regulations;
- probate law;

- newspaper regulations;
- third party insurance;
- workers' compensation;
- nursing home regulations;
- health profession registration;
- child care licensing;
- building regulations;
- pollution controls; and
- industrial relations.

Some success has been achieved. The states have agreed to a National Rail Freight Corporation. Agreement was also reached at the recent Premiers' Conference for uniform regulations over non-bank financial institutions, although regrettably the federal government is reluctant to take over this area itself.

The Course of Future Reform

The October 1990 Special Premiers' Conference on federal-state relations did propose some solutions to the wider issues. These included two areas of examination. First, the balance of Commonwealth, state and local government revenue raising capacity, including the distribution of taxation powers. Second, a review of the level of tied grants in order to determine whether greater flexibility should be available to state budgets.

Dealing with the first issue, in my opinion, the emphasis should not be on finding new taxes for the states to raise such as consumption tax, but should involve a reallocation of functions between the federal and state governments. This includes reducing duplication. That is the way to assist reducing the vertical imbalance between governments, whereby the Commonwealth raises 80 per cent of all public sector taxation but is only responsible for 50 per cent of public sector outlays for what are described 'own purposes'. That is why the Opposition put forward its proposal last year to transfer a number of functions to the federal government. In return we did propose a transfer back to the state of some responsibilities for service to delivery areas, particularly education and health, to enable reduction in the size of the associated bureaucracies. Duplication occurs not only with the federal government watching over the states, but also the states having to employ armies of public servants to fill in forms and follow complicated procedures to qualify for federal funding.

On the issue of tied grants, it is one that is clearly not as simple to resolve as first thought. Even as a representative at a state level, I see that there can be some benefits in the Commonwealth government having control in areas of tied grants, particularly in relation to issues such as housing and the environment. The federal government has legitimate interests in these areas. In recent years it has taken greater interest, and appropriately so, in environmental protection. In the past the states have been prepared to give up responsibility in areas of government administration in order to reduce duplication, allow greater uniformity and to reduce the costs to industry and consumers. Examples have included abolishing state purchase preference schemes, transferring meat inspection services to the federal government and, of course, the recent transfer of company and security law to the federal government. At the same time, I do not think the states would want to take back full financial responsibility for universities. The bottom line is that reallocation of functions is integral to the question of a fairer distribution of funding responsibilities between the federal government and the states.

We should be designing a federal system which has a more balanced approach between funding and responsibility, and reduces duplication, and, therefore, costs to consumers, industry, tax-payers and the economy in general. Then, of course, there is the need for more appropriate sharing of funds between the states, which I spoke of earlier. In this context, the distribution of funding between states should see the scrapping of the Commonwealth Grants Commission. It has outlived its usefulness. Instead, there should be a system of population-based payments rather than one that takes into account lines on a map.

WAGES POLICY IN AN EXTERNALLY TROUBLED ENVIRONMENT

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WAGES POLICY IN AN EXTERNALLY TROUBLED ENVIRONMENT

PETER SWITZER

As the Accord Mark VI drifts away from its Industrial Relations Commission (IRC) moorings, and the threat of the coalition's enterprise bargaining wages system becomes more likely, it is appropriate to assess the magnitude of our loss, if we eventually live without some Accord Mark 'something'.

From its inception, the Accord was a macroeconomic tool to rein in inflation and consequently promote employment. However, as the focus of the 1980s was abruptly switched to our foreign debt — balance of payments problems, the Accord became a central microeconomic reform weapon, in a battle to improve our cost competitiveness.

Those who praise the Accord do so in the belief that it has promoted lower money wage claims and lower unemployment than would otherwise have occurred.

Professor David Metcalf, a British incomes policy expert from the London School of Economics, when studying our Accord admitted that he thought the Accord was a superior kind of incomes policy because of its durability and flexibility.

On the other hand, Des Moore, a former Treasury secretary, and now of the Institute of Public Affairs, argued that monetary and fiscal policy have been hampered by the Accord. He maintains the severity of the current recession can be traced back to the Accord's impact on real disposable income.

So what's the real story? Is the Accord the saviour or the villain in the piece? What is undeniable is the fact that our progress in turning around the Current Account Deficit (CAD) has been poor. The CAD runs in at approximately 4.5 per cent of GDP and that's about double the level needed to stabilise the growth of the net foreign debt ($133.5b).

Even more worrying is the stubbornly high marginal propensity to import which underlines the fact, that the recession might reduce the cyclical component of the CAD but has done little to redress the structural problems underlying our external difficulties.

Adding to all this, the burgeoning growth of the debt servicing debit of $14.5b on the CAD of $16.5b, threatens to get out of hand. All this means, in the absence of a major policy play, Australia will have to be content with very low rates of growth to avoid big import bills, which simply translates into high unemployment rates for a long time.

Hence the need to assess the Accord in terms of its contribution in the battle against our balance of payments foreign debt nemesis.

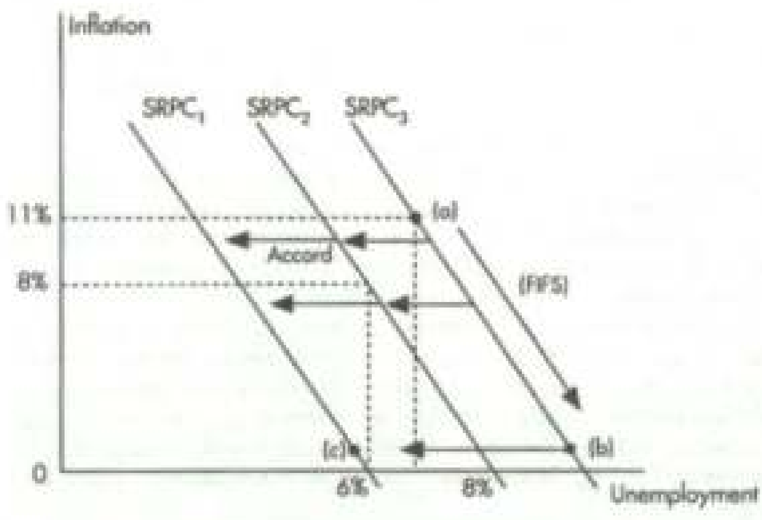
My argument is that the Accord has had a commendable record in terms of its initial prime objective unemployment. However, the winds of change and the new focus on our external predicament which is directly linked to our poor competitiveness, means it is time for an alternative wage experiment.

The Accord

The Accord was cooked up as a defensive strategy against the monetarist-inspired 'fight-inflation-first' policy stance which had captured the policy makers of the Fraser government in the early 80s. In those times, resident galahs at pet shops were talking stagflation, which meant inflation and unemployment were rising simultaneously. 'Fighting-inflation-first' implied contractionary fiscal policy, tight monetary policy and restrained wages growth. This was targeted to choke off demand, killing off inflation and inflationary expectations which fed the wage-price spiral. However, the price for success was a very high level of unemployment: a price the architects of the Accord-Messrs Willis, Crean and Kelty, weren't prepared to pay. Hence their construction of a corporatist or planning alternative to the 'scorched earth', fight inflation first strategy (FIFS).

Theoretically, the FIFS pushes an economy down a short run Phillips curve (SRPC), until inflation is say zero. See points a to b on Figure 1. And then as inflationary expectations follow, the economy first experiences rising unemployment, but the lower inflation and expectations

Figure 1



improve employment conditions and the economy moves to a lower SRPC (points b to c).

The Accord was designed to push the SRPC to the left by containing wage demands so that inflation could be brought under control without having to travel down the SRPC to socially ruinous levels of unemployment. If the Accord was a success it could reduce inflationary expectations, putting the economy on a more leftward SRPC. Also, its supporting policies could lower the natural rate of unemployment.

For the 1983 Hawke Labor government, which picked up and ran with Accord Mark I, this was primarily a macroeconomic policy crafted to influence the total wage outcome. It permitted an expansionary fiscal policy to promote job growth and meant monetary policy was accommodating, instead of tight. It was the linchpin of a different policy mix compared to the politically unpopular cocktail of the ex-Fraser government.

The Remaking of the Accord

Two things readily agreed to about the Accord by critics and supporters alike, is that it has been an amazingly durable and flexible incomes policy. Changing economic circumstances have paralleled the many 'marks' of the accord.

Mark I was a wide ranging policy which provided for full wage indexation, productivity increases, the introduction of Medicare, promises of tax reform, a Prices Surveillance Authority, etc. It was a big promise which Labor has roughly followed throughout the 80s. Of course, the Accord doesn't rigidly determine the actual wage increase — that comes out of the National Wage Case, which adjudicates on the Accord's deal and what the employers have to say. And as we've seen recently, the Industrial Relations Commission can overrule the Accord's provisions. Here, the policy was used to avoid a wage explosion following the 1982-83 wage freeze.

Mark II, in September 1985, saw the Accord adopt the flexible stance which it has become famous for. Faced with solid depreciations of the $A over 1985, the ACTU agreed to wage discounting and were rewarded with tax cuts in September 1986. The 3 per cent productivity increase was converted into a superannuation payment which took ages to implement and thus provided a cost benefit to the economy.

Mark III was the famous two tier system. In the first tier or level, everyone got a flat $10 increase and an additional 1.5 per cent increase, later in the year. These were 'get-even' adjustments to compensate for inflation and to reward the union movement for giving into wage discounting in 1985. However, the second tier was more troublesome. Four per cent was up for grabs but unions had to reform work practices to bolster efficiency, or agree to restructuring which would deliver cost savings. This innovation caused many problems and some unions waited over two years to get their 4 per cent. The two tier system brought wage determination down to a new reality, where a wage-cost increase was offset by an efficiency reform cost decrease. It was something the union movement branded as negative and paved the way for the 'Structural Efficiency Principle'.

Mark IV was a 'dire straits' decision — *money for nothing and your 'cheques' for free*. After the dentist-tugging experience of the two tier system, unions secured a 3 per cent rise and a flat $10 pay increase, later in 1988-89.

All that was required for the rise was a union commitment to the structural efficiency principle. For those nonplussed by the 'Structural Efficiency Principle', the Arbitration Commission in 1988 pointed out 7 dimensions which define the concept:

(1) the establishment of skill related career paths;
(2) multi-skilled workers in a broadband of related work activities;
(3) the creation of fair relativities (pay differences) between different workers;
(4) changed work arrangements to increase flexibility;
(5) fixed minimum pay rates;
(6) rationalisation of the respondents to awards;
(7) changing discrimination within awards.

Of course, central to all of this is **award restructuring**, which refers to attempts to reduce the number of awards, by compressing them into a smaller number of broad bands containing multi-skilled workers. The overall aim is to provide productivity or cost-reducing reforms to employers to offset wage increases. However, award restructuring in many cases is a 'slow burner' which will only deliver significant gains down the track.

Mark V came up with a whole range of payments ranging from $10, $12.50 and $15 a week for workers of different skill and training. A second level of payment was available for productivity rewards for implementation of award restructuring. Also, supplementary payments up to $70 was possible for low paid workers.

Mark VI was born out of a pre-election promise and offered a 1.5 per cent wage increase linked to the September 1990 CPI. This was paid instead as a tax cut in January 1991. There was already a tax cut sweetener and the latter was simply added on. Also, workers expected: a $12 flat increase; 3 per cent superannuation to be phased in over time and a 4 per cent over-award productivity payment, which was to be negotiated at an enterprise level.

However, in March 1991, the Industrial Relations Commission (IRC) refused to play ball, dumping the Accord's provisions and instead suggesting the economy could only cope with a 2.5 per cent pay increase. The IRC was worried about:—

(1) the incompleteness of award restructuring reforms;

(2) the prospect of a wage explosion and industrial disputes over enterprise bargaining disagreements for the 4 per cent.

Following the IRC's decision, the ACTU has decided to by-pass the IRC, preferring to negotiate Accord Mark VI with employers, directly. At this stage many unions were intending to refer negotiated settlements to the IRC for ratification, but since the rejection of the waterfront deal, there could be second thoughts about doing business with the IRC at all.

Well, that's the story of the Accord — so what have we learnt?

In 1985-86 when the collapse of the terms of trade 'knocked onto' the dollar, revealing a gaping hole in our balance of payments, the policy mix was swung around to tackle our external weakness.

Fiscal policy contracted into a budget surplus to push up savings to decrease the CAD. Monetary policy was tightened to slow up spending and imports. This, too, was done to decrease the CAD. Industry policy was revved up to speed along competitive changes, to decrease imports and increase exports in order to decrease the CAD. And wages policy was linked with industry policy to be the vehicle for microeconomic reform. The second tier of Accord Mark III and award restructuring of Accord Mark V were all about wages delivering productivity and lower costs, to assist in the turn-round of the CAD.

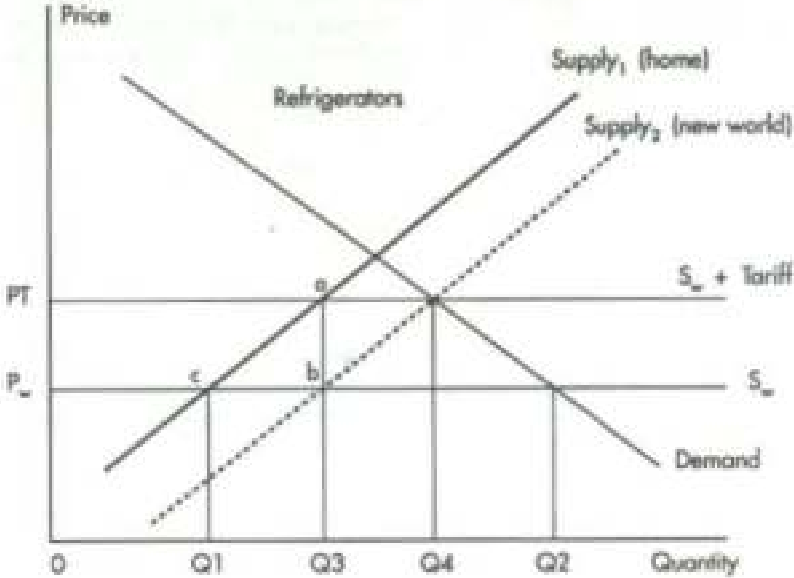
The tariff figure (see Figure 2) tells us where we've been and where we should be going. Through tariff protection (Pw-PT) prices rise, building in an inflationary bias into Australian industry. The area (Pw PT a c) is extra produce surplus which is an excessive profit paid to local car-makers. The triangle (cab) is an efficiency loss, which represents an over payment to resource owners, of which workers are a group.

Currently, local industry needs OPT to produce OQ_3. Through microeconomic reform and a restructuring of the economy, the supply curve should move to the right (S_2) indicating a lower-cost Australia, where OQ_3 is made at a lower price, without the need for protection.

So wages policy should bring costs down by raising productivity and this permits affordable pay increases. Without doubt, Accord Mark III's second tier was the best and most painful way of unwinding costly work practices, which stood in the way of making our tradeables sector sufficiently more cost competitive. Award restructuring was a slower, more palatable solution for the ACTU but destined to be a worry as the foreign debt meter ticked away in the fast lane of international trade.

With this in mind consider the following arguments for and against the Accord.

Figure 2



Case for the Accord

- Dampened the wage explosion of the early 1980s.
- Positive employment effects-eliminated the real wage overhang.
- Averted a depreciation-inflation spiral, 1985 and 1986.
- Restrained wages in the post crash boom, 1988-89.
- Improved the profit share of national income.
- Wage component of inflation decreased in the 1980s.
- Wage-tax benefits for inflation.
- Assists total macro management with more control over total wage outcome.
- Microeconomic reform benefits which raised productivity and reduced the cost — 'hit' of wage increases.
- Unemployment approached its natural rate of unemployment of 6 per cent, prior to 1991.
- Helped the government's creation of 1.7 million jobs 1983-90.
- Industrial disputation — longest period of industrial peace in 20 years.
- A durable wages policy, flexible to changing economic events.

The Kelty view: real unit labour costs are at the 1960s levels; post '83 inflation record better than the pre-'83 record when the terms of trade fell ('85 & '86) and real wages fell, but when the terms of trade rose in the late 80s, real profits took off; 'the moderate magnitude of the present Accord package is consistent with a continuing reduction in Australia's rate of inflation.' (*AFR*, 20-2-91, p15).

Case against the Accord

- OECD reports business unit labour costs in OECD countries rose more slowly than Australia, without an Accord.
- Since 1984, our labour costs have been double the OECD group.
- Increased real disposable income by 5 per cent over 1988-90.
- OECD report — OECD had similar wage restraint — 1982 recession.
- Slowed up microeconomic reform.
- Accord Mark 3's two tier system more ideal — union rejection.
- Wages should reflect export opportunities profits & demand changes .
- An overrated policy priority which contributed to fiscal policy easings and the eventual recourse to high interest rates which ended in this recession.
- During a recession — it's a good time to embrace enterprise bargaining.
- An ignorable inflation record.

P.P. McGuinness view (*The Australian*, 8 Jan 91):

> . . . And by imposing and maintaining obstacles to change and productivity growth, while it may not influence the cyclical behaviour of wages, it certainly ensures that they are lower in the long run than they should be.

Australia's inflation record shows that for only 2 years of the last 20 we got under the OECD average. This is a rough indicator that year by year our goods became relatively dearer to our trading partners. Meanwhile our productivity record, no matter how it's measured, is never impressive. In fact, the 1991 'World Competitiveness Report', had Australia 16th in a field of 23. We were 10th in 1989. And while inflation is not all wage-driven, apart from a recession of present dimensions, labour market productivity plays are essential to lock in low inflation levels.

To simplify the issue and to demonstrate where the Accord has missed out, consider the fact that defendants of the Accord point to the 10 per cent fall in real wages since 1983. Also, 10 per cent is the number offered for the fall in Real Unit Labour Costs (RULC). Clearly, if approximate numbers tell us that real wages have fallen by the same amount as RULC, then productivity must have been poor.

If productivity was higher real wages would not have had to fall and unemployment levels could have been held down. Table 1 explains the point:

Table 1

		AUSTRALIA	GERMANY
Δ REAL WAGES	= Δ LABOUR COSTS / Δ PRICES	6% / 8% ↓ 2%	4% / 2% ↑ 2%
PRODUCTIVITY		1% RELATIVELY SMALLER COST DECREASE & LESS EMPLOYMENT OPPORTUNITIES	3% BIGGER COST DECREASE & GREATER EMPLOYMENT OPPORTUNITIES

While these figures are hypothetical, they reveal something about what we need to achieve on the wages front. Macquarie Bank in its *Australia's Economic Challenge* publication pointed out, 'nominal unit labour costs should not increase by more than those of our major trading partners. This broad policy goal would be met if wages increases were matched by productivity improvements.'

By not pulling off a big productivity play, the Accord forced greater real wage reductions than might have been necessary. And its macroeconomic failing in relation to inflation and microeconomic failing in relation to productivity probably exacerbated the recession.

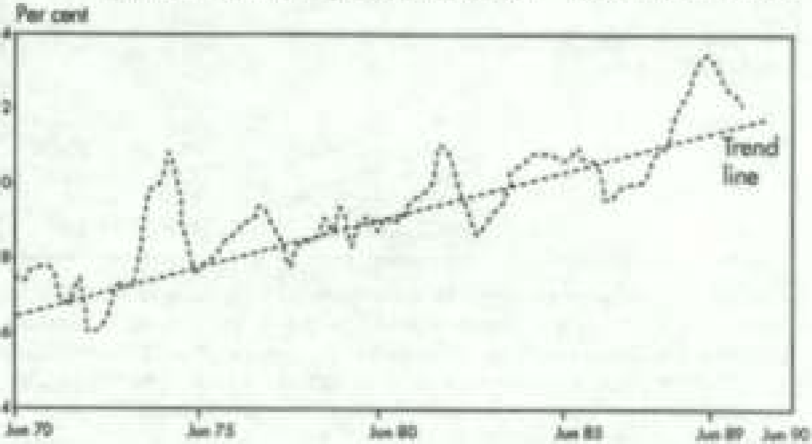
Conclusion

Compared to other periods in our economic history, the Accord is a well performed wages policy. It has achieved real wage restraint, a shift of national income back to profits and has, until 1991, decreased unemployment, while reducing disputes. However, the total or all-encompassing nature of the 'Accord's wage outcome over-rewards some workers and under-rewards others. It stifles big productivity plays making real wage increases less tolerable.

The CAD and in particular, the foreign debt, is like a thermometer thrust into the belly of the beast and it tells us we're running a temperature. In June 1990, for every 1 per cent increase in national income, imports rose by 2 per cent. At the same time the import penetration ratio indicated 13 cents went out on imports for every dollar spent. It is now, after a severe recession, 12 cents in every dollar! (see Figure 3). The longer we delay adjustment, the more painful will be that adjustment, as the recent period of high interest rates and now unemployment has emphasized. If the Accord slows up reform it becomes a part of the problem.

As has been shown, real wages can increase and unemployment can fall if more is being produced. That's why productivity is essential and the Accord is not.

Figure 3: **Import Penetration Ratio*** (average 1984-85 prices, seasonally adjusted) Source: Budget paper No. 21988-89



* Endogeneous imports as a percentage of non-farm sales (defined as gross non-farm product plus imports of services and endogeneous goods less changes in a private non-farm stocks)

AWARD RESTRUCTURING AND LABOUR MARKET REFORM

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AWARD RESTRUCTURING AND LABOUR MARKET REFORM

BRAHAM DABSCHECK

For more than a decade Australia seems to have been involved in a never ending debate concerning the need to reform the operation of the Australian labour market and its system of industrial relations regulation. A variety of different groups and organisations have competed with each other in offering a variety of proposals ostensibly designed to improve the performance of the labour market in an attempt to help bring about economic growth and recovery. For example, a group known as the 'New Right' have offered proposals which involve the abolition of trade unions and industrial tribunals; the Business Council of Australia has advocated an approach which places greater reliance on enterprise bargaining; and the Australian Council of Trade Unions, in *Australia Reconstructed* and *Future Strategies*, has argued that Australia should adopt a Swedish style corporatist model and reform unions along industry lines.

In addition, both state and Commonwealth governments are continually introducing legislative changes and/or have commissioned inquiries concerning various industrial relations and labour market issues. The Commonwealth government, for example, commissioned the Hancock Report to offer recommendations concerning the operation of Australia's industrial relations system. Both the New South Wales and Queensland governments conducted inquiries into their respective state industrial systems in the form of the Niland and Hanger Reports. Returning again to the Commonwealth level, the Kirby Report and a White Paper by John Dawkins, the Minister for Employment, Education and Training, have offered a variety of proposals concerning industry training in Australia. Furthermore, proposals have been offered or legislation has been enacted with respect to such issues as affirmative action and equal employment opportunity, industrial democracy, redundancy and occupational health and safety. As well as this, issues pertaining to taxation, social welfare, superannuation, tariffs, industry policy and government assistance to industry also have industrial relations and labour market implications.

Notwithstanding the range and variety of the various proposals that have been suggested or implemented over the last decade it might not be too unreasonable to suggest that the majority of these proposals coalesce around three inter-related issues. They are first, the question of the degree or balance between centralisation and decentralisation within the Australian labour market; second, the flexibility and/or adaptability of labour markets; and third, whether proposed reforms should be processed within or outside existing institutional (ie. industrial tribunal) arrangements. Since the second half of the 1980s award restructuring has assumed a significant role in attempts to reform the operation of Australian labour markets. This paper will be concerned with an examination of various issues associated with **award restructuring** and the **structural efficiency principle** developed under the auspices of the Industrial Relations Commission.

Before proceeding further, however, it might be useful to first provide information concerning the institutional setting which governs Australia's system of wage determination. Under the Australian Constitution the Commonwealth government is severely limited in its ability to become involved in industrial relations and wage determination. Section 51 paragraph xxxv of the Constitution only empowers the Commonwealth government to make laws with respect to 'conciliation and arbitration for the prevention and settlement of industrial disputes extending beyond the limits of any one state'.

This provision in effect bars the Commonwealth government from using legislation to determine wages, and hence reduces its ability to directly regulate the labour market. The Constitution forces the Commonwealth government to delegate power to industrial tribunals. The major tribunal at the Commonwealth level is the Australian Industrial Relations Commission. The Commission is independent of and from the parties and the Commonwealth government of the day, and has jealously guarded its independence. One of the former members of the tribunal perceived its independence so strongly that he referred to himself and his colleagues as the 'economic dictators of Australia'.

Award Restructuring: Evolution, Operation and Problems

In March 1983 the Australian Labor Party (ALP) was elected to government on a platform of national reconciliation and consensus. An important feature of the ALP's electoral program was an Accord, or agreement, negotiated between the ALP and Australian Council of Trade Unions (ACTU) which committed a Commonwealth Labor government and the ACTU to a centralised system of wage determination which had 'the maintenance of real wages . . . [as] a key objective'. The Accord also included a wide range of social and industrial reforms which would be pursued by a Labor government. Following Labor's electoral victory, the Commission, in the September 1983 National Wage Case, endorsed the wages side of the Accord in introducing a system of wage indexation where wage rises were linked to movements in prices.

The mid 1980s witnessed the Australian economy experiencing a number of major problems with respect to the balance of payments and the level of foreign debt. These problems were associated with a series of alterations or renegotiations of the Accord — involving wage-tax trade-offs — which, initially witnessed an end to the wage indexation assumptions inherent in the Accord, and a move away from a centralised to a decentralised system of wage determination. In a series of decisions in the second half of the 1980s, and into the 1990s, the Commission has linked wage rises to award restructuring and the structural efficiency principle.

The Commission sees the structural efficiency principle as helping to enhance the productive performance and efficiency of Australian firms and industry. It should be made clear that the Commission envisages that the application of the principle should occur at the enterprise level. Awards should be changed to remove provisions which have, hitherto, placed restrictions or limitations on employers at the workplace. In the August 1989 National Wage Case the Commission said it wanted to enable changes to occur to 'work methods and the application of new technology and . . . award provisions which restrict the right of employers to manage their own business unless they are seeking from employees something which is unjust or unreasonable'. The Commission in the April 1991 National Wage Case declared that it saw award restructuring as 'linking the granting of wage increases to the adoption by employers and unions of measures calculated to raise efficiency and productivity and to reduce costs'. Two additional points should be noted about the structural efficiency principle. First, the Commission maintains that it should not be an exercise in negative cost cutting to reduce award provisions for short term gain. Second, the Commission envisages the principle as being designed to encourage skills acquisition, training and retraining.

In the April 1991 National Wage Case the Commission concluded that limited progress had been made along the path of the structural efficiency principle. In doing so it referred to the lack of maturity of the parties, and to the lack of any real impact of the process of award restructuring at the enterprise level. The Commission, in its April 1991 decision, also rejected a move towards enterprise bargaining. Other than for the Metal Trades Industry Association, virtually all of the parties expressed support for enterprise bargaining. It should again be noted that the Commission perceives the structural efficiency principle being implemented at the level of the enterprise. Given its conclusion that limited progress had been made concerning the implementation of the structural efficiency principle, the Commission felt disinclined to endorse the adoption of what it regarded as an unknown system of enterprise bargaining. The Commission pointed out that the parties would need to develop more maturity before contemplating the introduction of enterprise bargaining. In addition, it pointed to differences between the parties as to the meaning of enterprise bargaining, its application, the calculation and distribution of benefits, whether there would be a limit on the quantum of benefits, and the role of the Commission in the process. Furthermore, it feared that enterprise bargaining would lead to a wages break out, with unions in strategic positions winning large increases with spill-over effects in other sectors.

Award restructuring with its emphasis on skills acquisition, training and re-training as a means to increase the productive performance of enterprises and industry holds out the prospect of heralding a new 'golden age' for the Australian labour market and the economy. This optimistic view may have particular relevance for workers who find themselves fortunate enough to be at the cutting edge of technological change and innovation, are employed in relatively large establishments which require a variety of different tasks and skills to be performed and easily lend themselves to the development of career paths and a concomitant ability to provide scope for advancement, and are represented by unions who have the wherewithal to negotiate on behalf of members to ensure that changes proceed on an 'equitable' basis.

Notwithstanding this, however, a number of potential problems associated with award restructuring and the structural efficiency principle can be identified. **First**, in moving from a centralised to a decentralised system of wage determination there may be important transaction costs which need to be considered. Both employers and unions, and other interested parties, will need to devote additional (scarce?) resources to facilitate the movement towards decentralisation. While large companies and unions may have the expertise and personnel to manage such a movement, others may not be so well placed. They will lack resources and the verve necessary to operate in a more decentralised industrial relations system. Evidence supporting such a proposition is provided by information recently gathered by the *Australian Workplace Industrial Relations Survey*. The Survey found that 53 per cent of workplaces had union delegates, with 66 per cent of unionised workplaces having delegates. Union delegates were relatively inexperienced with 50 per cent having been a delegate at their current workplace for less than two years. Some delegates had previous experience; however, only 34 per cent had been a delegate for a total of four years. Furthermore, the role and functions of delegates in workplaces were relatively limited with 82 per cent spending fewer than three hours per week on union affairs. In addition, the Workplace Survey found that management had similar high levels of inexperience; 49 per cent of specialist industrial relations managers had been in their job for two years or less, with 77 per cent having less than five years experience. The Survey also found that workplace negotiations took up relatively little time of such managers.

Second, as different workers acquire new/higher skills, tensions could emerge with workers who have traditionally performed elements of such higher skilled work. Such problems could be further exacerbated if safety considerations are an important aspect of such higher skilled work. Third, not all workers in the performance of their duties utilise all of the skill that they have acquired through training. The tasks that their employers require them to perform have been limited to a relatively narrow band of specialised tasks. It would seem inappropriate and a waste of resources to retrain such workers employed in areas of 'stable' task performance. The structural efficiency principle would appear to provide limited scope for such workers to improve their wages and working conditions.

Fourth, workers and unions with limited prospects for skill acquisition and lacking in bargaining power may be forced to provide 'give-backs' and/or erode award conditions to gain wage and other benefits under the structural efficiency principle. For such workers the principle may involve de-skilling and a general 'speed-up' of work processes. Alternatively, such workers will find it difficult to obtain wage increases. The problems that low skilled and low wage earners have experienced in obtaining wage rises under the structural efficiency principle is the major source of ACTU Secretary Bill Kelty's criticisms of the Commission. Fifth, employers who deal with well organised and strong unions may find themselves agreeing to wage and other concessions without gaining any productivity or efficiency benefits which are apparently available under award restructuring.

Summary and Conclusion

The labour market and Australia's system of industrial relations has been a continuing source of debate with various groups and organisations offering and competing with a variety of proposals for reform. Since the latter part of the 1980s the Industrial Relations Commission has embarked on a program of award restructuring in an attempt to improve the productive performance and efficiency of Australian enterprises and industry. This paper has provided information concerning award restructuring under the auspices of the structural efficiency principle, and the problems associated with its operation and implementation.

The volume of discussion concerning the need for labour market reform appears to assume (explicitly?) that the labour market is the source, or a major factor, associated with the economic problems or crises which seem to continually bedevil Australia. Is it conceivable, however, that the problems of the economy are more complex and are not caused by what happens in the labour market? While national economic problems always seem to have a labour market dimension (such as unacceptable levels of unemployment) it is not clear that the labour market, as such, is the source or cause of the problems of the Australian economy. In other words, in looking for solutions to Australia's economic problems, would policy makers be better advised to focus their attention on the operation of product, capital, money and other markets, not to mention the ability, or inability, of governments to collect tax (especially from the better off members of society) and developments in the international economy?

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INDUSTRY ECONOMICS

PROFESSOR BRIAN JOHNS

DEPUTY CHAIRMAN
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Brian Johns has had a distinguished academic career, holding a lectureship in economics from 1957-1981 at the University of Newcastle and from 1968 to 1981 he was Professor of Economics at the same university. Professor Johns was Director of the Bureau of Industry Economics from 1977 to 1989, when he was appointed as the Deputy Chairman of the Trade Practices Commission. He has also worked as a consultant for the IAC and the NSW Treasury and published a book entitled *Small Business in Australia: Problems and Prospects* (Allen & Unwin, 3rd edition, 1988). Professor Johns is a former member of the NSW HSC Economics Syllabus and Examination Committees.

INDUSTRY ECONOMICS

PROFESSOR BRIAN JOHNS

Introduction

The industry economics option is one which should appeal to many students and their teachers. It has a core of relatively straightforward theory; the relevance of the theory can be readily observed through examples in the Australian economy; and it addresses some key issues of government policy which are being discussed almost every day in the media and in the community generally.

Whilst this paper provides some brief remarks about each area of study identified in the syllabus it is mainly concerned with questions of public policy. An important reason for this focus is that, in my experience, teachers and students often find it difficult to keep up with the frequent changes in industry policy, competition policy, and business regulation in Australia. They welcome the opportunity to hear why the policies were adopted and their likely implications for the Australian economy. Some guidance on suitable source material for an understanding of these policy issues may be helpful. I have therefore included some references at the end of the paper.

What should we aim to achieve in the industry economics option? Hopefully we will ensure that a reasonably enthusiastic and hard-working student will emerge at the end of the course with a far better understanding about Australian industry and its place in the world, and that he or she will have acquired an ability to analyse and debate a range of important contemporary policy questions including for example:

- what policies are needed to make Australian industry more internationally competitive?
- why was it necessary to terminate the floor price scheme for wool?
- what is the best method of regulating telephone charges, after the OTC/Telecom merger?
- should the Australian government introduce tougher laws on mergers and acquisitions?
- what are the economic costs and benefits of the Very Fast Train project?

I should now like to move on to discuss some specific aspects of the Industry Economics syllabus. As many of you know the NSW syllabus is divided into three main areas of study

- the firm
- market models; and
- government policies

I propose to say something about each of these three areas in turn, but my remarks about the firm will be particularly brief as it is probably this area with which you will be most familiar.

The Firm

The firm in standard economic theory is a very simple abstract concept which is not intended to be a depiction of a business firm in the real world. The theoretical firm has only a few simple decisions to make, namely:

- what good or service to produce;
- what quantity to sell (per day);

  or
- what price to charge
  (even a monopolist cannot determine both the price and the quantity).

These decisions, simplified though they are, cannot be made until we know the firm's basic aim and the market environment in which it is operating. The basic aim of the firm is usually assumed to be the maximisation of profits, at least in the long-run. However, that aim cannot normally be achieved unless the firm is able to minimise costs at each possible rate of output. This implies that the firm is managed efficiently and is utilising the best available technology. There is no room in the theoretical firm for managerial slack or so-called 'X inefficiency'!

Two factors strongly influence the market environment facing the firm. The first is the demand for the product at each possible price level, and the second is the nature of the competition that it encounters from its rivals in the market, if there are any. In the real world, competition can take a wide variety of forms, while the strength of competition can ebb and flow with changes in technology or economic conditions. In the theoretical world, only some broad differences in the nature of competition are captured in four simplified market models

- pure competition
- monopolistic competition
- monopoly
- oligopoly

I shall be examining these market models in a little more detail in a moment.

It will be apparent that the so-called theory of the firm that we teach in industry economic courses is focusing the spotlight on only one aspect of the firm's everyday decisions — the pricing and output decisions in its product market. Other aspects of a real firm's decision-making are not considered. For example, no attention is given to the financing of the firm; the appropriate level of stocks of materials and finished goods; the need for training and an adequate supply of skilled labour; whether to sub-contract the supply of certain services or to perform them in-house; the appropriate level of new investment in plant and equipment; or the firm's relationships with its distributors. Does this mean that the simple theoretical concept of the firm is so abstract as not to be useful? Not so — the theory of the firm is a necessary building block in showing how the prices of goods or services are determined in a market economy. Prices are important, partly because the relative prices of goods and services guide the allocation of resources among different activities. Unless relative prices accurately reflect the underlying opportunity costs of the resources used in the production of the various goods and services, the nation's gross domestic product will be below the level that could otherwise be attained.

Market Models

The essential characteristics of the four market models are shown in Figure 1. You will notice that I have assumed that a firm supplying any of these markets would be aiming to maximise profits. This assumption may not necessarily hold for a monopoly or an oligopolist. In the absence of strong actual or potential competition, a firm in either of those market situations may prefer to enjoy 'a quiet life' rather than energetically pursuing greater efficiency and lower costs.

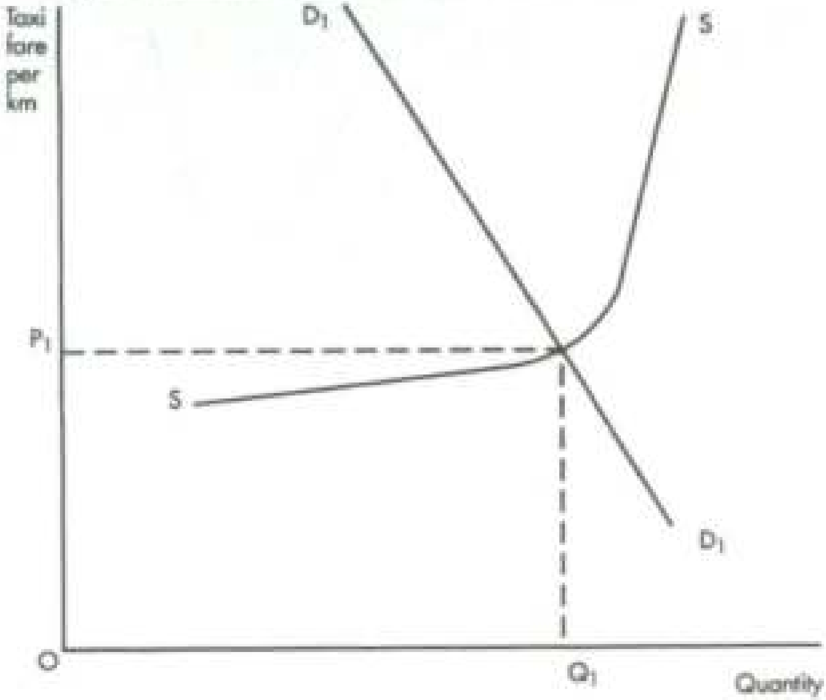
Figure 1 **Market characteristics**

	Perfect competition	Monopoly	Monopolistic competition	Oligopoly
Maximise profits	Yes	Yes	Yes	Yes
Number of producers	Many	One	Many	Few
Easy entry	Yes	No	Yes	No
Identical products	Yes	Yes	No	Yes/No

The easiest of the models to analyse are pure competition and monopoly. In both cases there is a homogeneous product. While there are many individual producers in perfect competition, each with a very small share of the market, in a monopoly situation, there is obviously only one producer. However, it is sometimes overlooked that these market specifications alone do not enable us to infer what the equilibrium price will be, even if the cost conditions and industry demand are known. The entry conditions to the industry must also be taken into account.

Take the case of the taxi-cab market, for example. There are many cabs

Figure 1: **Market for taxi services**

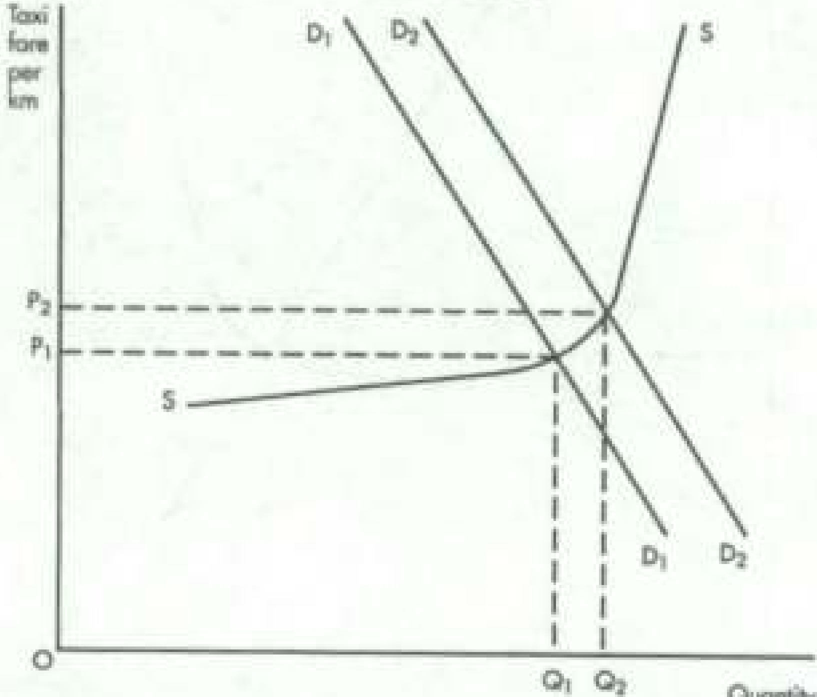


on the road in a major capital city and so each has a very tiny share of the market. The industry is not purely competitive however, because the issue of new taxi plates has generally been tightly controlled by the regulatory authority, making entry difficult. Nevertheless, a taxi plate can be purchased (at the going market price) from an existing holder who is prepared to relinquish it.

Figure 1 depicts this type of taxi market. For simplicity, I have ignored the usual flag-fall component in the fare and assumed that there is a flat charge per kilometre. You will notice that once a certain output has been reached (after OQ_1) a rise in taxi fares has very little effect in inducing a greater supply of taxi services. This reflects the limitation on the number of taxi plates on issue. The taxi-fare which clears the market and ensures that demand is met is shown as OP_1.

Figure 2 shows what happens if there is an increased demand for taxi services, due perhaps to the growth of population or higher rail fares. There is a rightward shift in the demand curve from D_1 to D_2.

Figure 2: **Market for taxi services**

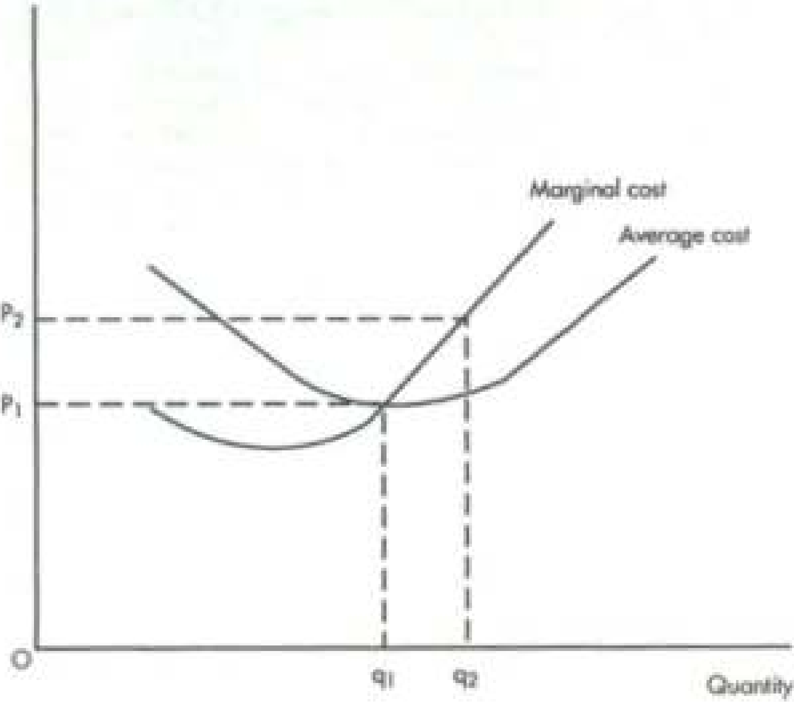


Consequently the market clearing taxi-fare will have to rise to OP_2 to meet the increased demand. (If the fare is kept down by regulation, then some customers will not be able to obtain a cab or they will have to wait longer).

Figure 3 looks at the same situation from the perspective of a single taxi-cab licence holder. Before the increase in demand, taxi-fares were at OP_1 and this meant that he/she was just able to cover average unit costs, including a normal profit.

Following the increase in fares to OP_2 the taxi is able to squeeze in some additional trips, but only from Oq_1 to Oq_2. Significantly, the fare per kilometre is now well above the average cost incurred and the licence-holder is earning more than normal profits. The end result will be that the market price for taxi plates will increase to reflect these additional profits. The market price will rise to a level where any newcomer wanting to buy a plate would only be able to earn a normal rate of return on his capital outlay (which is approximately what he could earn if he entered any other activity of equivalent risk).

Figure 3: **Individual taxi owner**



In the case of monopoly, the entry conditions to the industry are also decisive in determining whether the firm can charge the full short-run profit-maximising price. Consider for example the theory of 'contestable' markets which first came into prominence some 15 years ago. The theory suggested that in some markets previously thought to be natural monopolies (i.e. only one producer could be commercially viable), the incumbent firm would be obliged to keep its prices low to avoid the risk that a potential entrant would supplant it in the market or make a hit-and-run entry which would cause it significant temporary losses.

In the light of subsequent research it turns out that there are probably fewer 'contestable' markets than was first thought. The key is the extent to which the potential entrant would incur 'sunk costs' if it entered the market. Such costs cannot be recovered if the entrant is obliged to withdraw from the market after an unsuccessful foray. They include advertising and promotional costs, which are usually not recoverable. Also likely to be lost is part of the cost of items of specific equipment which may have to be resold at a price well below the original purchase price. The greater the magnitude of such 'sunk costs' the more secure is the incumbent monopoly against competition from a prospective entrant. Hence the closer will be the monopolist's price to the full short-run profit-maximising price.

The presence of a dominant buyer may also limit the exercise of monopoly power in the market. For example, one would expect that the price bargain struck between a monopolist and a monopsonist would be less than the monopolist's profit-maximising price, though it is difficult to infer on theoretical grounds precisely what price will be arrived at.

The most difficult of the market models to analyse in a satisfactory manner is oligopoly. The hallmark of this market is not just fewness in the number of producers, but rather their mutual recognition of their interdependence — the actions of any one producer affect the actions of the others. To analyse this type of market, assumptions have to be made about how each producer expects others to behave (e.g. that firm A will hold output or price at the present level if the other producer elects to vary his output or price). The variety of possible assumptions that can be made is large and theoretical models of oligopoly tend to be complex and rather removed from reality.

In general, it seems much better for the student to be made aware of real-life oligopoly markets and how the conduct of firms may vary over time with changes in demand, technology, entry conditions, and the strengthening of the market power of buyers. For example, you will probably have noticed the recent spate of price-cutting in industries such as fibre-board containers, petrol retailing, ready mixed concrete and now airlines. What characteristics of these markets give rise to such price-cutting? Why don't we see such price cutting among dentists, life insurance companies or even real estate agents?

For many markets, not just oligopolies, it is useful to ask students to enumerate the key features of the market in terms of structure and conduct. They will first need to be clear about what the market is, whether it is local or national, and what range of products/services is involved. Then the following features should be explored as they are likely to have a dominant influence on the industry's pricing, profitability and innovativeness:

- the number and size of producers
- the extent of economies of scale and scope
- the entry conditions
- import competition (if any)
- the number, size and knowledgeability of buyers
- the nature of government regulations affecting the industry
- the extent of recent changes in technology

Some brief comments on two industries will help to indicate that there is usually a rich vein of empirical material to be tapped and analysed.

In the tyre manufacturing industry there are significant economies of large scale production and hence only a very few Australian producers will be commercially viable. Although transport costs are significant, Australian manufacturers are liable to face competition in the domestic market from larger plants located overseas. Local manufacturers are constrained in their pricing not only by import competition but by the fact that a few local motor vehicle manufacturers are the only buyers of tyres sold as original equipment.

In the past, the level of protection has been a major factor affecting the profitability and performance of the local tyre industry. First, tariffs restricted imports of tyres. Secondly, the high protection of the motor vehicle manufacturing industry served to maintain a domestic market for tyres as original equipment. Thirdly, the local content plan for motor vehicles tended to ensure that the motor vehicle manufacturers sourced most of their tyres from domestic suppliers. Recent reductions in tariff protection, as well as those foreshadowed over the next few years, are now putting pressure on the local tyre manufacturers to lower their costs through improved productivity and the introduction of new technology.

Now consider the market for the services of solicitors. A preliminary question is whether the market for their services is local or national. The answer is not entirely straightforward. In some services, such as conveyancing, which represent a major part of the profession's aggregate income, the market is generally local or regional. However, there are many national firms of solicitors providing a range of legal and taxation advice to major national Australian companies.

Professional and educational requirements tend to limit the rate of entry into the profession. Government regulations also affect the profession by influencing the demand for their services. For example, the demand for conveyancing services by solicitors depends on whether other practitioners besides solicitors are permitted to carry out conveyancing work. In South Australia conveyancing is open to a broader group of practitioners but in New South Wales it is the domain of solicitors alone.

Relative to other providers of professional services, the average gross income of solicitors appears quite high. This may partly reflect higher expenses. However, it probably reflects two other factors as well — first a normal rate of return on the above-average investment in initial education and training and secondly an 'economic rent' arising from the restricted entry to the profession and the influence of certain restrictive practices which tend to limit the extent of competition.

Government Policies

I should now like to turn to some aspects of government microeconomic policy in Australia. I shall focus on three areas:

Industry assistance

Competition policy

Deregulation and microeconomic reform

Industry Assistance

There are many different forms of industry assistance in Australia including tariffs and quotas; sectoral plans for industries such as motor vehicle manufacturing and textiles, clothing and footwear; subsidies to individual companies (notably Kodak); export market development grants; tax incentives for research and development and offset requirements which oblige overseas contractors to government bodies to source some of their supplies from Australian producers.

The latest calculations by the Industry Commission show that the tariff remains the most important form of assistance to industry. This is despite the fact that the average rate of tariff protection has been declining in recent years and will continue to fall throughout the present decade as further tariff reductions already scheduled come into effect.

A principal concern about high tariffs is that they are likely to cause a wasteful misallocation of resources between industries. If there were no tariffs, Australian industries which had high costs by world standards would employ few resources because consumers would buy cheaper imports instead. Thus more resources would tend to be attracted to those Australian industries able to achieve low costs and compete internationally. However the tariff distorts that picture. Generally, the highest tariff levels have been provided to relatively high-cost Australian industries. As a result more resources tended to flow to the very industries which were the least competitive and used those resources least productively.

The more uniform the rate of tariff protection for different industries the less is the resulting misallocation of resources within the protected sector. Yet a few Australian industries continue to receive rates of assistance which are markedly above average. For example, in 1989-90 the average effective rate of assistance for the Australian manufacturing sector as a whole was 16 per cent. Yet the rate for the motor vehicle and parts industry was 65 per cent and that for clothing and footwear industries exceeded 180 per cent.

[Note: the effective rate of assistance is the amount of assistance provided to the industry as a percentage of the total value added by the industry's activity].

A further problem with the tariff and indeed most forms of assistance to particular industries, is that it tends to encourage 'rent-seeking'. In other words, resources are used wastefully to lobby governments to maintain or increase the protection for an industry although that lobbying activity will not result in any more goods or services being produced for the nation.

Moreover, evidence accumulated over the years shows that, when firms or industries are insulated from competition by the tariff or other forms of protection, the incentive to reduce costs and improve productivity is likely to be diminished.

Although most of the arguments are overwhelmingly in favour of reducing tariffs further in Australia, a case can be made for temporary protection in very limited circumstances. The best-known example is the infant-industry argument. This suggests that an industry which would eventually become internationally competitive could have relatively high costs in its initial stages and thus would never be started unless there was some short-term protection against imports. The argument may look persuasive but there are a number of questions that still have to be addressed. For example,

- what happens if the industry does not become internationally competitive after several years of tariff protection?
- is the tariff the best means of encouraging the infant industry to develop?

There is now widespread support among business, trade unions and politicians for a continuation of gradual reductions of tariff assistance to industry. In his statement of March 12 1991 on 'Building a Competitive Australia' the Prime Minister announced further tariff cuts. The nominal tariff on passenger motor vehicles is to be phased down to 15 per cent by the year 2000 and the maximum tariff for textiles, clothing and footwear will fall to 25 per cent by the same year. Meanwhile, the general level of agricultural assistance will decline in line with the tariff reductions in manufacturing. By the end of the decade the average effective rate of assistance will have fallen to 5 per cent.

While tariffs are clearly falling, there is quite strong support for alternative 'positive' measures of industry assistance designed to improve the international competitiveness of Australian industry. Among the positive measures already in place are:

- grants for export market developments;
- 150 per cent tax deduction for research and development expenditure by companies (after 1993-94 the deduction will be 125 per cent)

The rationale for these measures is rather different from the rationale for tariffs. It is likely that, if left to the free market, firms would spend too little on training, research and development and export promotion (compared with the social optimum). Why? Because firm A's expenditure on training, R&D or export promotion often benefits other firms as well but A does not usually receive any recompense for those external benefits gained by the others.

Take a simple example. An Australian firm seeking to develop an export market may have to spend considerable funds in developing local channels of distribution and publicising its products. As a result Australian exporters arriving later are likely to find it easier to establish distribution links and have their products accepted. Yet the later arrivals do not have to pay for these benefits, and this may discourage the initial firm from outlaying more than a minimum expenditure on export promotion.

This type of argument can provide a sound justification for government assistance to training, research and development and export market development. However, the design of an appropriate policy measure requires considerable care. For example, the present 150 per cent tax deduction for R&D expenditure is available to companies in respect of the whole of their R&D expense, not just the increase in R&D expenditure since the concession was introduced. Hence, a large part of the tax benefits flows to firms in respect of R&D they would have undertaken in any case.

Secondly, to what extent will a reduction in the cost of R&D because of the tax concession induce an individual firm to increase its outlays on that form of activity? This will depend on the importance of R&D costs in the overall cost of innovation. If a firm has to employ many other complementary resources (e.g. marketing personnel, production engineers etc) to introduce a new product, a small proportionate reduction in its R&D cost may have little effect on the size of its innovation program.

Finally, some of the benefits of R&D undertaken in Australia may flow to multinational companies which are able to transfer those benefits elsewhere. This can mean that a subsidy to R&D financed by the Australian tax-payer is benefiting overseas residents rather than Australian residents alone.

Competition Policy

As a preliminary to a brief discussion of competition policy in Australia, I thought it would be helpful to examine some new data on industry concentration which was released last year. Many people believe that big business is strengthening its power in Australia, partly through mergers. In many of our industries there are now only two or three major firms. There is clearly an element of truth in this, but it should not be inferred that there has necessarily been a serious diminution in competition.

Conventionally, seller concentration in an industry has been measured as the percentage of the industry's turnover contributed by the (four) largest firms in the industry. It was possible to judge from this type of calculation whether concentration in an industry was increasing over time. In a recent study, the Bureau of Industry Economics (BIE) has shown to what extent highly concentrated industries have increased their share of total value added in the manufacturing sector. In their definition, highly concentrated industries are those where the four largest enterprise groups account for 70 per cent or more of industry turnover. Such highly concentrated industries accounted in 1972-73 for just over one-quarter of manufacturing value added. By 1986-87 this proportion had risen to just over one-third. There has been a corresponding fall in the share of manufacturing output coming from industries with low concentration (below 40 per cent).

While these figures tend to support the view that Australian industry is becoming more concentrated, they fail to take account of the growing importance of import competition. Import penetration in the manufacturing sector has been increasing quite strongly in recent years.

Fortunately, the BIE has also been able to show how manufacturing concentration, changed between 1972-73 and 1986-87 after adjustments have been made for imports and exports of manufactures in each industry. The adjusted results show that highly concentrated industries have increased their share of manufacturing value-added to only a very small extent, although the share coming from low concentration industries has still decreased substantially.

However, it should be noted that in Canada and the United Kingdom, concentration in manufacturing industry appears to have been declining in recent years, partly under the influence of import competition. Thus, the Australian experience appears to be out of line with that in some other industrialised countries. This may reflect not only the smaller size of our economy, but also a less stringent approach to competition policy.

In Australia, the cornerstone of competition policy is the Trade Practices Act 1974 (as amended). The Act prohibits:

- price agreements between competitors.
- resale price maintenance, in which individual suppliers seek to force distributors to charge fixed prices for their products.
- misuse of market power, where a firm uses its market power in order to damage a competitor or prevent a firm entering the market.
- price discrimination which is likely to substantially lessen competition.
- some exclusive dealing arrangements.

Thus most forms of anti-competitive conduct are brought within the scope of the law and court action is taken if it appears that firms have breached the law.

There is nothing in the trade practices legislation directly aimed at modifying the structure of the industry — in particular, there is no parallel to the United States legislation which would permit the authorities to seek the break-up of a very large corporation (such as Standard Oil). However, the Australian legislation does address the issue of mergers and acquisitions. It is illegal for a dominant firm to acquire another corporation if this would increase its dominance in the market. Moreover, a corporation may not acquire a competitor if this is likely to result in it achieving a dominant position in a market.

It is sometimes claimed that this aspect of competition law is liable to conflict with the broader objectives of industry policy. For example, an acquisition which would lead to a monopoly in an Australian manufacturing industry may be necessary to achieve the benefits of economies of scale and a greater degree of international competitiveness. Yet, the acquisition could be stopped by the merger provisions of the Trade Practices Act, because it would lead to the dominance of the Australian market by a single firm.

What this argument overlooks is that there is a mechanism in the Trade Practices Act which can resolve this dilemma. A firm can obtain authorisation for a proposed acquisition if it can show that the likely public benefits of the merger outweigh any apparent anti-competitive detriments. In fact, in the last two weeks, the Trade Practices Commission has authorised the acquisition by ACI of the Smorgon's glass container plant at Penrith, which will lead to a virtual monopoly in the manufacture of glass containers in Australia. The reasons for the decision included the saving in capital cost, the smaller loss of employment, and the better continuity of supply to small customers that would result from permitting the merger. Most importantly, ACI was prepared to give some formal undertakings that the prices charged to many of its domestic customers would not rise by more than the increases in the average cost for a basket of relevant cost items.

Deregulation and Microeconomic Reform

Recent moves by the Australian government to deregulate some government business enterprises stem from a belief that greater competition can promote lower costs for certain services and facilitate the more rapid introduction of new technology. Such a reduction in costs would assist Australian industry generally, as users of these services, to become more internationally competitive.

The areas in which deregulation and microeconomic reform are already beginning to take place include:

- telecommunications
- domestic airlines
- rural marketing authorities
- the waterfront

In the past, the existing firms or organisations in these industries have had entrenched market power, generally backed by Commonwealth legislation. Even when this legislation is amended, the incumbent firms often retain substantial market power, sufficient perhaps to deter many prospective entrants. The problem then is how to encourage competition while providing fair and equitable treatment for incumbent firms, and at the same time ensuring that community service obligations are met.

The issues can be illustrated by reference to the domestic airline industry. This is generally regarded as a contestable market in which potential entrants can exercise a considerable influence on fare levels. The reason that it can be attractive to entrants is that the market is growing, and sunk costs are not very large. In particular, terminal space and aircraft can be leased and personnel hired on short-term contracts so that sunk costs are limited to such things as advertising and promotional outlays (which will not be recovered if the new venture is unsuccessful).

One new airline, Compass, has entered the industry since deregulation became effective on 1 November last year. Another, Transcontinental, has been mooted as a potential entrant. One problem that was recognised even prior to deregulation is that the two major existing airlines, Ansett and Australian, have 20 year leases on the terminal buildings at most airports and no new terminal buildings are contemplated for some time. This brings into question the long term effectiveness of any new entry. The current arrangements are that the leases require Australian and Ansett to negotiate on reasonable terms with new entrants (called third party carriers in the lease) for gates at the main trunk route airports. However, the leases do not require Australian or Ansett to disadvantage themselves in order to accommodate a new entrant, nor does the lease set out in any detail what facilities are to be provided at what standard. These matters are the subject of negotiation between the parties.

A second problem, which has been most evident at Sydney airport, is peak-hour congestion. There are a limited number of slots available for landing and departure of aircraft at peak hours. How should these slots be shared between the existing airlines and the newcomers? Would a system of auctioning slots enable the financially stronger airlines (probably the incumbents) to outbid the other airlines and blunt their competitive strength? What would be the effect of reserving some of the slots for a limited auction confined to new airlines alone?

If Australia is to achieve real benefits from the moves towards microeconomic reform the balance must be shifted towards more effective competition in some previously regulated industries. Much detailed work has to be done to ensure that that goal is achieved.

This is not to say that all regulation is bad. Table 2 provides a broad perspective on the scope and need for regulation in the modern economy.

Table 2

		Is competition feasible?	
		Yes	No
Is competition desirable?	Yes	*Most cases*	*Entry restricted by dominant firm*
	No	*Excessive entry*	*Natural monopoly*

In the great bulk of industries competition is both feasible and desirable. However, there are a small number of industries which are true natural monopolies (e.g. electricity transmission). In such cases competition is neither feasible nor desirable. Public ownership or government regulation will be needed to ensure that a natural monopoly does not exploit its market power.

The top right-hand corner of Table 2 refers to those industries where a dominant firm has the market power to restrict entry. This could occur even after an industry has been deregulated (e.g. telecommunications). In that case competition policy and trade practices legislation will be needed to ensure that the prospective entrant firms are given a fair chance to compete.

Finally, there is the rather rare case where competition is not desirable because it tends to be excessive, such that private firms are discouraged from producing the good or service because it is not profitable to do so. This case is sometimes known as 'cream-skimming'. It arises for example when a firm is willing to sell product/service A to a group of consumers only if it can cross-subsidise this activity through the profits obtained from selling another product, B. However, its profits from producing B are quickly eliminated in practice because other competitors enter the market to skim off the cream. Hence if product A is to be produced at all, some form of restriction on competition may be needed in the market for B.

Conclusion

This paper has traversed a wide field very briefly. I hope it has been useful in pointing out the range of interesting and exciting issues which can be discussed in the Industry Economics option.

The success of government policies on structural change, deregulation and microeconomic reform will have a crucial bearing on the future standard of living in this country. Some of you may have come across a recent book by William Baumol, Sue Blackman and Edward Wolff entitled *Productivity and American Leadership: The Long View.* It makes some bold projections of the growth of productivity (GDP per work hour) in 16 advanced countries from 1979 to the year 2020. On their projections Australia ranks near the bottom of the list at 14th position — ahead of only Canada and the United States. Clearly this rather pessimistic projection is not immutable. It is important for us to recognise that the design of appropriate microeconomic policies can make a positive contribution to our future productivity growth. This is a message not only for ourselves but for our students who will represent the next generation of economic policy makers.

Further Reading

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MICROECONOMIC REFORM

HON GEORGE SOURIS MP

MINISTER FOR SPORT, RECREATION & RACING AND MINISTER ASSISTING THE PREMIER ON MICROECONOMIC REFORM

George Souris was educated at the University of New England and is a fully qualified public accountant, company auditor and taxation consultant. He was elected Member for Upper Hunter in the New South Wales Parliament in March 1988 and served on various Ministerial Committees before being appointed in June 1991 as Minister for Sport, Recreation and Racing and Minister assisting the Premier with Privatisation and Economic Reform. He is also the Vice Chairman of the NSW Public Accounts Committee. George is a former Shire Councillor of Singleton Shire Council and served as its Deputy President for 4 years. He has represented Australian Colts, Australian Universities and NSW Country in rugby.

MICROECONOMIC REFORM

GEORGE SOURIS

What is it?

- It covers reform of ports, railways, revised prudential supervision of non-bank financial institutions, removing duplication and conflict from regulation between the Commonwealth and States and among the States.

  The Special Premiers' Conference process has generated a broadly based commitment to a wide ranging structural reform of the Australian economy.

  It is this reform process that has come to be known as microeconomic reform.
- This speech focuses on the reform of the public sector in NSW only, specifically corporatisation.

  I stress this is only one aspect of microeconomic reform.
- Reform in N.S.W. goes back beyond the recent Premiers' Conference agreements to the previous Labor administration.
- The first significant step was the establishment of a task force on classification of government organisations.

  Government authorities and departments are classified into six categories ('A'-'F') depending on the degree of market competition and financial dependence on the budget.

  The categories range from 'A' — no financial independence, no market competition (e.g. The Cabinet Office); through to category 'F' — total financial independence, fully competitive (e.g. GIO).

  The degree of control exercised by central agencies (especially Treasury) depends on the category of departments/authorities.
- The NSW government advanced the micro-reform process a step further with the development of a corporatisation policy for government trading enterprises (GTEs).

What are GTEs?

- Government organisations producing goods or services which are, or could be sold or tendered in the market place.

  It is the market orientation (or potential) which sets GTEs apart from the 'inner budget sector' (e.g. Premier's Department).

What is Corporatisation?

Corporatisation involves:

- Establishing an operating environment for GTEs which replicates the internal and external conditions that successful private enterprises face.

Aim of Corporatisation — Why Corporatise?

- Unlike other States corporatisation is not budget driven in N.S.W.
- The aim of corporatisation is to produce an 'incentive environment', or 'framework of incentives' which increases productive and allocative efficiency.

  Productive Efficiency – minimising the cost of a given level of output. This ensures GTEs do not pay for waste.

  Allocative Efficiency – obtaining a mix of goods and services that maximises society's welfare.

  The aim is to ensure that consumers do not subsidise GTEs to waste resources. If resources are wasted by GTEs, then the costs of products elsewhere in the economy are higher.
- Corporatisation is not privatisation.
- Corporatisation is not commercialisation.
- Corporatisation is not 'incorporation'.
- Corporatisation is the systematic implementation of the analytical framework set out in the Report of the Steering Committee on GTEs.

  The report 'A Policy Framework for Improving the Performance of GTEs' is based on a property rights theory of organisation and the NZ experience with corporatisation.
- The report contained five conditions to be satisfied to encourage efficient resource use.

  These conditions are known as the *Five Principles of Corporation*.

  The principles are:

  1. Clear Objectives;
  2. Managerial Autonomy;
  3. Performance Evaluation;
  4. Rewards and Sanctions; and
  5. Competitive Neutrality.

  The first four principles are designed to secure **productive** efficiency.

  The fifth principle is designed to achieve **allocative** efficiency.

Clarity of Objectives

- It involves distinguishing commercial, social and regulatory objectives.

  Currently GTEs often have elements of all three types of objective.

  This makes overall clarity of objective impossible.
- GTE activities are principally commercial.

  Thus the objective of corporatised GTEs is to be as efficient as any comparable business (State Owned Corporations Act 1989, Section 8), i.e. the aim is to maximise the market value of the State's investment in the assets managed.

  This purely commercial focus provides GTE managers with a clear, non-contradictory objective.
- Social objectives, or Community Service Obligations — CSOs, can be pursued separately or by contracting with the GTE.

  Because government pays separately for CSOs, the community can see what subsidies are provided — and make better informed decisions.
- Regulatory functions must be separated from commercial operations, e.g. water boards should not set standards for or police their own effluent discharge.

  Regulation should be performed by an independent body (e.g. Environment Protection Agency (EPA)).

Managerial Authority

- Involves giving boards of directors and management complete responsibility and authority for achieving commercial objectives (and delivering on CSO contracts, if any).

  Cannot effectively impose the right incentive on GTEs.

  External controls tend to stifle managerial creativity and innovation.
- Importantly, they diffuse responsibility between managers and controllers.

  Result — often no-one is held accountable.

  Under corporatisation the government can focus on monitoring how well GTEs perform commercially.
- Boundaries of responsibility are clarified by clear commercial agreements between shareholders (Ministers) and GTEs.

Performance Monitoring

- This involves improving the accountability of GTEs by subjecting them to rigourous external monitoring.
- Need to understand that there is a difference between external monitoring and control.

- Monitoring is necessary because GTEs do not face the same scrutiny as public companies:
  - not subject to takeover (because government owns 100 per cent);
  - not subject to threat of bankruptcy;
  - not subject to scrutiny by debt markets (because all funds borrowed by Treasury Corp).

  All these issues need to be covered by the monitoring system.

Rewards and Sanctions

- Involves introducing a market based system of rewards and sanctions for GTE directors and managers.

  Rewards paid and sanctions enforced in relation to performance of individual GTEs.

  Performance is monitored against agreed targets.
- Need to clearly establish that sanctions as well as rewards (most often higher pay) are real — no more job for life. If you don't perform you are out.

Competitive Neutrality

- Involves creating a 'level playing field' *viz a viz* the private sector.
- That is, remove the special advantages and disadvantages applying to GTEs because of their government ownership.

  As noted earlier, this is essential for allocative efficiency.
- Advantages to be removed include:
  - exemption from tax (to be paid to State Treasury);
  - government guarantee on debt (GTEs to be assessed by a ratings agency and a fee paid to Treasury Corporation in addition to the interest charged to raise cost of debt to the same as if the GTE was not guaranteed);
  - tied customers.
- Disadvantages currently facing GTEs as a result of government ownership include:
  - some GTEs face tied suppliers;
  - external control of executive salaries;
  - provision of subsidised services without adequate compensation.

Market Reforms

- Corporatisation clearly involves not just structural reforms of GTEs but also reform of the markets in which they operate.

  For example, reform of the Electricity Commission will involve extensive restructuring of the electricity industry:

- establishment of competing generators;
- establishment of a 'spot' market for electricity.

Creation of Grain Corp involved the deregulation of the grain handling industry in NSW.

Reform of the egg industry involved deregulation resulting in substantially cheaper eggs for consumers.

Establishment of EPA will radically reform the market in which water boards operate by separating responsibility for supply from obligation to monitor and ensure quality standards observed.

Outcomes from Corporatisation

- Corporatisation is designed to achieve better delivery of services.
- Corporatisation improves accountability:
- Managers clearly accountable to boards (who appoint them), not Ministers, for performance;
- Boards in turn clearly accountable to shareholding Ministers (who formally appoint them instead of Governor). Boards no longer 'advisory' in nature or practice but clearly responsible; and
- Minister remains accountable to Parliament.
- Financial information supplied by GTEs becomes more relevant.
- Information provided in advance on targets through a Statement of Commercial Intent so Parliament knows what the GTE is aiming to achieve. Parliament can then assess if performance matches aims.

  Replaces old system where often inadequate information is provided long after failures occur, allowing Parliament only an opportunity to review the undesired outcome.
- Allows more effective social expenditure. Contracting for the provision of CSOs with efficient GTEs allows either:
- the same level of social service to be provided for a lower cost: or
- more social services to be provided for the same cost to the budget.
- Also allows the community to make better informed decisions about the subsidies provided via CSOs.

Conclusion

Peter McInlay says in 'Corporatisation: the Solution for State Owned Enterprises' (Institute of Policy Studies, 1987):

> 'The issues involved are not simply ones of whether organisations are better owned by government or by private individuals or firms. At the heart of the reform issue is how to remove the conflicts of interest and confusion of objectives which have been inherent in the operation of many public sector organisations, both trading and non-trading.'

This is what the corporatisation process in NSW is all about.

PART THREE

CONTEMPORARY ISSUES IN ECONOMIC EDUCATION

ENVIRONMENTAL ECONOMICS

CHRIS BURNUP

ASSISTANT DIRECTOR
BUSINESS COUNCIL OF AUSTRALIA

Chris Burnup is currently working as Assistant Director of the Business Council of Australia, dealing primarily with issues related to the environment; and the role of government. Her responsibilities in the environmental area include advising major corporations, preparation of policy matters such as sustainable development and contaminated sites, as well as liaison with government and conservation bodies. Chris has held various senior positions in the Victorian State Public Service and published papers covering a range of topics including women's participation in education and training, and the links between education and industry.

ENVIRONMENTAL ECONOMICS

CHRIS BURNUP

I am here representing the Business Council of Australia. The Council membership comprises the Chief Executive Officers of major Australian corporations. Naturally, our interest in the environmental debate reflects a concern for the way in which business is conducted.

I have been asked to talk about environmental economics and I intend to do some of that. However I also intend to talk briefly about the nature of the environmental debate itself.

I also want to draw your attention to an important conceptual framework which is being used in Australia (far more than in other countries) i.e. **sustainable development**.

I will also spend some time discussing the question of **energy** because I feel that this is the nexus between industry policy and environmental concerns.

I will talk briefly about the competing policy approaches (and competing ideologies) which surface when the relevance of **market** *versus* **command and control mechanisms** is debated.

Finally, I want to turn to the impact that the current debate is having upon **business decision making**.

Nature of the Debate

The current description for this subject area in the NSW syllabus states:

> students are encouraged to investigate current environmental issues. Emphasis, however, is on the private and social costs and benefits associated with resource management rather than on the emotional and political overtones often highlighted by the media.

This is a legitimate description to contain a particular subject area. However, it is worthwhile restating that the environmental debate is:

A debate which is about conflicting values and

- highly politicised;
- filled with emotion;
- subject to manipulation by a host of pressure groups;
- a debate plagued by ignorance of the the most basic scientific facts.

Students studying the subject of environmental economics enter classrooms with strong and sometimes clear opinions on the subject.

All the available research suggests that the environment is regarded by the public as an issue second only in importance to the economy. There is no indication that this concern is lessening in the recession.

Václav Smil recently published an excellent article in *the Independent*

Monthly entitled 'A Guide for Green Skeptics'. In it he raised some provoking questions, including the salient fact that the key indicator of environmental quality — average life expectancy — has risen all over the world with the exception of black Africa. He contrasts these gains with the warnings of imminent catastrophe from the more extreme commentators.

Václav also poses a series of questions which test our understanding of basic environmental facts. I am going to borrow three of those questions and put them to you now so that you can think about them during my talk.

1. What is the total number of living species on the Earth?
2. What is the typical productivity of tropical rain forests?
3. How much carbon dioxide is there in the atmosphere?

(There will be a test at the end of my session.)

Any approach which fails to recognise the complex nature of the debate will achieve very little.

There is an added dimension in Australia. In many countries the primary debate is around pollution issues; how to manage effluent, how to deal with urban sprawl etc. In this country we are fortunate to have vast areas of wilderness remaining. The emotive and philosophical concerns of wilderness preservation are sometimes translated into the everyday management concerns of the urban environment.

Having recognised the complex nature of the area, it then becomes important to create some sort of meaningful framework for study. In a philosophical sense the environment is everything, but it is important to impose some limits so that a useful focus can be achieved.

Sustainable Development — A Possible Framework

Sustainable development occurs where economic and ecological sustainability overlap as illustrated below.

Australia has adopted the concept of sustainable development far more readily than other countries. This is in part because of the federal government's initiative in establishing a major consultative process — involving nine Prime Ministerial Working Groups. The Business Council has representatives on five of the working parties and is involved in co-ordinating the industry input into the process.

The concept of sustainable development, first popularised by the Brundtland Commission in the mid 1980s provides a useful conceptual approach to many of the challenges of environmental economics. The core definition of sustainable development is:

> Economic development which meets the needs of the present without compromising the ability of future generations to meet their own needs.

The main principles of sustainable development (termed Ecologically

Sustainable Development in Australia after long debate) are agreed upon by most of the parties:

- integrating economic and environmental goals in policies and activities;
- ensuring that environmental assets are appropriately valued;
- providing for equity within and between generations;
- dealing cautiously with risk and irreversibility;
- recognising the global dimension.

However, the real argument comes with the way in which these core principles are translated into real practice. For example the way in which natural capital is treated differs markedly depending upon the values held. The Business Council's approach to achieving sustainable development depends on the encouragement of market based solutions.

The major players in the Australian debate have agreed that development and the environment are compatible. It is only those on the fringes of the debate who are prepared to espouse an anti-growth approach.

Energy — A Key Link Between the Environment and the Economy

Another way of focusing on the question of environmental economics is through the use of energy. This is certainly the way in which the sharp end of the public policy process is focused — through the Industry Inquiry etc.

Australia is currently participating in the negotiations on climate change leading up to the major UN Conference in Brazil in mid 1992 which may frame an international convention to reduce greenhouse gas emissions.

At present, Australia is committed to interim planning targets which aim to reduce greenhouse gas emissions by 2005 to 80 per cent of the levels in 1988. In order to achieve such a target, Australia will have to consume much less energy.

The Business Council published a study in May, entitled 'Energy Prospects 2005', which attempts to assess the feasibility of achieving those planning targets without adverse economic impact. The results suggest that we will be able to go about halfway.

In the course of undertaking the study, we became aware that two factors were poorly understood:

- First, Australia is a resource-based economy, with the minerals sector currently accounting for more than 40 per cent of merchandise export revenue, $4 billion of (annual) capital investment, 10 per cent of Gross Domestic Product, and direct employment of about 74 000 persons. A recent report prepared for the Business Council of Australia, drawing on the work of Michael E Porter, identified Australia as being amongst the most efficient suppliers in the world in the resource area.

One could argue, therefore, that Australia's comparative economic advantage lies in this sector and energy use is likely to increase as a consequence. Australia is also a net energy exporter. This is in sharp contrast to most OECD countries and many of those countries which are Australia's competitors in the areas of trade and investment.

- Second, Australia has a relatively high rate of population growth which is a major contributor to the rate of growth of carbon dioxide emission. Australia's annual rate of population growth over recent years is 1.5 per cent compared with 0.3 per cent in Western Europe.

  The expected high rate of population growth and consequent increase in energy consumption in Australia will make the task of achieving the desired reduction in greenhouse gas emissions substantially more difficult than will be the case in most other industrialised nations with much lower predicted population increases.

The Tasman Institute has recently published a study entitled 'Greenhouse Gas Abatement' which estimates the cost of implementing the Toronto targets. The study estimates that the lost domestic production by the year 2020 would amount to $75 billion, an amount which would climb year by year ($75 billion is equivalent to 20 per cent of the present level of GDP). Lost exports would be additional to this.

Other studies undertaken in 1991 for the federal government imply a net benefit of over $7 billion if the targets are implemented. How is such a discrepancy possible? This enormous range of results seems to be very pertinent in reference to a question set in the 1990 NSW HSC examination:

The question asked in part: 'What are the main problems in applying cost-benefit analysis to environmental problems?'

The winter edition of *Solutions*, a newsletter published by the Renewable Energy Council of Victoria attempted to deal with the wide discrepancy by pointing to benefits which can be overlooked including:

- reduced oil imports;
- opportunities for the development of new industries based on energy efficient and renewable energy technologies;
- increased employment opportunities;
- reduced energy costs to consumers; and
- avoidance of further investment in fossil fuel power stations.

The article raises problems with the projection of past trends and recommends the approach of focusing on the end use of energy.

In citing these various studies and the contention which surrounds them, I do not have any definitive answers for you on whether Australia can (or should even attempt to) meet the Toronto targets in regard to reduced energy use. The issue has been raised because it provides a tightly focused debate where establishing a reasonable set of numbers will be absolutely crucial for all areas of the Australian economy.

It also demonstrates very clearly that we are dealing with a rapidly emerging policy area. The best references are studies which have been done very recently and which are not yet included in textbooks.

I have spent time explaining this because it seems to me that a subject like environmental economics requires grounding in an accurate understanding of the Australian situation and in particular, the unique nature of the Australian economy to be meaningful.

Market Forces versus Command and Control

This area is most often the focus of the environmental economics taught in schools. The Business Council takes the view that governments should set the framework for efficient markets, through a minimum of regulation.

There is a deal of evidence to suggest that many of our current environmental problems arose from misguided command and control policies. The glaring problems of Eastern Europe are often cited to demonstrate the failures of such an approach. Nearer to home the inefficiencies (and environmental excesses) of public utilities can be compared to the conduct of private business to draw similar conclusions.

The discussion about market versus command approaches is not theoretical.

For example, in the current round of negotiations on climate change, there is a great deal of discussion about how best to achieve reductions in greenhouse gas emissions. The United States is advocating a system of tradable emission rights whilst others favour mandated targets.

The best summary that I have come across recently, describing the market mechanism in this debate, has been published by Jeff Bennett in *The Economics Education Review* in the January/February 1991 edition. Jeff describes the key issues:

- market failure, where private property rights are unenforceable for one reason or another;
- government failure;
- private property rights – how markets can be created in unusual areas;
- the provision of public goods;
- management of common property;
- the international dimension (of great concern for Australia);
- market environmentalism.

The only addition that I would make to Jeff's summary is to place more stress on two important questions which the ecologists have put before us: firstly, biodiversity and the importance of the gene pool, and secondly, the ability of the environment to assimilate the waste products generated by development. There is a legitimate concern that this assimilative capacity is of more concern than scarcity of raw materials.

Because of the policy significance of 'market environmentalism', more is being published. The bulk of this material is in the form of consultants' reports, and responses to various government consultative enquiries.

It is important to emphasise the linkage between theoretical approaches to market environmentalism and real life problem solving.

In 1988 a major American study was conducted under the direction of Robert Stavins, J F Kennedy School of Government at Harvard entitled 'Project 88'. The study does not propose a free market. Instead it focused on finding better mechanisms to achieve appropriate environmental standards.

It examines specific examples of market mechanisms in areas as diverse as air quality, solid and hazardous waste management and wetlands conservation. The mechanisms are as simple as 'the elimination of subsidies for environmentally destructive timber sales or as intricate as a system of auctioned tradable pollution permits to control acid rain'.

Emissions trading has been in place in the United States since 1974. The programs have not been widely used but are estimated to have resulted in more than $4 billion in savings in control costs, with no adverse effects on air quality.

In the rush to develop appropriate policy instruments, there have been cases where inappropriate methodology has been applied.

One notorious example of this has been the use of **contingent valuation**, particularly in the Resource Assessment Commission's inquiry into mining in the Conservation Zone. On that occasion, the study produced a result which can be interpreted to indicate that the community would be prepared to value land within the zone at 100 times that of prime Melbourne CBD land. Quite rightly, the Commission eventually decided to disregard these results.

Business Decision Making

There is a greatly increased environmental awareness in business and industry. To some extent this is generated because employers and employees are part of the community and affected by the same concern that others share. More directly, it is because environmental considerations are impacting on the viability of all types of business. This occurs in a variety of ways:

- In the context of **resource use** e.g. fishing, forestry timbers.
- In terms of **environmental protection** in regard to both processes and products.
- The **risk assessment** associated with any business undertaking e.g. contaminated sites. (This issue has the potential to change the value of all occupied land).
- The **decision making processes** at local, state and federal levels.

At present there is a great deal of uncertainty in the business community and this is affecting investment.

- An *Access Economics* study indicates that conflict between environmental policy and economic growth in this country has cast doubt over the future of 26 business projects worth $16 billion.
- These projects could generate $3 billion a year in export income.
- Included in these figures are the cancelled $1 billion Wesley Vale project and the BHP Gold Coronation Hill joint venture; 12 paper mill projects worth over $6 billion and 12 resource projects — including three uranium developments — costed at almost $5 billion.
- Other projects delayed or complicated by environmental questions include the $350 million Cape York spaceport and the $4.5 billion Very Fast Train project.

There are confused jurisdictions and competing standards. In particular, there seems to be little understanding of the importance of **timeliness** in regard to business decision making. The Business Council co-sponsored a study with the Bureau of Industry Economics entitled 'Environmental Assessment — Impact on Major Projects', which demonstrated that the most significant problem for industry were the delays associated with the approvals process.

Rather than attempt to provide you with a list of relevant papers, I would simply point out to you that the various industry associations are invaluable sources of information on these topics. For example, in the *Business Council Bulletin*, which is published monthly we have run a series of articles dealing with a range of environmental controversies.

Conclusion

At the beginning of my talk I asked you three questions. You will recall:

1. What is the total number of living species on the Earth?
2. What is the typical productivity of tropical rain forests?
3. How much carbon dioxide is in the atmosphere?

I am not going to ask for volunteers; the answers are:

1. We do not know: about 1.4 million species (slightly more than half of them insects, 250, 000 plants and about 41, 000 vertebrates) have been described in biological literature, but a total of around five million is much more likely, with the highest estimates going well over 10 million. The fact that we do not know the total invalidates all of the recent estimates of the rate of the global species loss.
2. In terms of net primary (a measure preferred by ecologists, expressing the total of new leafy and woody mass created by photosynthesis), mostly around 20 tonnes of dry biomass per hectare a year (range of 10-35 t/ha), roughly twice the productivity of temperate forests or

grasslands. But most of this newly synthesised rainforest biomass is rapidly eaten and decomposed by microbes, invertebrates and higher animals and the net ecosystemic productivity (actual gain in the biomass in a year) is negligible — even nothing at all).

3. Annual mean measured in remote, clean locations (Hawaii, South Pole) is now just over 350 parts per million, or 0.035 per cent of the atmosphere by volume, roughly 10 per cent higher than 30 years ago, and 50 per cent above the pre-industrial era mean (for comparison, atmosphere contains 78 per cent of nitrogen and 31 per cent of oxygen).

Those of you who were right can feel very worthy. Those of you who were wrong can feel reassured that you are in the majority.

The point of raising such basic questions is to demonstrate the difficulty of creating a rational policy framework when the answers to such questions are certainly not widely known.

I hope that I have provided you with some insights into the reality of environmental economics, its importance to some key decisions, both in business and industry and also to governments.

I also hope that you may find the various concepts useful. In particular I think that the notion of sustainable development is a very useful umbrella concept which should encourage serious discussion.

Finally I hope that you might make use of some of the sources which I have mentioned because there is some very exciting work going on at present.

COMPARATIVE ECONOMICS

AXING SOCIALISM — WHY AND HOW THE EAST EUROPEANS HAVE BEGUN THE TASK OF THE 1990S

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AXING SOCIALISM

WHY AND HOW THE EAST EUROPEANS HAVE BEGUN THE TASK OF THE 1990S

WOLFGANG KASPER

'Грабь награбленное' 'Loot the looters!'

Lenin, 1917

When, in 50 years' time, our students look back to their formative years in the late 1980s/early 1990s, the changes in the formerly communist countries of Eastern Europe and Asia will stand out as the crucial historic event. No less than a counter-revolution is unfolding there — the demise of four to seven decades of revolutionary socialism (Table 1).

It would be a failure of teaching not to cover and analyse the changes in the ex-command economies (XCEs[1]).

Before we can embark on discussing

- why socialism came unstuck (Part II),
- what strategy to replace the failed system is to be adopted (Part III), and
- how the tactics of implementation are working out (Part IV),

we need a thumb-nail sketch of the modern theory of economic growth and development to provide us with a logical reference system.

What Matters for Economic Growth?

A generation ago, economists focused their attention on capital accumulation as the central driving force of economic growth. They advocated high, often forced, savings, and the transfer of capital from rich to poor countries. Access to natural resources was also seen as a precondition for growth. These views appealed to national economic planners and social engineers who hoped to create economic growth from the top down by collectivist/statist means, mobilising capital and natural resources (development planning). But we have since learnt that nations can have unimpressive growth in living standards despite very high rates of capital formation and bountiful natural resources. The USSR and the East European economies have demonstrated that the mere piling up of capital goods and the unchecked mining of resources are sure-fire ways to continuing underdevelopment!

The analysis of the unprecedented economic growth in the West has demonstrated that production factors other than labour and capital (so-called 'third factors') now account for half to three quarters of measured economic growth.

GDP = f (**K**[apital]; **L**[abour]; **SK**[ills]; **TEC**[hnology]; **NR** [nat. resources]; Δ**STR**[uctural change]; **E**[ntrepreneurship]).
$\longleftarrow$ 'Third factors' $\longrightarrow$

This so-called 'third factor growth' derives from:

- innovation of products and processes which draws on advances of technical and management knowledge,
- the learning of new skills,
- structural adjustments by producers to exploit new production opportunities and to respond to new market demands, and
- entrepreneurs who act like catalysts in uncovering and mobilising resources and combining them into wanted production.

The focus in the economics of growth has thus shifted from the 'hardware' aspect of growth to knowledge and enterprising people with skills — the 'software of development'. This is not to say that economic development does not require physical capital and natural resources, but the quality of people and entrepreneurship have gained centre-stage in modern development theory (Kuznets, 1980; Rostow, 1978; Abramovitz, 1980; Harberger, 1984).

This has raised a further question in economics: what political, social and economic system is most conducive for people to develop and apply useful knowledge, skills and enterprise? The know-how needed for enhancing productivity growth in a modern economy is so complex and changes so dynamically that only the search and experimentation by freely

Figure 1 **Economic systems of eastern Europe** as of late 1991

competing, self-motivated individuals can yield sufficient results. What matters is not only the allocation of given, known resources to satisfy given wants (static efficiency), but the dynamic discovery of new resources and the evolution of new wants (dynamic efficiency). This is so complex a task that only the 'dollar votes' signalled through markets can tell us which of the many new ideas that are being developed by producers all the time, are wanted by the buyers sufficiently, to cover the costs and offer a profit. In short: only **market competition** can help us discover and process the information needed to support our high living standards and to support the world's large, growing population. No-one, or no central body could ever hope to know and evaluate all the relevant technical and commercial knowledge used in a modern industrial society (Hayek, 1945; 1968; Kirzner, 1984; Friedman, 1980: 27-47).

People will not compete in markets if they cannot appropriate the hoped-for gains. This requires the incentive of **secure property rights** (property law protected by independent law courts; transparent, predictable taxes; security from 'expropriation by inflation').

Experience has shown that only three incentives induce people to produce for each other:

- love and friendship (solidarity);
- a material gain and self-interest; and
- coercion.

The social system with which we (I hope) have grown up is based on the first motive, namely the *microcosm* of family and friends. However, solidarity cannot be extended to cover all those with whom we interact in the *macrocosm* of a large, complex modern economy, simply because we cannot know and love all those with whom we interact economically. The complex, modern division of labour amongst thousands of people does — most regrettably! — not work on love and friendship alone[2]. It requires *either* coercion (i.e. *gulags*) *or* what Hayek called the 'extended order' of private property and markets (Hayek, 1973-9; 1988). If one abolishes the coercive methods of central, Soviet-style planning, one has to replace them with capitalism based on private property. There is — most regrettably! — no 'third way' for large, modern societies[3,4].

We have also learnt that market processes do not function well in a vacuum: they require reliable institutions, such as the rule of law, adherence to a code of ethical conduct, the enforcement of liability for one's actions, and provision of non-inflationary, stable money which permits consumers and producers to read the price signals correctly. Appropriate framework conditions (often referred to as the **socio-economic order**) keep the transaction costs of economic enterprise low and ensure that those who make an effort to enhance the material lot of their fellow men have a good chance of keeping the rewards.[5] We have learnt that the arbitrary rule of men, market interventions, cumbersome regulations and the politicisation and bureaucratisation of economic life tend to undermine productive enterprise. In such conditions, people's energies are channelled into rent-seeking, i.e. obtaining unearned incomes at the expense of others. This is a zero — or even negative-sum game (Buchanan-Tollison-Tullock, 1980; Baumol, 1990) — whether it is played to the benefit of Party *apparatchiks* in Moscow, military hierarchies in Third World countries, or Canberra bureaucrats and the Industrial Relations Club in Melbourne. Rent-seeking is, over the long term, invariably at the expense of economic growth[4].

History has shown that the openness of the economic system is crucial to directing enterprising people away from their natural tendency to seek rents and towards productive wealth creation: when national economies are open to competition in product and factor markets, the rulers cannot create rents, because those against whom they discriminate take their assets elsewhere, voting with their feet. Rather, governments have to compete by creating economic institutions that facilitate high rates of return. Openness was at the very basis of European industrialisation, because the rivalry of the trading states promoted the rule of law and business-friendly customs and institutions (North-Thomas, 1973; Jones, 1981; North, 1991). Openness has also been the foundation for the success of the new industrial countries of Asia (Kasper, 1990). With rapid globalisation thanks to the increasing international mobility of know-how, skilled people, capital and firms, the forces of an open world economy are now increasingly limiting the scope for political interventions almost everywhere (Ohmae, 1990).

Seen in this light, the break-up of the former Soviet Union in the wake of the coup in September 1991 is a boon. Gorbachev's presumption that the communist system could be revised and a cohesive empire could be kept together is now irrelevant. Instead, there will be much independent experimenting in smaller, more open political units. Some experiments in how to axe socialism will fail, others will be successful in raising living standards and promoting liberty. The successes will be imitated. The break-up of the Soviet empire will allow diversity and genuine discovery about how to undo socialsim.

Last but not least, a political order of electoral democracy with a division of powers between legislature, executive and judiciary is normally a prerequisite for the maintenance of a competitive market order. What matters for economic dynamism is the guarantee of civil liberties, so that a pluralist society — including the pluralist rivalry of independent competitors — can unfold (Friedman, 1962). Totalitarian governments are, sooner or later, bound to restrict individual civil and economic liberties, even if they favour markets to promote economic achievement. This was for example borne out by the developments in China after 1985, and especially after Tiananmen Square, and by Gorbachev's difficulties with a reformist course in late 1990/early 1991 (Appendix A).

Why Did Socialism Come Unstuck?

The lesson about the importance of the 'software aspects' of growth and the importance of the extended order to growth and innovation was re-learnt in the West (and in East Asia) a generation ago. The lesson that know-how matters centrally to modern growth was half-recognised in the communist countries in the 1970s, when their economic growth ran into limitations[7]. They tried to get access to more productive technology by borrowing and importing advanced technology from the West. But the leaders of China and the Soviet bloc did not accept that the productive use of technology also requires competitive, profit-motivated management and *free 'citizens of property'* who compete in *free* markets, as well as government support for individual freedom, self-reliance and a productivity-oriented set of rules. The massive technology imports therefore went largely to waste from East Berlin to Shanghai.

It was only the continued progress of Western industry during the 1980s in areas like electronics and software — based on such phenomena as numerous young Americans experimenting and competing in software development and micro computers, or the US government developing 'Star Wars' technology — and the unrelenting progress of the capitalist economies in the OECD and East Asia that forced the leaders of the civilian and the military *apparat* in the Soviet Union to realise the need for an open exchange of information (*glasnost*) and for decentralised structural change (*perestroika*) (Gilder, 1989). This led to some reforms, in particular the removal of coercive central planning. But, once coercion was dropped, production contracted, because the vacuum was not filled with the efficiency- and cooperation-maintaining voluntary alternative of market capitalism. Central planning provided the Soviet economy only with an insect brain compared to the nervous system of the modern market economy, but Gorbachev's first reform performed a complete lobotomy! Little wonder that the Soviet economy, which had stagnated in the early 1980s, is now collapsing (International Monetary Fund, 1991). In any event the institutions, the laws and the moral and legal rules are not present for markets to function spontaneously. Indeed, the Gorbachev reforms (driven by the wish to emulate the progress and success of the capitalist system) began to overtake their initiator and took him on an uncharted course for which few thinkers in East or West were prepared. (For a chronology of the key historic events in the Socialist revolution and its undoing so far, see Appendix A).

The collapse of central planning *further* lowered the backward living standards in the socialist countries. Measures of material living standards

Table 1

Population and income of ex-command economies

Country	Population (mill., 1988)	Per-capita income (in US-$, 1988) own est. rounded	Per-capita income (in US-$, 1988) official data	Sources
Ex-GDR	**16.4**	**6,800**	10,246	1989,3,†
Poland	**37.9**	**1,500**	1,160-1,860	1, 2
Czechoslovakia	**15.6**	**2,460**	2,461	1
Hungary	**10.6**	**1,900**	1,880-2,460	1, 2
Romania	**23.0**	**n.a.**	n.a.	2
Bulgaria	**9.0**	**n.a.**	n.a.	2
Sum of above	112.5			
Yugoslavia	**23.6**	**2520**	2,520	2
USSR	**283.7**	**800-1,700***	ca. 3,500	††
China	1088.4	330	330	2
For comparison				
Eur Community	324.3	12,518	12,518	2
West Germany	61.3	18,480	18,480	2
Spain	39.0	7,740	7,740	2
Portugal	10.0	1, 650	3,650	2
Greece	10.0	4,800	4,800	2
Malaysia	16.9	1,940	1,940	2
Thailand	54. 5	1, 000	1, 000	2
Australia	16.5	12,340	12,340	2

* *Estimates of per-capita incomes for the USSR vary greatly. In any case, they are not very meaningful since consumers get a much smaller share of average GNP than in the West. The consumer income is on average probably around US$ 800, comparable to Papua New Guinea*

† *Probably overestimated by 1/3*

†† *Probably overestimated by 45-60%*

Sources:

1 *International Monetary Fund, International Financial Statistics, March 1991.*

2 *IBRD, World Development Report 1990 (New York: Oxford University Press).*

3 *German Institute for Economic Research, Berlin.*

in the socialist countries have long been grossly exaggerated.

> (The widely quoted income data from UN and CIA sources) were false … income per-capita in Hungary and Yugoslavia … in 1988 reached half the level of Greece … Poland's income per-capita … only matches half the level of Portugal…. It is not true that living conditions in the rich former socialist countries … were on a par with less advanced nations of Western Europe. Moreover, environmental damages were ignored, medical facilities were inappropriate, housing was poor and social security insufficient (Siebert, 1991:5).

Although there are few hard statistics available, all recent estimates show that East German per-capita incomes were probably only half those in West Germany (as against previous data indicating a gap of only 10 per cent, Table 1). Latest estimates indicate that the USSR has an average living standard in the lower-middle income category (average national output roughly in the neighbourhood of Mexico and Peru, but consumer living standards roughly as low as in Papua New Guinea); income levels are very uneven between city and country and various regions.

Whilst it had long been accepted that 'socialist construction' requires sacrifices (in the shape of long queues and poor-quality consumer goods), the increasingly visible shortfalls in the innovative potential for capital goods and military hardware were the real reasons why direct coercion through central planning was abandoned by the Communist elites. However, the vehemence of the spontaneous opposition to the old system, which was no longer ruthlessly defended from about 1987-8, had much to do with other failures of socialism:

- Despite the propaganda, the supply to the average citizen of education and health services was extremely poor. Average schooling is far shorter than in the West or the advancing East Asian countries, and scholastic achievements of the average pupil (as distinct from the 'display students') are low. Schools are extremely poorly equipped, and teachers in all socialist systems are poorly paid.
- The 'hardware bias' of growth, which stressed quantities of production and not quality, and the absence of rationing by price led to an enormous waste of natural resources and a destruction of the environment which no open democratic society would ever have tolerated.
- The lack of material incentives created what one Soviet writer called the 'Three Riders of the Socialist Apocalypse: Indifference, Secrecy and Incompetence'. This destroyed the quality of life of all but the top Party elite. But progress in communications technology enabled glimpses of life in the market economies (through videos, satellite TV, fax, and photocopying), and their own situation was increasingly perceived as intolerable. Long before observers in the West stopped to

compare socialist utopian *theory* with capitalist *reality*, the citizens of Eastern Europe avidly compared socialist reality with capitalist reality; and they found the result deeply depressing.

- The system led to pervasive duplicity and incredible moral decay. Party careerists could live a life 'more equal than the proletariat' (as Russian President Yeltsin remarked when he joked that 'Communism has already been achieved in the USSR — for the top 200 functionaries!'). The rhetoric of worker liberation and the constant claiming of the moral high ground by the Socialists could no longer cover up for the ruthless, ideologically disguised rent-seeking by an unelected *priviligentsia*.

The pervasive involvement of the State in the details of the citizen's life prevented any form of civil society from developing. Civil society is defined as 'the separation of private life and the economy from state direction . . . [as] a prerequisite . . . of genuine political freedoms and economic prosperity . . . Under civil society, the dispersion of economic power means that political and legal power cannot be monopolised, and that checks and safeguards against the abuse of power are able to operate . . . [ultimately, this will ensure] the heightened civility of relations between the people' (D. Lovell in Kukathas *et al.* , 1991:6-7).

More than under the material failings of socialism, the people suffered therefore under the pervasive repression of their freedom and the destruction of morality and trust. This is why 'civil society' is now so high on the list of priorities, namely the cultivation of free associations, families, churches, voluntary assistance schemes, friendships, business networks, free trade unions, and the many other social relationships which individuals organise below the level of the state. These failures of socialism had a lot to do with the fact that the people would not work for love alone. They had to be coerced by Stalinist show trials, forced-labour camps and other means of direct coercion. The freedom of speech and information, the freedom of travel and economic choice, and the freedom to elect governments, which we consider essential for the pursuit of happiness, had to be denied to maintain the command economy. Even the ownership of desktop computers, photocopiers and fax machines had to be restricted to protect the 'dictatorship of the proletariat'; and all associations that make up a civil society had to be kept under state surveillance.

These failures of socialism explain the vehemence of the push for the current counter-revolution, once matters began to move.

What is the Best Strategy to Replace the Failed System?

As we saw, modern growth is based primarily on human knowledge. Its efficient use requires complex pre-conditions (a) at the macro level of social, legal and economic order, (b) at the micro level of markets and

Table 2: **Reform agenda in the XCEs**

Strategic Task	Tactics of Implementation
Macro-Framework	
• legal order	• constitution —— civil code —— independent judiciary
— civil rights	
— economic rights (esp. property and freedom to contract)	• protection of private property (property law)
	• company and contract law — commercial court system
• economic order	
— stable money	• two-tier banking system; independent central bank
— fiscal order; hard budget constraint	• control of public-sector deficits — control of deficits of public companies — tax reform
Micro Level: Market Competition	
	• privatisation (> rules for privatisation >> privatisation authority)
	• de-control of all factor and product markets
• Autonomy of the firm	• trade practices supervision; international competition freedom to start businesses (minimum regulation; real estate supplies elastic)
• monopoly control	
— free entry and exit	• trade liberalisation; currency convertibility
• open international trade and finance	
• non-economic regulations	• minimum safety and health legislation >> policing these laws
Management Level	
• expertise	• management training
— technical	• exposure to competition; end of soft budget constraint (no bail-outs)
— commercial/accounting	
• taxation	
• state administration (various levels)	• firm, transparent tax rules; broad-based taxes with low rates on business

competition, and (c) at the micro-micro level of management (Figure 2). The transformation of the XCEs requires changes at these three levels. We shall first discuss the elements of a strategy of reform at these three levels, and then briefly mention a few critical tactical problems of implementation.

Macro framework. Since the basic legal framework has been destroyed under socialism and since the East Europeans do not want to incur the time and cost of the gradual evolution of case law, the governments in the XCEs have decided to impose a citizen-friendly legal order by a written constitution and written law codes. This effort is based on constitutions which ensure basic social and economic freedoms, in particular the guarantee of private property and the freedom of contract. The legal changes will require not only the declaration of a new constitution (which Hungary has already done), but also the adoption of a civil code, property, company and contract laws, and the creation of an independent judiciary. The quickest solution to meet this requirement was German unification: the legal framework (and the know-how and institutions of the *Rechtsstaat*) was put in place overnight. Respect for the law and legal practice however, cannot be introduced so easily, since legal restraints have been totally discredited and few people understand the importance of the law. For new law to become accepted, it will have to be simple, transparent, consistent and citizen-friendly.

The second part of a minimal macro framework that efficient markets require relates to a stable economic order: the XCEs need stable money and a transparent, equitable tax and expenditure system. To date, the East European economies have a unitary banking system which provides no competition in financial markets and no effective control over the money supply. Indeed, public deficits tend to be automatically financed by the printing press, which in some countries is not under any one authority (e.g. Yugoslavia and the USSR). The problem of monetary discipline is complicated where people have accumulated huge unspent money balances (as was the case in Poland), where the tax collection system breaks down (as in the USSR and Yugoslavia), or where uncontrolled state firms are running up increasing deficits which are covered automatically from the state budget because social upheavals are feared (this is virtually the case in all XCEs, (Kornai 1990)).

Monetary discipline can therefore only be achieved:

- if a two-tier system with an independent central bank is created;
- if state firms are confronted with a 'hard budget constraint', the credible prospect of going broke; and
- if taxes and public expenditures are rationally designed and administered under an elected parliament that is respected by the citizens.

Apart from eastern Germany where these conditions were 'imported' and where generous public transfers are on offer, Poland has faced up to the requirement of stable money most consistently: after run-away inflation was allowed to wipe out monetary balances (as well as high nominal pensions of former Party functionaries), fairly strict monetary discipline has been applied and the inflation rate has been brought down. The floating *zloty* exchange rate of the convertible currency was stabilised and tied to the US-$ (Lipton-Sachs, 1990). Nevertheless most XCEs suffer from accelerating inflation. Private traffic increasingly uses stable foreign currencies as a unit of account and means of payment (e.g., Slovenians have *de facto* become enthusiastic members of the D-mark bloc).

The single most stupid act to destroy trust in money (the very basis for a productive division of labour which the reforms are to achieve) was the arbitrary confiscation of money balances in the USSR, where big rouble bills were declared illegal in late 1990. While this reduced the monetary overhang, which the *apparat* had been creating, it greatly undermined material incentives to improve the economy by gain-motivated effort and saving.

Market competition. Market competition requires firms to be autonomous of central directives. Firms have to be eager to make a profit from competing with product and process innovation, advertising and after-sales services. The first requirement can be met – and be met quickly – by 'corporatising' production units in agriculture, industry and services, and by confronting all the managers with a 'hard budget constraint' (no more subsidies). This second requirement can probably only be met by privatisation. But privatisation poses a number of problems in the XCEs:

- Intending buyers cannot evaluate the worth of a company as long as there are no market prices for inputs and outputs. The participation of foreign bidders in sell-offs can offer some information. But this raises the spectre of Western, especially German domination in societies whose public psyche is still deeply mired in the nationalism of the 1920s and 1930s, having missed out on the exhilarating experiences with internationalisation in the West since 1945.
- In those countries, where money savings are small, citizens will not have the money to buy even small businesses or shares in bigger companies. This problem can be circumvented, as is done in Czechoslovakia, by endowing all citizens with vouchers which they can use to bid for state property (Klaus, 1990).
- Political elites and workers in industries that are being privatised exert political pressures against privatisation. This requires that privatisation authorities be independent of government and charged only with the task of selling the assets (not also with management tasks, as is the case with the German *Treuhand*). They must also be given clear deadlines and the right to liquidate unsellable production units.

- One impediment to genuine privatisation arises from formal or informal property rights claimed by the workers: in Poland and Yugoslavia, for example, worker councils hire the management and act as an entrenched interest group against market pressures to cut costs. Worker-managed firms tend to under-invest and overexpand labour costs.
- Where privatisation is turned into a complicated bureaucratic process, it is slow, or it is bypassed by 'informal privatisation' (farmers simply grabbing plots of land or apartment dwellers acquiring property rights in their dwellings). Where such activities are fairly evenly spread (e.g. Hungary), they may be an acceptable manifestation of the counter-revolution.
- Privatisation should not be the only way to start private businesses. Favourable conditions have to be created for the start-up of new businesses, including foreign participation. This requires the de-control of real-estate, capital and other factor markets.

Most centrally planned economies were typified by large autonomous monopolies. Thus, two thirds of Soviet industrial products are supplied by only one or two firms. In such circumstances, privatisation would create monopoly capitalism, in other words it would do little for public welfare and sustained growth. The task can be solved by breaking up large 'combines', if possible, and in any event by opening up the market to international competition. The Hungarians and Poles, with their high priority for early trade liberalisation and free currency convertibility, are on the right track. They utilise world market forces to break ingrained rent-seeking and stimulate innovation and competition-supporting institutional change.

Other countries, especially the USSR, act more on the lines of an inward-looking policy and economic nationalism. The chances for getting proper reforms off the ground are correspondingly diminished.

Management. Last, but not least, economic reform requires massive changes at the management level, both in the psychology of producers and in the skills of management. The present administrators of industries have grown up thinking in quantity and engineering terms and in administering scarcity. Now they have to think in terms of costs and profits, and in terms of market opportunities. They have to learn that the command no longer comes from 'central', but from the sovereign consumer. It will take some time to adjust to new reward structures and to find out what qualities and skills make you a winner. In the process, industrial administrators may lose guaranteed privileges. Not surprisingly, members of the old *nomenklatura* are often inclined to sabotage change.

The implementation of the market mechanism will take time because learning at the management level will take time. But fortunately much of the expertise will be learnt by competing and doing. Necessity will – once the basic conditions at the macro- and the micro-levels are put in place – be the mother of learning. The incentive to copy practical know-how from the West will be as great as it was in East Asia in the 1960s; cultural and geographic proximity to the advanced societies of Western Europe will greatly facilitate learning. This is where openness and in particular the openness to international movements of capital, technical knowledge and skilled labour, as well as to entire firms, will be crucial and where nationalist xenophobia will be costly.

How to Implement Change?

It is now accepted throughout Eastern Europe and the USSR that socialism was a costly detour on the road from capitalism to capitalism! But the big strategy and the final goals are not yet clearly understood, and the tactics of transition seem often confounded. The essential conditions for market capitalism, as set out in Part I, are not yet widely accepted. Trials and errors will be numerous and many decentralised experiments will provide valuable learning experiences on how to conduct the counter-revolution. Another problem is that a large part of the public in the XCEs seems not, as yet, convinced that they have to incur the full pain of adjustment to market competition. Long isolated and cared-for by a dominant, paternalistic state, people are slow to embrace self-reliant enterprising attitudes and accept the risks of self-reliance and self-provision that the collapse of socialism foists upon them.

A number of tactical issues of transforming the economic system are presently being discussed:

- Should one reform as fast and as heroically as the Poles or the East Germans (see Case Study, Appendix C) have done, or more cautiously as the Czechs and Slovaks are doing? The arguments in favour of intense, but short adjustment pain, coupled with consistent, correct signals from now on seem strong. Slow microeconomic reforms can easily be hijacked by rent-seeking pressure groups; contradictory signals from various interdependent reforms are less likely to arise.
- What is the right sequence of reform?

  (a) The central issue — political or economic reform? — has been clearly decided in the advanced East European countries, where there are no doubts in favour of priority to energetic political reform, but accompanied by economic reforms. However, as one moves further east and especially into the USSR, the answers are less clear to date. In China during the 1980s it became clear that inconsistencies between political control and economic reform make the reform course unstable[8]. A reform strategy, to be effective, requires the mutual support of political moves towards more civil rights and economic reform to material self-sufficiency of the individual and the firm. After all, the two aspects of reform are not separable.

(b) Another important issue in sequencing is whether to institute a new, market-supporting legal/economic order before privatisation and before competitive conditions are introduced. This seems to be the approach in the Czechoslovak Federal Republic (CSFR). Or should competitive conditions be created before the legal, economic order is formed and before the bulk of industries are privatised, as seems the approach in Poland and Hungary? There are probably as many sequencing theories as economists who write about them. The best solution probably is to signal the intended end state, as Ludwig Erhard's *ordo* liberalism did in West Germany, and to move pragmatically and fast wherever reforms can be driven forward.

- Should the reforms be imposed from above or be driven from below? Can the state be trusted to reduce Statism? Libertarians are inclined to let things sort themselves out from below. But where such massive structural changes are involved, gradual competitive evolution is too slow and costly. The undoing of the dominant socialist state has to be accelerated and streamlined by government action. This is the justification for a privatisation authority rather than market forces, for the creation of stable government money, and for a written constitution and written civil and commercial codes rather than evolving case law.
- How much of a safety net to provide during the change? Many observers initially argued in favour of big income supports. But the poor, collapsing economies of the East cannot afford comprehensive safety nets and they lack the resources to administer them. Moreover, generous welfare provisions would weaken market signals. But some sort of minimum income support will have to be implemented by the fragile new democracies. The reverse side of this coin will be that a whole generation — those who are now going into retirement — will suffer from poverty. The faster the reforms generate overall growth, the more likely it is that a basic welfare net for that 'lost generation' can be afforded.

Conclusion

The tasks are daunting; and there will be accidents. It is, however, not correct to say that the East Europeans are the first people to face the task of undoing a command economy: The Chinese farmers undid the Communes very quickly in the late 1970s/early 1980s and achieved enormous productivity increases almost spontaneously. When I visited China at the time, the atmosphere was optimistic, almost exhilarated. And the West Germans responded enthusiastically after the initial shock of the Erhard reforms of 1948-50 (monetary reform and comprehensive, fast liberalisation in 1948-49). They surged from the stagnant national-socialist command economy into a veritable 'economic miracle' in a few years and quickly forgot the public protests against Erhard's forced market medicine and the scepticism of foreign economists and journalists.

First indications are that the East Europeans will act no differently, although some countries may slide from socialist into nationalist collectivism and atavistic tribalism. However, most East Europeans seem to find the prospect of undoing socialism worth whatever the cost and the risk. They see it as the only chance of regaining the cherished freedoms of a civil society. The example of the successful Western market economies is, despite all its shortcomings, exerting a most powerful invitation to imitate. The 'third way' — combining market competition with socialised ownership or pervasive controls as in the 'Swedish model' or the 'Yugoslav model' — are now widely rejected as unworkable. The reformist zeal in some ex-command economies may even lead them to surpass the degree of free market capitalism practiced in the West!

The international competition of economic systems will be one of the more exciting spectacles to watch in the 1990s.

Footnotes

[1] Observers are hard-pressed to find a common denominator to describe the diverse, changing components of the Soviet empire. Geographic definitions like 'Central and Eastern Europe' do not offer the right coverage. Neither do political-constitutional descriptors (like 'ex-Communist' or 'newly democratic') apply to all countries where the economic system is changing:

- Poland	- the former GDR	- Czechoslovakia
- Hungary	- Yugoslavia	- Romania
- Bulgaria	- Albania	- the diverse components of the former USSR.

The only aspect all these areas have in common is that coercive central planning has been abandoned.

[2] This is not to belittle the essential role of love and loyalty in civil society. As a matter of fact, if we solve most productive cooperation tasks efficiently by markets, we will have more resources at our disposal to dedicate to those we care for and with whom we want to share because we know them (Giersch,1989:4-5). See also the 1991 Papal Encyclical which endorses the principle of market capitalism as the way most conducive to civility and human self-realisation (Joannes Paulus II, 1991: 39-42, 48-74).

[3] Some observers have realised the necessity of market capitalism for modern mass society. But they reject capitalism and advocate the return to idyllic village life (e.g. some Greens, or Solzhenytsin who appears to yearn for the idyll of Russian village harmony (*mir*)). Before one gets too attracted by this vision, one should study the history or Third-World villages: the arbitrary repression of freedom, the grime, the ignorance, the disease, the constant threat of starvation and the short life expectancy of traditional village life do not automatically recommend themselves (for a readable description of pre-capitalist village life, see Braudel, 1973: vol. I, 104-304). Moreover, the world population would have to be much smaller if we were to abandon market capitalism (Hayek, 1988).

[4] In the 1930s and 1940, the Polish economist Oscar Lange contended that state ownership of capital could be married with making use of markets to solve the allocation problem. Ludwig von Mises showed that state property destroyed the incentives for efficient production. Although the 'academic Lange -Mises debate' was clearly won by von Mises, Yugoslavia and Hungary experimented with 'market socialism', as did China in the 1970s and early 1980s. These experiments have been failures because the incentives do not promote cost-cutting and investment, only high wages.

[5] The quest for the appropriate economic framework within which market processes can work efficiently and with the most desirable social results has not played a big role in the Anglo-Saxon countries where these conditions have been given, by and large. But they played a key role in German liberal thinking, especially in the 1940s when a market order had to be re-created from the ruins of totalitarian, collective dirigism. The 'Freiburg school' (the 'ordo liberals') made the distinction between the economic **framework** conditions and economic **processes** and concluded that the state must shape the framework, but stay aloof of market processes. This school of thought which has in recent decades gained some adherence in the Anglo-Saxon countries (institutional economics, public choice theory), is playing an important role in Eastern Europe where the basic framework conditions for market processes have to be recreated from scratch.

[6] An excellent, highly readable summary of the preconditions for a functioning market economy can be found in M. Friedman (1990) which summarises Friedman's lectures and discussions in 1980 and 1988 with Chinese leaders. For a full expose of the issues: Seldon (1990). Also see: Bethell (1988) and Gordon (1988).

[7] After the middle of the 19th century, when the growth of the capitalist market economies slowed down, Karl Marx extrapolated the situation to predict a 'crisis of capitalism': compressed profit margins, industrial concentration and declining real wages. However, such crises have turned out to be temporary, as the Soviet economist N. Kondratieff and the Austrian-American economist Joseph Schumpeter have shown: new knowledge sooner or later creates new production and profit opportunities, and the capitalist system rejuvenates itself (Kasper, 1982:80-6). By the 1970s, the centrally-planned economies had reached a Marxist 'crisis of State capitalism', in that they found it hard to raise productivity and ran into declining rates of return and economic stagnation. But different from the market economies, they did not have a good mechanism for discovering useful new knowledge and motivating innovation.

[8] In the late 1970s, the Peoples Republic of China opted explicitly in favour of economic reforms whilst retaining the Communist Party's monopoly on political power. Many observers (this author included) hoped that the momentum of economic reform would, sooner or later, force political reforms. In this we were mistaken, at least for the time being. The political *apparat* swung back to more repressive methods when economic freedom and success led to demands for political and civic freedoms.

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APPENDIX A

REVOLUTION AND COUNTER-REVOLUTION

A CHRONOLOGY

Table A

Benchmarks of the socialist revolution

Date	Place	Event
1840	France	'What is Property?', by Pierre Joseph Proudhon.
1848	London	Karl Marx and Friedrich Engels publish the 'Communist Manifesto' advocating the overthrow of existing society by force.
1867	England	K. Marx publishes the first volume of 'Das Kapital'.
Mar-May 1871	France	Paris Commune: armed Leftist uprising in the wake of the lost Franco-Prussian war.
14 Mar 1883	London	Karl Marx dies.
8 Mar 1917	Russia	In response to the burdens of WWI and inflation, riots in Petrograd. Abdication of the Tsar. Formation of Provisional parliamentary government under social-democrat leadership (February Revolution).
6-7 Nov '17	Russia	After 3 failed attempts, left-socialist intellectuals — led by Lenin and financed by Germany (the Bolsheviks) — succeed with a *coup d'état* which cannot be overturned by the 3-year civil war that is to follow.
25 Nov '17	Russia	General elections for Constituent Assembly. Bolsheviks, who previously formed an autocratic government, win 24%.
18 Jan '18	Russia	Bolsheviks dissolve Constituent Assembly by force; beginning of 'Red Terror'; Leon Trotsky forms Red Army. Nationalisation of industry. Famine.
Jan '19	Germany	Spartakist/communist uprisings in the wake of WWI.
2-6 Mar '19	USSR	Third International formed by Lenin, proclaims world revolution; split with moderate Social Democracy.

Mar '21	USSR	After economic collapse of 'War Communism', Lenin declares New Economic Policy (NEP), partly reversing socialisation. Obtains Western aid.
Jul '19	Sh'ghai	Formation of Communist Party of China; alliance with Kuomintang.
1921-23	USSR	First forced labour camps are opened. Planned hyper-inflation (1918-23: price level +65 million %). Famine.
21 Jan '24	USSR	Lenin dies. Stalin wins power battle against Trotsky.
1929	USSR	Stalin wins dictatorial supremacy. Liquidation of moderate Bolsheviks. Start of central planning. Collectivisation and mass deportations of resisting peasants. Agricultural crisis. Famine in 1932-33.
Oct 34-Nov '35	China	'Long March'.
1936	USSR	New Constitution cements the leading role of the Communist Party, also of officer corps. Show trials and expurgation campaigns.
1940	Balt. St.	Red Army occupies Baltic Republics. Incorporation into USSR. Occupation of Moldavia.
1941-45	USSR	Fight with Nazi Germany. Initial heavy losses turned into offensive with Allied assistance.
Jul 44-Jun 45	Poland	Communist Liberation Committee follows Red Army into Poland and installs government. Nationalisation.
Feb '45	USSR	Yalta Conference proposes to divide Germany. Cedes Polish, Slovak and Romanian territories to USSR, and German and Hungarian territories to Poland and Romania.
Mar '45	Yug'la	Popular Front under Tito elected with 90% of vote.
15 May 1945	Germany	Red Army occupies Berlin.
Nov '45	Hungary	Land reform. Elections. Communists (17% of the vote) gradually take power under Red Army protection.
Nov '45	Bulgaria	Communists win election under Red Army protection.
Apr '46	East Ger.	Under Red Army occupation, formation of Socialist Unity Party. Land reform. Industry expropriation.
20 May '46	CSSR	Elections. Communists win 38% of the vote.

		C. Gottwald (Communist) becomes prime minister. Land reform, nationalisation.
Feb '47	East. Eur.	Bulgaria, Romania, Hungary conclude treaties with the USSR ensuring the permanent stationing of Red Army.
Mar '47	USA	Marshall Plan launched by US to assist European reconstruction. Beginning of 'Cold War', 'Iron Curtain'.
Jul '47	CSSR	Czechoslovakia, under Soviet pressure, renounces participation in Marshall Plan.
Aug '47	Hungary	Elections. Nationalisation. Show trials.
Feb - June 48	CSSR	'Prague coup'. Complete Communist takeover. Show trials.
Jun '48	Germany	Berlin blockade in response to introduction of monetary reform in Western zones of occupation. West resists.
Jul '48	Yug'la	Yugoslavia expelled from Comintern because of Tito's designs on Albania.
25 Jan '49	East Eur	Foundations of COMECON to plan East European economic cooperation.
30 May '49	Germany	GDR proclaimed in response to the formation of the Federal Republic of Germany.
21 Sep '49	China	People's Republic proclaimed by Mao Zedong. Land reform. Communist Party launches 'Common Consultative Programme' on China's future as a mixed economy.
1950-52	China	Rapid economic recovery. Mass executions (estimated at 24 million people).
5 March '53	USSR	Death of Stalin.
17 Jun '53	Germany	Popular uprising against production norms. Put down by Red Army.
25 Feb '56	USSR	Nikita Khrushchev denounces Stalin at the XXth Congress of the CP.
Jul '56	Poland	Worker uprising in Poznan. Gomulka prevents Red Army intervention. Land restituted to small farmers.
Oct '56	Hungary	Popular uprising in Hungary, put down by the Red Army.
Feb '57	China	'Hundred Flowers Campaign' leads to temporary liberalisation and renewed repression of intellectual freedoms.

23 Jun '60	**China**	Mao breaks with the USSR and returns to militant struggle. Withdrawal of Soviet aid experts.
1958	**China**	'Great Leap Forward'. Forced collectivisation (drop in agricultural productivity by 25%). Creation of 2600 Communes covering 500 million people.
13 Aug '61	**Germany**	Construction of Berlin Wall to stem exodus of people to the West.
13 Oct '64	**USSR**	Leonid Brezhnev takes power from Khrushchev.
1965/70	**China**	After the failure of the 'Great Leap Forward' and brief liberalisation, Mao starts the Cultural Revolution.
1968	**Hungary**	Janos Kadar implements market socialism, giving enterprises limited freedom from coercive central planning.
Jan-Aug '68	**CSSR**	Alexander Dubček launches 'Prague Spring' of economic and political reforms. Put down by Red Army.
Dec '70	**Poland**	Official price increases trigger worker revolt, which is repressed by Polish army. E. Gierek becomes leader.
1970s	**East Eur**	To enhance productivity, most Communist countries borrow capital and technologies from the West. Rapid rise of their foreign indebtedness.
Jan '75	**China**	National People's Congress calls for 'Four Modernisations', also by making pragmatic use of market forces.
8 Sep '76	**China**	Mao dies; 'Gang of Four' arrested.
1977	**China**	Deng Xiaoping opens China and begins reform of centrally planned command economy, allowing for limited market incentives, especially in agriculture.

Table 8

First steps in the capitalist counter-revolution

Date	Place	Event
1975	Finland	Helsinki Accord between East and West to monitor human rights policies throughout Europe.
8 Sep '76	China	Mao dies; 'Gang of Four' arrested.
'77	China	Deng Xiaoping opens China and begins reform of centrally planned command economy, allowing for limited market incentives, especially in agriculture.
'77	CSSR	Over 500 intellectuals sign Figureer 77 demanding basic human rights. Václav Havel arrested.
From '79	China	Starting with de-collectivisation in Sichuan, economy is liberalised. Dissolution of Communes leads to big productivity increases in agriculture (1977 to 87: + 65%).
Dec. '79	Afgh'an	Invasion by Soviet Red Army to support a Communist government.
Summer '80	Poland	Lech Walesa leads Gdansk strike. 'Solidarity' recognised as free trade union.
13 Dec '81	Poland	General W. Jaruselski declares emergency. Arrest of Solidarity leaders.
Nov-Dec '81	Poland	Emergency ends. Walesa freed.
4 Mar '85	USSR	Mikhail Gorbachev elected First Secretary of Communist Party.
25 Apr '86	USSR	Chernobyl.
Dec '86-Jan '87	China	After student demonstrations for democracy, a new 'Campaign against Bourgeois Liberalism' signals the assertion of renewed Party control over economy and a CP veto against democratic rights of the people.
25 Jun '87	USSR	Gorbachev announces 'glasnost' and 'perestroika' to enhance innovation and productivity. 'Law on State Enterprises' heralds the end of central planning and the eventual collapse of the Soviet economic system.
Dec '87	Geneva	Reagan and Gorbachev sign first strategic arms accord. USSR anxious to stop 'Star Wars'.
May-Sep '88	Hungary	Following the sacking of Kadar, formation of a (non-Communist) Democratic Forum.

31 Aug '88	Poland	Communist military government, at a Roundtable Forum with Solidarity, has to promise free elections.
Feb '89	Poland	Solidarity legalised.
26 Mar '89	USSR	Elections, allowing for alternative CP candidates. Although CP is only party, 15% of votes go to independents.
Apr-Jun '89	China	Student demonstrations in Tian An Men Square. Military terminate demonstrations on 4 June. Communist reformer Zhao Ziyang removed from office.
4-18 Jun '89	Poland	Elections. Solidarity wins all parliamentary seats not reserved for Communists. T. Mazowieski first non-Communist premier in Eastern Europe.
Summer '89	GDR	After Hungary dismantled Iron Curtain, mass exodus of East Germans to West. New Forum leads demonstrations.
Oct '89	GDR	Gorbachev signals that Red Army will not intervene in support of SED leadership. Honecker orders troops to intervene against street demonstrators. Local officials overturn the order.
23 Oct '89	Hungary	Communist government falls. Declaration of 4th Republic with multi-party democracy.
9 Nov '89	Germany	Berlin Wall is breached, later dismantled.
Nov-Dec '89	CSFR	'Velvet Revolution' follows mass demonstrations. Communist government falls. 29 Dec: Václav Havel President.
Dec '89	Romania	After anti-Communist demonstrations and the murder of Ceaucescu, National Salvation Front (led by Communist reformers) takes power.
Jan '90	Poland	'Big Bang' freeing of market prices, zloty convertibility. By May 1990, prices have risen to over 2000% over the average of 1988. Strict monetary control to moderate subsequent inflation.
11 Mar '90	Lith'ia	Parliament votes by a wide margin for Independence. V. Landsbergis elected President.
15 Mar '91	USSR	Gorbachev elected USSR President. End of Communist Party monopoly on power.
18 Mar '90	GDR	Communist government falls. Free elections: Christian Democrats: 48%; Communists: 14%.
25 Mar '90	Hungary	Free elections. Jouzef Antal (of the nationalist-conservative Democratic Forum) Prime Minister.

26 Mar '90	USSR	Establishment of Presidential Council, calls for 'controlled transition to social market economy'.
Apr/May '90	Yugo'la	Half-free elections. Centre wins power in Slovenia; (nationalist) Independents in Croatia; Communists in Serbia.
9 Jun '90	CSFR	Free elections. Marian Calfa (Forum) confirmed as Prime Minister.
Jun '90	Bulgaria	Elections lead to ousting of Communist old guard.
Jun '90	USSR	Russian Parliament elects Boris Yeltsin President of the Russian Supreme Soviet.
1 Jul '90	Germany	Economic union and introduction of the D-mark in the GDR.
Jul '90	USSR	Ukraine and Byelo-Russia declare their sovereignty. Most republics slow transferral of taxes to the Soviet central government.
12 Sep '90	USSR	Signature of treaty with Germany that promises gradual withdrawal of Red Army in exchange for huge transfer payments.
24 Sep '90	USSR	Gorbachev obtains powers to rule by decree and to fix prices and salaries.
1 Oct '90	Russia	Yeltsin presents 500-Day Reform Plan for fast transition to (partial) market capitalism.
3 Oct '90	Germany	Political unification by accepting eastern States into Federal Republic, followed by general elections on 3 Dec.
19 Oct '90	USSR	Supreme Soviet adopts in principle the market economy. Unsustainable external deficit as exports drop & uncontrolled unfunded imports rise. Budget deficit (10% of GDP); loss of monetary control. GDP drops 10% in 1990.
26 Nov '90	USSR	Government under direct Presidential control. Gorbachev commits himself to maintain cohesive Soviet Union.
3 Dec '90	Poland	Walesa elected president of Poland. Implementation of more capitalist-inclined government policies.
Late '90	USSR	Gorbachev rejects fast transition to markets, siding with Communist conservatives. Shevardnadze resigns, warning of a hard-line take-over.
13 Jan '91	Lith'la	Soviet military units kill 14 civilians, in Vilnius, the capital of Lithuania that strives for independence.

16 Jan '91	**USSR**	Gorbachev calls for suspension of press freedoms.
Jan '91	**CSFR**	Beginning of comprehensive privatisation programme, after a voucher system has been adopted.
19 Feb '91	**USSR**	Yeltsin calls for the resignation of Gorbachev; offical price increases for staples and partial increases in wages.
6 Mar '91	**Serbia**	Massive street demonstrations against the nationalist-Communist government of Serbia.
Mar '91	**USSR**	Referendum marginally favours new, looser Union. Six Republics (representing 21 million citizens, or 7.3% of the total population) boycott referendum.
Apr '91	**USSR**	Gorbachev decrees students and other city dwellers must help in agricultural emergency. Inflation accelerates.
Apr '91	**USSR**	Consumer goods shortages and massive price increases, widespread strikes of coal miners and in Byelo-Russia. Outlawing of strikes is met by calls for Gorbachev's resignation.
23 Apr '91	**USSR**	Against the background of 50 million workers on protest strikes, Gorbachev concludes vague pact with heads of 9 Republics and pre-empts initiative of hardliners to sack him. Recognition that six other Republics may leave Union.
during Apr '91	**Germany**	Demonstrations against increasing unemployment and closing of plants in eastern States of the Federal Republic.
Apr '91	**China**	Price increases for basics lead to queuing and panic-buying.
May '91	**Yugo'ia**	Inflation since 1985: + 164,750 %. Ethnic violence between Croats and Serbs; Army threats of intervention.
15 May '91	**Yugo'ia**	Serbia (which favours a socialist, centralised federation) breaks Constitution by refusing to cede Federal Presidency to Croatia (which favours a loose confederation and scope for markets). Serb minority problem in Croatia.
18 May '91	**Croatia**	Croatians in a referendum vote for secession.
11 Jun '91	**Poland**	The first democratically elected President, L. Walesa, seeks powers to rule by decree.
12 Jun '91	**Russia**	Popular election of Boris Yeltsin, who campaigned on a pro-market, decentralisation

		platform, as President of the Russian Federation. Leningraders vote for restoring the name of St. Petersburg.
16 Jun '91	USSR	President Gorbachev signals that he will retrench Communist hardliners to relaunch a reformist course.
26 Jun '91	Yugo'ia	Slovenia and Croatia declare unilateral independence from the existing Yugoslav Federation, starting a civil war with Serbia.
15 Jul '91	USSR	President Gorbachev attends Group of Seven capitalist market economies and seeks massive aid, which is refused.
27 Jul '91	USSR	President Gorbachev declares to the Central Committee of the Communist Party that Marxism-Leninism cannot serve as the inspiration to renewing the nation. He concedes the superiority of a pluralist, market-driven approach.
19 Aug '91	USSR	Coup led by Yanaev and state of emergency imposed by a junta consisting of the prime minister, the heads of the three security services and the representatives of the 'military industrial complex'. Gorbachev under house arrest in the Crimea.
19-21 Aug '91	USSR	Counter coup led by Yeltsin, independent minded republican governments and the people of Moscow and Leningrad. Recognition that the USSR will break up and that Gorbachev's Communist-revisionist line is irrelevant to reform. Ukrainian independence.
20-21 Aug '91	Baltic St.	Baltic States declare their independence from the USSR.
Sept '91	Former USSR	Negotiations about a free-trade zone in most of the former USSR and about destroying or negotiating nuclear arms.
3 Sept '91	Poland	Impatient with EC refusal to admit free-trade in foodstuffs, Poland breaks off negotiations with Brussels.
Sept '91	Croatia	Open civil war in which Serbia occupies Croatian territories.

APPENDIX B
SOCIALISM AND THE CONSEQUENCES

The Ideas

'Property is theft!'

Pierre Joseph Proudhon, 1840

'Loot the looters!'

Lenin's slogan to the workers after the Bolshevik coup in October 1917 when he encouraged everyone to expropriate state and private property

'The market is the nidus of infection from which constantly ooze germs of capitalism.'

N. Osinskii (Soviet economic theoretician), 1918

'The socialisation of the economy begins with the liquidation of the market'.

L. Trotsky, 1920

'Parallel with the strengthening of the socialised economy and the introduction of greater planning in distribution, the need for money should diminish.'

S. Chutsaev, Ekonomicheskaia zhizn, 13 Nov. 1920 . . .

state capitalism [will] be our salvation . . . state capitalism is something centralised, calculated, controlled and socialised . . .'

Lenin, 1918

'[We will achieve] the organisation of accounting, control of large enterprises, the transformation of the whole of the state economic mechanism into a single huge machine, into an economic organism that will work in such a way as to enable hundreds of millions of people to be guided by a single plan'.

Lenin, March 1918

In defending compulsory labour, Trotsky wrote:

' . . . It is said that compulsory labour is unproductive. This means that the whole socialist economy is doomed to be scrapped, because there is no other way of attaining socialism except through the command allocation of the entire labour force by the economic centre, the allocation of that force in accord with the needs of a nation-wide economic plan.'

L. Trotsky, April 1920

'Without mercy, without sparing, we will kill our enemies by the scores of the hundreds, let them be thousands . . . let there be floods of blood of the bourgeoisie — more blood, as much as possible!'

Krasnaia gazeta, official Red Army organ, 1 Sept. 1918, cited in Pipes, op. cit., p. 820

Table 3:
The impact: prices and production in the early USSR

	1917	1920	1923
Prices	100	1,275	85,858,000
Large-scale industry output	100	23	

	(1913)		1920
Coal	100		27
Iron	100		2.4
Cotton yarn	100		5.1
Productivity per ind. worker		100	30
Cereal production		100	70

	(1918)	1920	1921
Employment	100	77	49

Source: R. Pipes, *The Russian Revolution 1918-1919* (London: Collins Harvill, 1990):671-97.

Quod erat demonstrandum

'The social order which ensures the greatest productivity will triumph in the end'.
Lenin 1906

APPENDIX C

CASE STUDY

THE CONTRACTION IN EAST GERMANY: A FAILURE OF CAPITALISM?

The gross domestic product of the ex-GDR shrank by 18.8% in 1990 and is predicted to shrink another 15 per cent in 1991. Industrial production, valued at prices at which it can be sold*, now runs at 48 per cent of pre-unification levels. Total employment has dropped from 9.6 million in 1989 to 6.5 million by mid-1991, that is by 33 per cent. Nearly 3 million people are out of work or on 'short time' [DIW-IfW, Kiel, 1991]. The unemployment rate is expected to reach 40 per cent after July 1991, despite the fact that many employees are retained in dys-functional government jobs. Some observers consider the economic collapse as a failure of capitalism; others deem this a failure of socialism which was hidden in the past. In any case, these figures bring out the adjustment costs to market capitalism which the strongest of the XCEs, the GDR, has to incur. What can explain the massive contraction under sudden exposure to market capitalism?

Germany was economically united in July 1990, a few months before the legal and political unification (Table 1). The speed of unification was determined by political considerations, not least, doubts about the durability of the reformist Gorbachev-Shevardnadze line in the USSR. The D-mark was introduced in the eastern states at an exchange rate of 1:1 and 1:2 (depending on the type of asset or contract). Most wage contracts were converted at a rate of 1 D-mark to 1 *Ost*-Mark, a political decision which all economic experts considered excessive. (The *Ost*-mark traded at around 1:7 in the free market.)

Optimists close to the Kohl government argued that, even at a rate of 1:1, eastern wage rates were about half those in comparable western German industries, but that productivity was about 60 per cent of comparable western workers. This meant that eastern labour-unit costs were competitive (see Table 4), giving the eastern states a locational advantage, that would attract private investment. This and the discipline and relatively high educational standards of the workforce in the east would lead to high, sustained productivity growth, closing the productivity gap with the west in a decade ('second economic miracle').

Reality has, so far, worked out differently: eastern labour productivity was probably half or less that of western workers; and education and skill levels, as well as attitudes to work and learning, are much poorer than expected. A massive wage push, instigated by [western** and ex-Communist eastern] union functionaries, has raised wage rates to 60 per cent and more of western wage rates, with the prospect of wage-rate parity in a few years in key industries, such as the metal industries. The prompt push towards wage parity was helped along by currency union and generous public transfer payments, also for the temporary, artificial maintenance of uncompetitive industrial jobs. In addition, inward investment is greatly hampered by costly social-security legislation which makes it costly and cumbersome to reduce overstaffing (a common occurrence in Socialist industry). Job-guarantees may have a place in a productive economy like the West German, but the immediate extension to the eastern states delays productivity enhancements and makes more industries unattractive to investors who would otherwise rescue many jobs from being destroyed.

Uncompetitive labour unit costs now have stopped most productivity-enhancing investment from the west. And this compounds the awful consequences of two other blights inherited from socialism: the burden of unbelievable environmental destruction and the burden of an obstructionist, overbearing bureaucracy. The prospect is a durable regional problem in the east, similar to the 'Mezzogiorno problem' in Italy, where low productivity, endless public transfers and private emigration have been going ever since Italian unification in 1870.

Table 4:

Competitiveness of East German industry: a schematic presentation (in % of West German levels)

	Wage rates (wage/ work hour)	Labour productivity (output/ work hour)	Labour-unit costs (wage/ productivity)
Optimist expectation	50	60	83
Reality (mid-1991)	60 +	50	120 +
Prospect (for late 1990s)	100	80	125

The problem of locational competition for mobile capital, know-how and firms also exists for workforces and governments of the other XCEs, but — different from the ex-GDR — these economies have the flexibility of the exchange rate to correct an overshooting of wage rates by depreciation and, in any event, have different wage levels, expressed in separate currencies.

* NB.: 'Sale' in the former command economy meant transfer to the state distribution organisation at some nominal book value. By contrast, 'sale' now means that autonomous buyers decide whether the quality and function of the product are worth the asking price.

** West German unions have little interest in preserving jobs in the east that undercut the security of jobs of their western members, but can hope to gain membership in the east by advocating high pay.

THE ECONOMICS OF WELFARE PROGRAMS

JAMES COX

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James Cox has held positions with the Reserve Bank of Australia, the Department of the Prime Minister and Cabinet and the Social Welfare Policy Secretariat of the Department of Social Security. He was a principal economist at the office of EPAC between 1986 and 1989 and since 1989 has been a consultant to the New South Wales Cabinet Office. Jim was a visiting fellow at Monash University during 1985 and has assisted the New Zealand government with social policy changes during the early part of 1991.

THE ECONOMICS OF WELFARE PROGRAMS

JAMES COX

Background

This paper is about some issues arising from welfare programs which are of concern to policy makers in Australia and New Zealand today. Welfare programs are a large and important part of our economy and it is not possible to discuss all the relevant issues here.

There are a number of possible definitions of welfare programs. The pension and benefit programs of the Departments of Social Security and Veterans' Affairs are certainly part of society's social policy effort. But we might also include :

- Benefits in kind that are provided by government (health, education, welfare services etc.);
- Taxation concessions with a purpose which is related to social welfare (e.g. superannuation);
- The provision of utility services to certain groups (e.g. pensioners, residents of rural areas) at a price which is below the cost of supply;
- Private expenditure with a welfare-related purpose including self-provision, transfers to family members, donations to charity and expenditure by employers (e.g. on sick leave).

Information about the cash payments and benefits in kind that are provided by governments is fairly readily available from Commonwealth and State government budget papers and so on. It is harder to assess the effects of the other items although they are an important part of Australian social policy. One has to work out how much revenue would have been gained in the absence of the concession to estimate the cost of a tax concession. This cannot be done with any great certainty. Similar problems arise in assessing the effects of pricing policies in the public sector. Only patchy information is available about private welfare expenditures. But these seem likely to be more important in total than government welfare expenditures.

Public expenditure on social security and welfare, education, health and housing (social expenditures) grew from about 11 per cent of GDP in 1963-64 to around 20 per cent of GDP in 1983-84. Social expenditures then fell to around 18 per cent of GDP in 1988-89. Because of the recent recession and policy changes it is not clear to what extent this fall will be sustained in subsequent years. Public expenditure on goods and services for education increased from around 2.8 per cent of GDP to around 5.4 per cent in 1978-79. It then fell to around 4.1 per cent of GDP in 1988-89. Public expenditure on goods and services for health increased from 1.7 per cent of GDP in 1963-64 to around 3.4 per cent in 1978-79. It remained a roughly constant share of GDP over the next ten years. Public expenditure on transfers to persons increased from 5.8 per cent of GDP in 1963-64 to 9.9 per cent of GDP in 1983-84; it subsequently declined to 8.8 per cent of GDP in 1988-89.

There have been some important changes in the composition of government spending on pensions and benefits in recent decades. In 1965, age pensions represented about 70 per cent of total spending on pensions and benefits by the Commonwealth government. By 1986 the share was around 40 per cent. Expenditure on unemployment benefits increased from 1 per cent to 21 per cent of the total and expenditure on pensions and benefits for widows and sole parents increased from 8 per cent to 15 per cent of the total. The Hawke government has done a great deal to refocus welfare spending on the neediest: for example through the introduction of the Family Assistance Supplement for low income families; by tightening means tests; and by emphasising work, training and rehabilitation requirements.

Australia's welfare state is unusual in several respects when compared with those of overseas countries. There are no social insurance programs here (social insurance programs, e.g. for pensions and health insurance, are programs in which both contributions and benefits are related to income). Australia instead makes extensive use of means tested programs. Some 60 per cent of the relevant age group receives a full (means tested) age pension or equivalent and a further 20 per cent receives a part pension. Australia also makes extensive and growing use of private effort to achieve welfare ends. Retirement incomes are increasingly being provided by superannuation; sole parent families are increasingly being assisted by child support from absent parents; worker's compensation and motor accident third party cover are provided by private insurers (at least in New South Wales); education is provided by private schools; and care of the aged, infirm and children by non-government welfare organisations.

These factors have resulted in a relatively low level of government spending in Australia. It is less certain whether the total welfare effort (including private welfare) is less than elsewhere.

Strengths and Weaknesses of Government Welfare Programs

The main advantage of government welfare programs is that governments can ensure that benefits are available to all who need them. It is unlikely that the market would provide health insurance or unemployment insurance for everyone. If society wants a minimum level of welfare to be available to everyone, or universal participation in health and education programs, then government involvement in the provision of these services is unavoidable. (Delivery may be by private organisations which act as the agents of government.)

Governments can also make sure that everyone takes part in the financing of welfare programs. In the absence of compulsion, some people may decide not to take up their share of the financing burden and to rely on the efforts of others. This is known as the 'free rider' problem.

Some education and health expenditure produces external effects which benefit the economy as a whole rather than the individuals who receive the service. These external benefits provide a reason for government subsidy of the relevant item of expenditure. The precise importance of these external effects is a matter of some controversy.

Government welfare programs limit the distributional uncertainties that result from modern economic life. This is likely to be consistent with the public's views about economic justice. They may also promote the mobility of labour by making it easier for people to live far away from their relatives. Private welfare spending may achieve the same results to some extent.

There are a number of disadvantages of government welfare programs:

- The service may be provided inefficiently. For example, costs may be higher than is absolutely necessary because too many people are employed. The scope for competition is limited by the subsidies which are frequently associated with government-provided services.
- The costs of government welfare programs have to be financed through taxation. This reduces the incentive to work, leads to problems of evasion and avoidance and so on.
- Interest groups form to promote the continued existence and extension of government welfare programs. The programs may be hard to change when needs change.
- An underclass of long-term welfare recipients may develop. An increasingly large proportion of benefits may come to be paid to a small proportion of the population who lack motivation to become self-supporting and also have only weak incentives to become so.
- Poverty traps may develop from the interaction of a number of means tests and the tax system.

It has been argued by Goodman and Nicholas in a recent CIS publication that private welfare (e.g. charities) can avoid these problems to some extent. This is because private donors are likely to have more information about their beneficiaries than is likely to be available to a government agency which has to follow general rules.

The Analysis of Means-Tested Programs

Means testing is a way of minimising expenditure on welfare programs while ensuring that those who really need assistance receive an adequate amount of assistance. Suggestions are therefore frequently made that more benefits should be means tested — for example, Medicare benefits and tertiary fees.

Means testing, however, causes certain problems. Economists often think in terms of effective marginal tax rates (EMTRs) — the amount that is lost in increased taxes and reduced benefits if an extra dollar of income is earned. The combination of tax and a number of means tests can easily lead to a situation where EMTRs are close to, or even exceed, 100 per cent — these are commonly known as poverty traps.

An example may help. Consider a taxable pension which is income tested at a rate of 50 cents in the dollar. If an extra dollar is earned, the pension is reduced by 50 cents. Total taxable income has gone up by 50 cents of which 25 per cent (i.e. 12 $\frac{1}{2}$ cents) is paid in additional tax. The total amount lost in tax and reduced benefits is 50 cents plus 12 $\frac{1}{2}$ cents, which equals 62 $\frac{1}{2}$ cents.

Suppose that the person is also losing an untaxed in-kind benefit (such as a public housing subsidy) at a rate of 25 cents in the dollar. The total amount lost in tax and reduced benefits if an extra dollar is earned is now:

50 cents + 12 $\frac{1}{2}$ cents + 25 cents = 87 $\frac{1}{2}$ cents

In other words, the person is only 12 $\frac{1}{2}$ cents better off from earning the extra dollar.

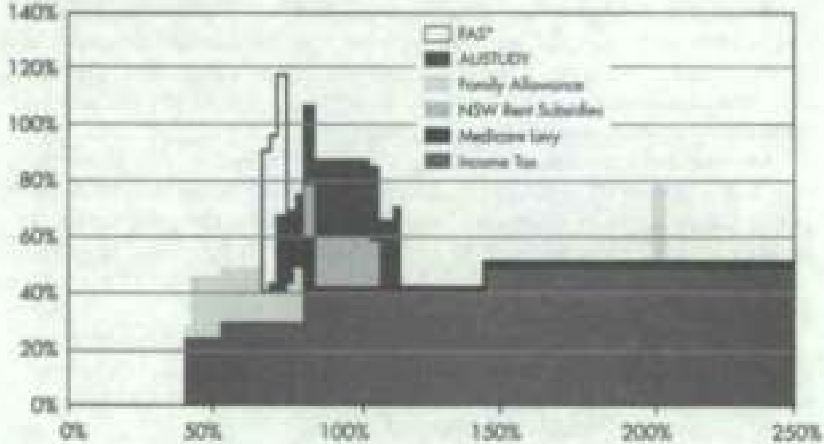
It is easy to see how poverty traps arise where several benefits are being abated away over the same range of income. Figures 1–4, from *EPAC Council Paper* No.35 (Oct 1988), show that these situations actually occur in Australia.

Few people locate themselves in areas of the income distribution where EMTRs are high. Economists would expect this. Why bother to work the extra hour if the return from doing so is so poor? Some commentators have suggested that means tests may be undesirable because they introduce a sharp division between the working population and the beneficiary population.

Many people have suggested that we overdo means testing in Australia and that means tests should be eased. This seemingly obvious suggestion would not necessarily improve things. An easing in means tests would reduce EMTRs for those presently in the means test range. A given amount of assistance would, however, have to be phased out over a wider range of incomes if the abatement rate is reduced. EMTRs would be raised for those who become newly eligible for benefits. It is not obvious whether faster or slower abatement is to be preferred. This depends on the numbers in each group, the amount that they earn in wages, and on the responsiveness of labour supply to economic incentives. (Although I have tended to discuss the incentives for work, it should be clear that similar considerations arise for the supply of capital, risk taking and so on.)

Figure 1:

Equivalent marginal tax rates for a one income couple with two children (aged 16 and 10) in public housing, 31 Dec 1987.

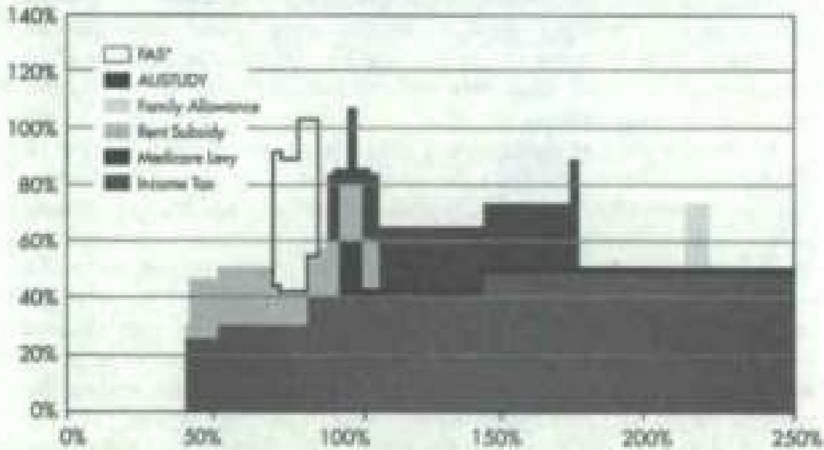


Private income per week as a percent of Average Weekly Earnings.

* FAS is the family allowance supplement

Figure 2:

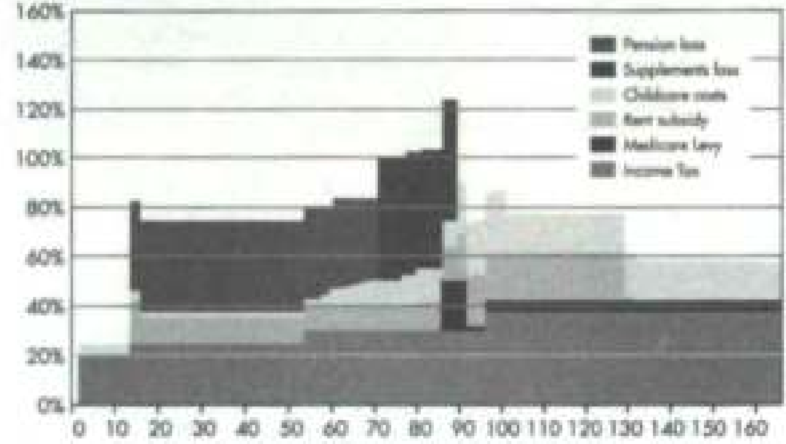
Equivalent marginal tax rates for a one income couple with four children (2>15 years on AUSTUDY) in NSW public housing, 31 Dec 1987.



Private income per week as a percent of Average Weekly Earnings.

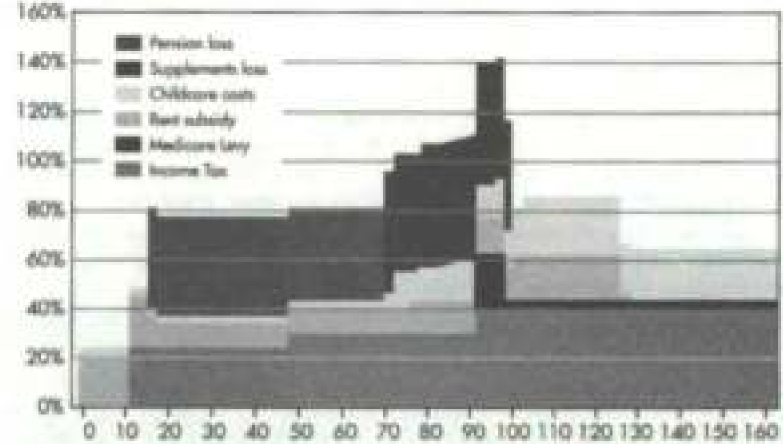
* FAS is the family allowance supplement

Figure 3:
Equivalent marginal tax rates for a sole parent with one child (under 13 years) in NSW public housing, 31 Dec 1987.



Private income per week as a percent of Adult Female Ordinary Time AWE*
* Adult Female Ordinary Time AWE were $390.45 pw as at 31 Dec 1987.

Figure 4:
Equivalent marginal tax rates for a sole parent with two children (under 13 years) in NSW public housing, 31 Dec 1987.



Private income per week as a percent of Adult Female Ordinary Time AWE*
* Adult Female Ordinary Time AWE were $390.45 pw as at 31 Dec 1987.

An alternative might be not to have means tests at all but to pay universal benefits and provide universal services which are financed out of taxation. This requires tax rates to be higher than they would have been if the programs had been means tested. Once again there would be disincentive effects.

There are two general points which are worth making about this complex situation. First, the seriousness of disincentive effects is likely to be more closely related to the size of benefits than to whether they are means-tested or not. The smaller benefits can be while continuing to achieve the government's social policy objectives, the less serious disincentives are likely to be.

Secondly, the poverty trap problem arises not so much because several benefits are means tested but because the separate means tests are not coordinated with each other. A single means test for all programs is an alternative to having separate means tests for each program. Under the single means test approach the total amount of social assistance for a family (pension, child assistance, housing, AUSTUDY, child care etc.) would be added up and assistance would then be abated away at whatever rate was considered to be appropriate. This would ensure that EMTRs do not exceed, say, 70 per cent. There would be no gaps between the level of income at which the means tested program ceases to operate and the level at which the next one starts to be abated away. Given the abatement rate which is considered to be acceptable the costs of providing a particular level of assistance would therefore be minimised.

Developments in information processing mean that it is now practicable to introduce the single means test. In effect, the payments functions of the Department of Social Security would be expanded to form a single social assistance department.

Private Welfare

The provision of welfare in Australia has always involved a complex mixture of public and private effort. An important reason for the growth in government welfare during the first half of the Twentieth Century was the belief that the previously existing non-government arrangements were not sufficient to maintain economic justice during the depressions of the 1890s and 1930s and the two World Wars. The period since 1949 has seen the conscious use of the market to achieve government ends.

Even today, private expenditure with a welfare purpose (including savings and transfers to relatives) is probably more important than government expenditure on social security and welfare. Private welfare has important advantages in leading to a diversity of services. This is increasingly important for a community which is becoming more prosperous and better educated.

There is a good deal of evidence to suggest that government welfare tends to 'crowd out' private welfare. For example, there appears to be little self-provision for retirement in those countries (such as Sweden and Germany) which have extensive government provision. Not only does government provision make private welfare less necessary but the taxes that are required to finance government welfare make it harder for people to provide for themselves and for others.

There are a number of ways in which governments might be able to achieve their objectives more efficiently through the greater use of private effort in the delivery of welfare services. Greater acceptance by the public of the use of prices (or user charges) to direct resources to their most productive use in the welfare sector would make it easier to implement these ideas. Distributional objectives might then be met through undirected or earmarked cash benefits which might be made either to the beneficiary of the program or to a representative who can be trusted to act on his or her behalf.

Some of the possibilities for the greater use of private effort to achieve government objectives include the following :

- The greater use of contracts and competitive tendering;
- Extension of the scope for competition to include commercial, as well as government and non-profit making organisations;
- The replacement, perhaps on an optional basis, of some in-kind benefits by earmarked or undirected cash payments;
- The introduction into welfare services of the 'brokerage model' in which payments are made to agents who develop and then purchase a package of services on behalf of particular aged or disabled clients;
- Enabling those with private insurance (e.g. for health) to choose not to receive the equivalent government benefit and to opt not to pay the associated financing measures;
- Phasing in tighter means tests so that those with adequate financial means are less able to claim government benefits;
- Establishing special means tests for those private payments (e.g maintenance) which are close substitutes for government benefits;
- Reviewing non-income eligibility criteria such as training and work requirements;
- The development of regulatory regimes for private welfare (e.g. in superannuation) which do not unduly restrict the scope for competition.

These options are ways in which the private sector could help the government to improve its performance in welfare. There are some other options which would enable the preferences of private individuals to play a greater part in determining the size and nature of the welfare program. These include the following :

- A more favourable tax and social security treatment of gifts of income between relatives and perhaps of some forms of self-provision;
- The introduction of the proposal which was advanced by Goodman and Nicholas in a recent CIS publication to allow tax-payers to allocate a proportion of their taxes to one or more members of a list of approved private charities.

I think that it is quite likely that the ideas for the greater use of private effort to achieve government objectives will increasingly be taken up over the next few years. In many cases these amount to the further development and wider extension of policies that the Commonwealth and State governments are starting to put in place. It is less likely that governments will reduce their own influence by allowing the preferences of private individuals to play a greater part in determining the size and nature of the welfare program.

Conclusion

The next few years may well be difficult ones for the Australian economy. Australia's traditions of needs-based welfare and private provision of welfare represent a stock of intellectual capital which, if built upon, may enable us to avoid the worst of the dangers which have been pointed to by critics of the welfare state while continuing to meet the most important of the community's aspirations for economic justice.

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NEW TEACHING STRATEGIES IN ECONOMICS

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In 1991 Virginia and Mike co-authored *Teaching Commerce* (Kia Orana Virmic, Sydney, 1991), a book on teaching strategies for commercial education.

NEW TEACHING STRATEGIES IN ECONOMICS

VIRGINIA FROST
MIKE HORSLEY

The aims of this paper are to introduce participants to some of the pedagogical developments which may help teachers to improve their economics teaching and to report on some recent research on the use of textbooks in economics classrooms.

While new knowledge in economics is rapidly increasing and being widely disseminated new developments in pedagogy and teaching methods have been neglected. It was for these reasons that we have prepared our new book on *Teaching Commerce* which was launched at the conference. It reports on a number of useful strategies for commercial educators which are not widely known and which will help teachers improve their abilities to plan and design lessons to meet the needs of their students.

This paper explores two themes . . .

1. The Learning Styles of Students
2. Using Textbooks Effectively and Promoting Literacy

Learning Styles in Economics

An extraterrestrial being is sent to earth by the Council of the Universe to investigate how humans learn . . . . Observing the teaching process in many classrooms she notes that the teacher stands at the front of the classroom telling students information and making notes on the board. She makes a reasonable conclusion and reports to the Council of the Universe that humans learn in the same way.

We know that people differ markedly in their cognitive styles, their affective styles and in their physiological styles. Keefe (1987) briefly describes 32 learning styles identified by researchers in this area. For example, in terms of cognitive styles each of us is aware of our own preferred mode of receiving information — some like to read quietly, some like to see visual representations such as a video clip, some like to hear the information and some like to participate in a concrete demonstration — yet we often do not make allowances for differences in our students. We are also aware of the level of interest we have in a particular subject and our own attention spans which in part characterise our affective learning styles. How often we speak of being a 'morning person' or a 'night person' or how we can or can't work when we are too cold, sick, there is too much light, or there is too much noise i.e. we know our physiological learning styles. Differences in cognitive, affective and physiological learning styles in your classroom will obviously have a marked effect on the quality of the learning that takes place.

If Keefe has been exhaustive in his review of the literature it means that in your commerce class the combinations of different learning styles that could be present are some 32 to the power of 30! Pike and Selby (1988) report on the research of Anthony Gregorc who grouped learning styles into four quadrants.

> According to Gregorc learning style is the outward expression of the human mind's **mediation abilities** (i.e. the means and capabilities we employ to receive and express information). Two principal factors in determining learning style, he maintains, are the ways in which we perceive and order the information we encounter. **Perceptual abilities** are the means whereby we grasp information; our perception may be abstract (through reason, emotion or intuition) or concrete (through the physical senses of hearing, sight, smell, taste and touch). **Ordering abilities** are the ways in which we arrange, systematise and dispose of information; our ordering may be **sequential** (linear, step-by-step and methodical) or **random** (non-linear, leaping and multifarious with 'multiplex patterns of data' being processed 'simultaneously and holistically').
>
> Pike and Selby, (1988:83)

Gregorc's Style Delineator Model thus profiles learners on a 2 x 2 matrix which results in *four* distinct learning patterns:

- Concrete Sequential (CS)
- Abstract Sequential (AS)
- Concrete Random (CR)
- Abstract Random (AR)

By diagnosing the learning styles of students in schools and their teachers it is possible to explore the match and mismatch implications of teaching and learning styles. Gregorc charts the preferred teaching/learning strategies of people whose dominant learning style falls into one of these quadrants:

Table 1

ORGANISED • keeping records of experiences • preparing charts, summaries, checklists • preparing displays • conducting surveys • writing computer programs • observing & classifying phenomena • undertaking practical work **CS**	**ANALYTICAL** • listening to lectures • comparing and contrasting different accounts and interpretations of events • project research • essays • library study • group or plenary discussions **AS**
CR • experiential units • simulation games • practical experiments • role plays • problem-solving exercises • independent studies **INVENTIVE**	**AR** • group discussion work • interpersonal work in small groups • role plays • guided fantasies • imaginative writing • preparation of multi-media presentations **SENSITIVE**

From: Pike and Selby (1988)

It is interesting to note that when teachers stand at the front of classrooms encouraging the learning of facts and the promotion of analytical thinking, it is favouring those students with a dominant Abstract Sequential learning style at the expense of the majority of learners in their classrooms!

Research by McCarthy (1981) with 17-18 year olds in two Chicago high schools revealed that approximately equal percentages of male and female students fell into each of the four learning style quadrants, that 60 per cent of the sample still favoured the Concrete Experience dimension and that more students (46 per cent) were right-brain dominant as against left-brain dominant (28 per cent) and integrated dominant (25 per cent). Further she found that only the analytical learners (AS) contained a higher percentage of left-brain dominant thinkers.

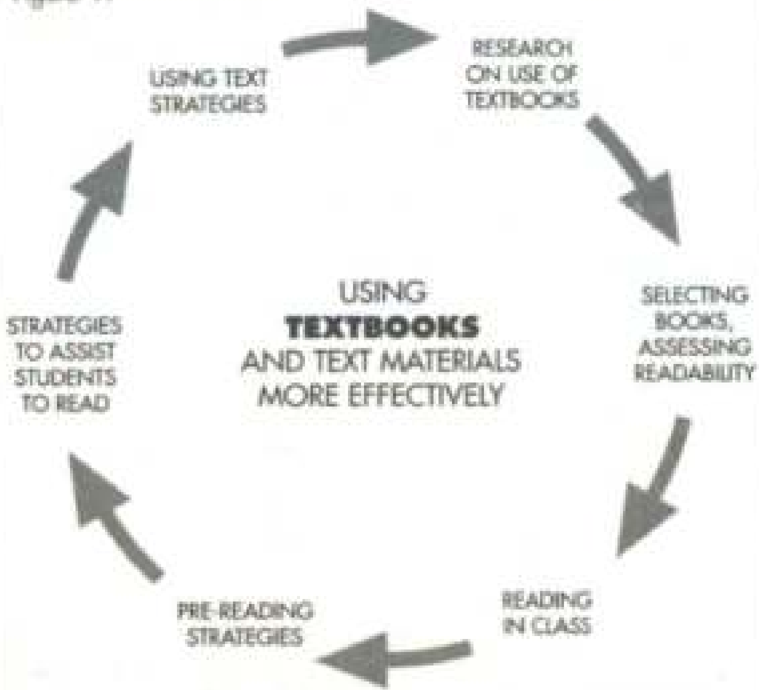
> **When teachers stand at the front of classrooms encouraging the learning of facts and the promotion of analytical thinking, it is favouring those students with a dominant Abstract Sequential**

learning style at the expense of the majority of learners in their classrooms.

It is common for teachers to structure their lessons for the analytical learners. If students deserve to spend at least 25 per cent of their time learning in their favoured quadrant, what are the implications for teachers?

Using Textbooks Effectively

Figure 1:



The Figure above illustrates the effective teaching cycle for using textbooks in the economics classroom. This paper in the following few pages discusses only one part of the cycle — using pre-reading strategies.

Pre-reading Strategies

Students learn best when they are able to make linkages between their own experiences and new information. Learning experiences which capitalise on the innate interest and curiosity of students provide greater opportunities for students to move from simple conceptual understanding to more complex levels of thinking. Therefore, students are more likely to read when:

- they recognise that they already know something about the topic; and
- they feel that the topic is relevant.

> **Pre-reading activities are planned and executed before students read text.**

As adults we read snatches of text to satisfy our curiosity and less frequently we read entire books related to our career choices or to our leisure-related interests. Most of us would resent someone instructing us on a regular basis to read pieces of text without a clearly explained purpose. It is most important for each of us to reflect upon the way we read and the way we observe others reading, so that we don't perpetuate the practices of our teachers which may not have any sound justification in theory or effectiveness in practice!

The following pre-reading strategies are based on extensive research and should be utilised wherever practicable.

Engage the Interest of Students

There are numerous teaching/learning strategies teachers can employ when introducing text materials which will motivate students to read. Some common strategies are . . .

Telling an anecdote	Poster display
Overview	Listening to music
Debates	Purpose discussion
Role play	Predicting
Brainstorm	Problem Solving
Showing a film/video	Experiments
Analysing illustrations	

Students will be far more motivated to read when they have had the opportunity to engage in such learning strategies and to explore controversial issues from different points of view **before** they read. The main purpose of pre-reading activities is for each student to identify her/his own purpose for reading. For the teacher this also means helping students generate their own questions.

Students can be encouraged to formulate their own questions by being challenged to respond to topic issues such as:

> 'What questions do you have about international trade/federal cabinet/demand/privatisation . . .?'

A blackboard summary of resultant student questions will help provide a focus for reading for all students in the class.

Ask the Author Questions

We all learn best when we are seeking answers to self-initiated questions.

Proficient Reading is a Directed Search for Meaning

Students will thus be more likely to encounter difficulties when classroom reading assignments lack purpose and have no clear understandable structure. Those students you observe to be gazing out the window, turning pages aimlessly or engaging in attention-seeking behaviours may be inefficient readers. Such students are often overwhelmed by a mass of words and are unable to process the information because they cannot recognise any structure in the author's words. Focusing students' attention on the author and asking them to formulate questions from the topic or article heading will increase students' interest in the following reading.

'Ask the author' type strategies help students to comprehend the meaning of the writer. They can also assist the teacher in establishing focus questions and topics for inquiry and to promote **reading for meaning and understanding.**

How to use this strategy.

1. Prior to reading explain to students that they have to imagine that the author of the article or text is
   - sitting in the next room waiting for their questions
   - arriving tomorrow to answer their questions.
2. Ask the students to write down questions they would like to ask the author, specific points of clarification, what the meaning of particular words are, anything they want to ask about. This technique is very powerful in developing students' skills in **enquiry.**

Purpose Discussion

Teachers make decisions about what text materials their students will read yet it is interesting that teachers rarely share with students the importance and usefulness of the material to be read. Teachers can stress the

Importance

and

Interest

of the material to be read and why it has been chosen for study. This purpose discussion can also include the importance of the concepts and information embodied in the reading.

Another way of establishing purpose is to consider different ways of posing questions prior to reading.

One way of approaching pre-reading questions is to encourage reading for understanding. This can be done by:

- setting questions (and discussing them prior to reading)
- reading
- answering questions without looking or referring to the text.

Obviously this has to be trialled and explained to students but they do get used to the technique and change their approach to reading so that they learn to read for more meaning and understanding.

Efficient readers tend to skim through printed material searching for key words or phrases which pinpoint the part(s) of the text they need to read more carefully in order to find the desired information. Therefore:

Efficient readers

- Have a clear purpose for reading
- Can identify key words and phrases

Teachers can further help students in their search for meaning by encouraging students to formulate a structured overview of the topic or a section of a topic before they begin to read.

Develop a Structured Overview

A structured overview (see Figure 2) helps students understand reading material because it highlights major concepts and their relationship to each other. In some teacher reference books this technique for helping students to organise their thoughts is referred to variously as 'graphic organisers', 'concept webs', 'concept maps', 'semantic maps', and 'concept hierarchies'. All of these techniques begin with an umbrella concept from which radiate key words. These words are connected together by lines or dots to show clusters of concepts which relate to specific aspects of the topic.

In general, more abstract concepts are recorded at the top of the 'web' and more detailed or concrete concepts are recorded lower down. Students can add or remove words from the overview as they read.

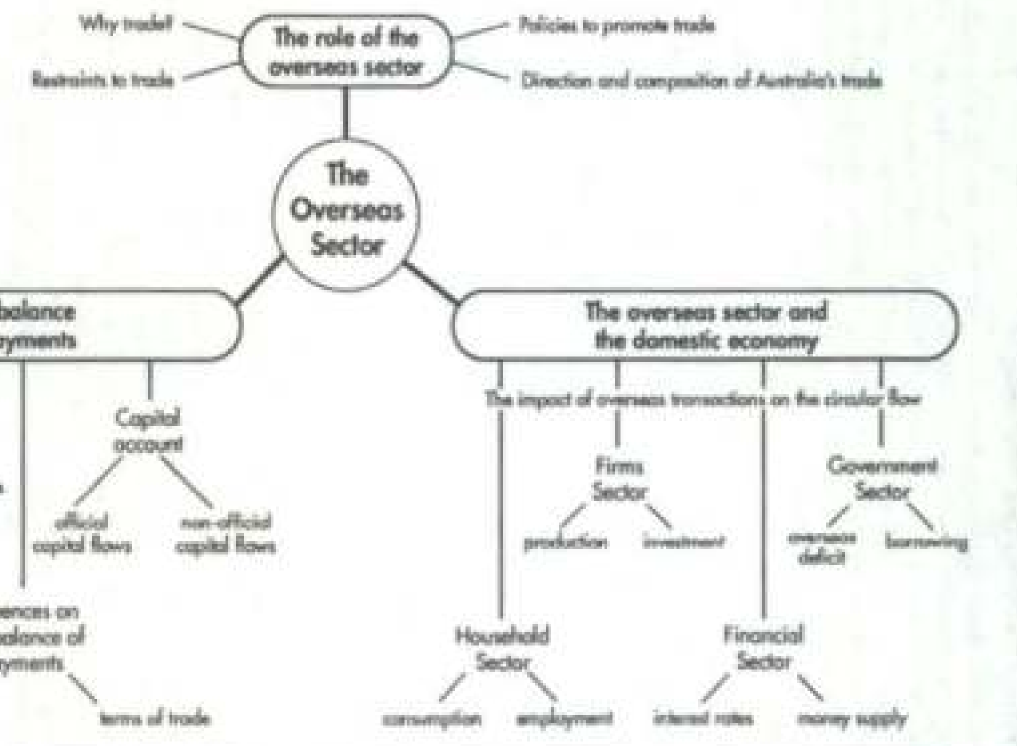
The aim of such a structured overview is to show the logical relationships between ideas. When students engage in the construction of these overviews, they gain practice in sorting ideas and seeing relationships among ideas.

The structured overview following could be used to show the organisation of concepts related to the **overseas sector**.

Use a structured overview to:

- introduce a topic;
- conclude a topic; or to
- review a topic at some later date.

Figure 2:
The overseas sector



Interpret the Specialised Vocabulary

The Economics Syllabus contains numerous terms and concepts students may encounter for the first time. As well as these concepts, there are a number of other terms and concepts students will encounter which are used by business people, lawyers, politicians, unionists, economists and journalists to communicate with each other in clear unambiguous terms. It is therefore of vital importance for students to know and understand the precise meanings of these terms so that they too can communicate with others using these terms and concepts.

Much of the literature on promoting literacy skills in students recognises the need for special emphasis to be placed on the ways in which new words are introduced. When students begin to read from a text or journal and encounter a lot of unfamiliar words they may become frustrated and give up. So it is important for the teacher to introduce students to this new specialised vocabulary before they begin to read. Teachers will therefore need to read text before asking students to do so, and they will need to identify difficult words which may interrupt the free flow of reading by students and limit their ability to make sense of the text.

Once a list of difficult vocabulary has been devised, it should be issued to the class at the beginning of the topic. Students should be encouraged to seek out these words in an article or text and attempt to define them from the context clues. They are more likely to become independent learners if they have regular practice interpreting such context clues.

The following newspaper article from the *Sunday Telegraph* entitled the 'Psychology of Shopping' appeared on March 11, 1990. Many teachers would have cut it out for use in such Commerce topics as 'Wise Buying' or 'Consumer Awareness'. There are, however, a number of difficult words which would have prevented students making sense of the text. The entire text of the article has been included with permission to illustrate the technique of using a numbered vocabulary guide to pieces of text. Obviously, when issuing photocopies teachers can simply underline the difficult words and ask students to tick those they know and write in the margin the meaning of those they don't after using context clues, discussing the meaning with peers or consulting a dictionary.

Psychology of Shopping

by Paul Broekhuijse

It's a familiar story. Shoppers diligently write up their shopping lists, carefully calculate their expenditure and set out for the supermarket. But somewhere between entering and leaving the store, items you never planned on buying somehow find their way into the trolley.

The budget's been blown again. Many — including a few distraught partners — blame it on the simple lack of willpower. But there's more to it than that. Of course, no one forces us to buy anything. But supermarkets and other retailers do have a few subtle tricks to tempt the shopper. There are a host of little techniques, all apparently innocuous, which conspire to make consumers spend money.

It's all about the psychology of shopping, and while shoppers may not be aware of it, retailers certainly are. The most obvious methods involve the layout of stores.

Most supermarkets have staple items such as meat, dairy products, bread and fruit and vegetables right at the back of the store. These are the products that almost everybody wants to buy. But to do so, customers must pass through the whole length of the store, exposing them to more opportunities to buy.

Typically stores spread out their items throughout the shelves so that shoppers must pass through the whole store to get their groceries. And just in case shoppers are planning to by-pass a particular aisle, retailers put special bins with attractive specials at the ends. This has the effect of enticing shoppers into aisles they would otherwise have avoided. In large department stores, items such as electrical goods or furniture are usually put at the back of the store.

'These are the items which people must be highly motivated to buy,' said Dr Stan Glasser, from the School of Marketing at Macquarie University. 'But in order to get to them you have to pass right through the store or even a few storeys, so you pass all the other goods on sale.'

There are several other layout tricks. One is to place impulse items, such as chocolates, cigarettes and magazines, near the checkouts. These are the sorts of products people may well not have put on their list. 'Retailers tend to put only certain types of items next to the checkout counter,' said Macquarie University psychologist Rod Power. 'If your four-year-old child demands sweets while you are waiting at the checkout, you're more likely to buy some, partly because if the child throws a tantrum it's in front of lots of people.'

Magazines are placed near checkouts because shoppers can flick through them while they are waiting. And according to Sydney University psychologist Dr David Robinson, if a retailer wants to sell something it's important to get the item into the hands of the potential customer.

If you pay attention next time you shop, you'll also notice that certain brands get the prime spot — at adult eye level — on the shelves.

This is not a matter of luck. Manufacturers sometimes actually pay retailers for the best positions, and may have to pay for the privilege of getting on the shelves at all.

According to Guy Ellicott, a researcher with the ABC's consumer affairs program The Investigators, consumers are actually paying extra for the efforts of retailers to sell them things. 'If you are launching a new product, you want a premium position on the shelves or the product will die,' he said. 'Manufacturers pay for this, and the premiums are passed onto consumers as part of the advertising budget. The consumer is actually paying for them to sell the product to them.' Mr Ellicott says consumers can take advantage of this trick. 'Items that the store wants to shift are placed at eye-level, but quite often you can find cheaper items below,' he said.

Certain goods — such as sweets and toys — are often placed closer to the ground, where children can see and grab them. Dr Glasser said the general decor of the store has an effect on shoppers: "different market segments have very different preferences. The general ambience of the store is important. People like to feel at home, and they'll tend to be loyal to a store they like."

The overall image has a profound effect. While many customers believe that certain stores are always the cheapest, the truth is that this varies very much from suburb to suburb. Macquarie University's Rod Power says warm colours, such as reds and oranges, tend to entice people into a store and make them move faster — which is useful for a supermarket relying on high turnover.

Cooler colours, such as blues and greens, offer a more up-market image and tend to make people move less quickly. This is useful for stores selling expensive items such as furniture and hi-fi equipenent, where people need time to consider a purchase.

Dr Power said cheaper clothes shops go in for brighter lighting to keep people awake and doing something, whereas up-market shops use softer lighting and more subtle colours. The use of colour can sometimes be purely misleading. Potatoes, for example, are often wrapped in red plastic, in order to disguise any green spots on the spuds.

Another colour trick is the use of special lamps. If a supermarket has a meat department, chances are there is a special pink lamp hidden somewhere which shines on the meat and makes it look more red than it actually is. 'You can't normally see the source of the light, because otherwise your vision would take it into account,' Dr Power said.

Another trick is to place certain colours next to each other. Psychologists tell us that complementary colours — such as red and green, or blue and yellow — have the effect of enhancing each other if placed side by side. Placing a green capsicum next to a red tomato, for example, makes both of them look better.

According to some psychologists, stores with cluttered aisles have the effect of making some people think they are cheaper. Shoppers usually believe that the only reason stores have cluttered aisles is that they are trying to cut overheads, such as storage costs, and this saving will be passed on. 'People will buy things in markets because they think they are cheap, but that's often not really the case,' Dr Glasser said. 'People think they are cheap because there is a lot of jumble and it's very busy.'

Stores with big open aisles present the alternative message: more expensive, but better quality. Many supermarkets now have canned music — or even a type of in-house radio station — operating. Psychologists say that frenetic music played on the stations can make people move more quickly, which means more shoppers are able to pass through the store.

Some supermarkets use more subdued music, which makes people feel at home and stay around longer — increasing the chances they'll buy extra things. 'Advertisements on in-house radio tend to be very effective, because you have people who are about to make a decision — you've got a captive audience' Dr Glasser said.

Another factor to be borne in mind by budget-conscious shoppers is hunger. Psychologists say that if you shop while you're hungry, you'll buy a lot more.

Sunday Telegraph
March 11, 1990

Use the list for students to seek out these terms and concepts in the article and ask students to define the terms from the context clues.

Vocabulary

Before you read the article entitled the 'Psychology of Shopping' find the following words in the passage and attempt to define them from the context of the sentence in which each is found. Note that the numbers refer to: (page number - column number - text box number - line number)

- diligently (192 - 1 - 1 - 1) ______________________
- innocuous (193 - 1 - 1 - 7) ______________________
- enticing (193 - 1 - 4 - 8) ______________________
- premium position (193 - 2 - 5 - 7) ______________________
- segments (194 - 1 - 1 - 3) ______________________
- ambience (194 - 1 - 1 - 5) ______________________
- profound (194 - 1 - 2 - 1) ______________________
- complementary (194 - 1 - 6 - 3) ______________________
- overheads (194 - 2 - 2 - 7) ______________________
- frenetic (194 - 2 - 3 - 7) ______________________

By employing this teaching/learning strategy for each topic most students should have adequate vocabulary preparation for meaningful learning to occur in that and subsequent topics.

Interpret the Signposts

When students begin to read from texts they can become overwhelmed by the words and may not be able to extract the key points or issues. When we pick up textbooks, we generally examine the **Contents** section to ascertain the appropriateness of the text to meet out current needs. We also make extensive use of the **Index** of most books. Most of us were not taught these techniques but as self taught experts we fail to recognise the need to teach these same techniques to our students.

Modern computer-generated layouts of texts have given us a whole new world of **signposts** to the author's intentions. The size of headings, the colours of headings, the font type, the font size and the graphics used can illustrate the author's intentions yet teachers often fail to work with their students to 'crack the code' of each new text.

Graphic Outlines

The value of a graphic outline of a text is that it provides students with the signposts for selecting the relevant information. This technique is best used with texts or journals which have clear headings and subheadings.

At the beginning of an economics course none of the students in your class will be familiar with the structure or content of the text(s) you have selected for their use. Students will begin to recognise the main points and skim over the irrelevant material if they learn to use a graphic outline to identify the headings as the key indicators to identifying the organisation of content and changes in the direction of that organisation.

Once students become proficient at completing a graphic outline for a text or article they can then begin to predict the content of sections of the text from the heading and subheading clues.

The video *Better Readers, Better Learners* produced in 1990 for the Geography Curriculum Implementation Coordinating Group by Resource Services of the Department of School Education shows the use of graphic outlines for textbooks and for journal articles.

The graphic outline on the next page is a highly generalised example of the way we can structure learning experiences for our students. Preparing such a graphic outline enables us to demonstrate to students the relative importance of various pieces of text.

What are Text Patterns?

One of the important characteristics of textbooks is the text pattern or structure which the authors use to convey the ideas to be transmitted to the students. In the last twenty years a great deal of research has been conducted into the distinctive organisational pattern or structure of text. A number of teaching strategies to help students learn and understand these text structures have been developed.

What Kinds of Text Patterns do we find in Textbooks?

In the expository writing found in most texts, researchers have identified five main structures or patterns.

The Five Main Patterns are:

TEMPORAL ORDER

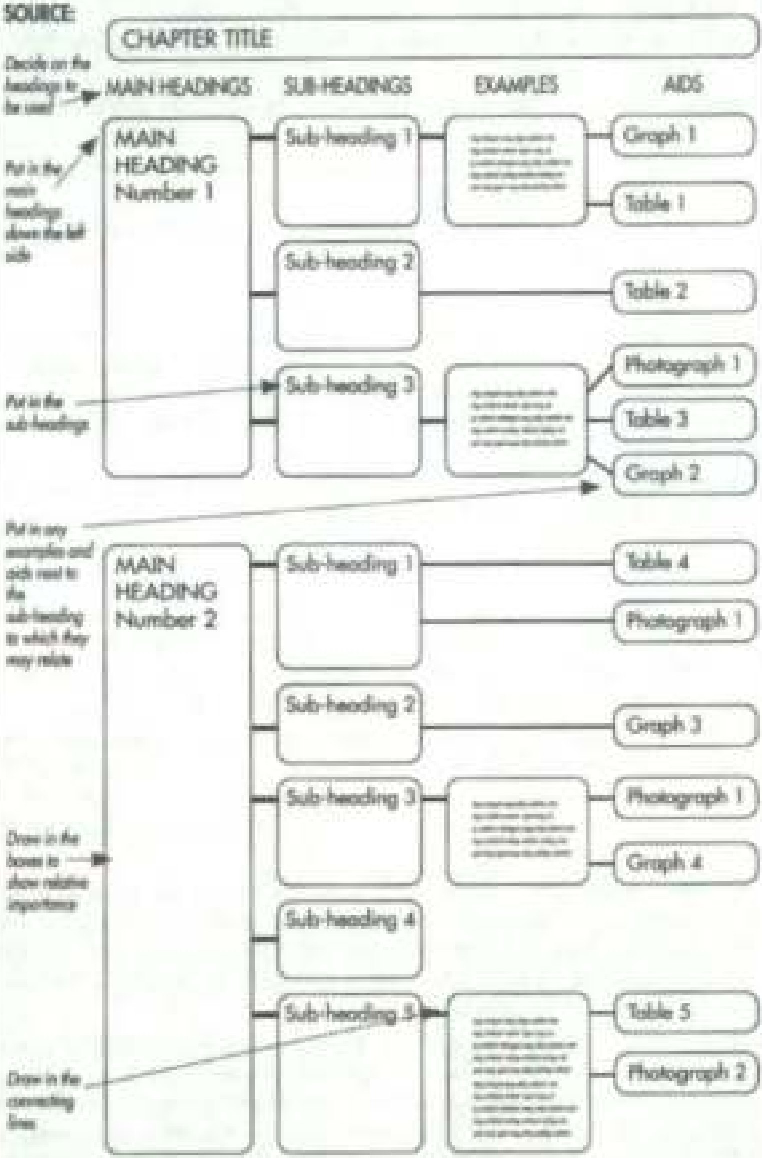
ATTRIBUTION, COLLECTION, DESCRIPTION

COMPARE – CONTRAST

CAUSE – EFFECT

PROBLEM – SOLUTION

Figure 3



After: Morris, A. and Stewart-Dore, N. Learning to Learn from Text Addison-Wesley; North Ryde, NSW 1984.

These patterns:

- exist at the sentence level, the paragraph level, the chapter and whole book level;
- are basically used by the authors to give the discourse its overall organisation and form;
- are indicated by key words and cohesive ties that bind the ideas together;
- are used by readers to understand the meaning of the writing, and relationships between the ideas;
- may appear singly, or in the same text, or a number of different patterns may appear.

Let us explore each pattern in a little detail.

Temporal order or time order is common in much writing where authors are using a narrative style of writing. It includes techniques like flashbacks and foreshadowing which authors use to manipulate time sequence. Temporal order is signalled by words like 'first', 'second', 'third', 'next', 'then', 'suddenly'.

Attribution refers to descriptions or listing where authors are basically describing or noting something. A number of attributes on specifics or settings are presented together. This sort of text pattern is signalled by words like 'first', 'in addition', 'as were', 'furthermore', 'next' and 'finally'.

Compare – Contrast is used to organise information when two ideas are being organised on the basis of their similarities and differences. This pattern is signalled by words like 'however', 'nevertheless', 'on the other hand', 'different from', 'the same as', 'like', and 'similarly'.

Cause and Effect combines elements and ideas in a 'before and after' sequence in a causative way: where one thing influences the characteristics of another. The cause and effect pattern is signalled by words like 'so that', 'thus', 'because of', 'as a result', 'since', 'in order to', 'therefore' and 'consequently'.

Problem – Solution is where problems and specific solutions are presented although solutions may be presented before problems. Usually causative relationships between problems and solutions are outlined. This pattern is signalled by words such as 'an answer is', 'a question is', 'the solution is' and 'the problem is'.

A characteristic of the different text patterns is the varied clue words which are signals for the patterns. These sorts of words are also known as connectives. It has often been argued that lack of knowledge of connectives by students will be related to poor performance in reading. An American study of 35 textbooks from grade 6 to 12 showed that different subjects used different connectives and the connective load varied quite widely. For example social sciences type subjects were less burdened by connectives than the physical sciences. The study also revealed a quite different top twenty connectives for five different high school subjects.

Why are Text Patterns Important?

> Much like expert drivers, readers who are successful in schools somehow acquire a specialized knowledge about the patterning of their texts. This may include knowledge of overall text design, of chapter formats, of substructures within chapters, of paragraph structures, and so on. Expert readers come to know the macrostructure of a text and the microstructures that are guideposts for following the meaning of a text.
>
> Horowitz (1985).

School students must do much complex reading in very specialised content areas. Quite often text patterns used to treat particular topics may be unfamiliar. Readers may benefit greatly from acquiring knowledge about these patterns which can be used for studying and retrieving the information.

Some Pre Reading Activities Based on Text Patterns

1. Teachers can alert students to the type of patterns they will be working with.
2. Teachers can ask questions designed to model the text pattern.
3. Teachers, especially with NESB students, can help make sure students understand the connective or linking words prior to using the text. This can be done especially in conjunction with NESB teachers who may assist in the team teaching of lessons.
4. Graphic organisers can also reveal text pattern differences since the graphic organisers for different text patterns look different.

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Appendix: Learning Style Questionaire.

Answer questions working down the page, using1 to indicate 'least like you'; 2 – 'not much like you'; 3 – 'a lot like you'; 4 – 'most like you'.

1	2	3	4	5
Are you easily influenced by others' opinions?	Do you like to get every little detail right?	Do you think you are reliable?	Do you work well with your hands?	Are you careful with ideas?
Do you prefer to work things out with numbers?	Are you more interested in the end result?	Are you always ready to do as you are told?	Do you work out things in a very set pattern?	Do you take an interest in new ideas?
Are you sensitive to others' feelings?	Do you like to add lots of colour?	Do you always want to give your opinion?	Do you think you are lively?	Are you aware of what is going on around you?
Do you guess what the teacher will say next?	Do you often take risks?	Do you show you have understood?	Do you notice things around you?	Do you like to make things?

Once all the questions are answered, add up the numbers along the top row and put the total in the Total box. Do the same for the other three rows. The highest figure(s) gives some indication of your learning preference.

C = Concrete A = Abstract S = Sequential R = Random

6	7	8	9	→ Totals
Do you always finish a task well?	Are you down to earth?	Are you well organised?	Do you constantly demand attention?	CS Total
Do you work out a problem using reason?	Are you critical of others?	Do you like to see proof before you believe in an idea?	Do you think long and hard about a problem?	AS Total
Do you use the first idea that springs to mind?	Are you interested in people?	Do you often think about the people around you?	Do you think what a thing looks like is important?	AR Total
Do you try to find fault with new ideas?	Do you think up new ideas?	Are you satisfied with many answers to one question?	Do you have a vivid imagination?	CR Total

(After Gregorc 1985)

AUSTRALIA'S ECONOMIC FUTURE

MAX WALSH

FINANCIAL COMMENTATOR

Max Walsh holds a BEc and is currently a columnist and commentator with the *Sydney Morning Herald*. In the last decade Max has been a presenter of the Walsh Report on the Ten Network, the Carlton Walsh Report on the ABC and was one of the founders of Nine's Sunday Program. Between 1974 and 1981, he was editor and then managing editor of *The Australian Financial Review*. Before that he was that paper's chief correspondent in Canberra for 8 years. Max Walsh has covered the political, economic and business scene in Australia for over 30 years. He was made a member of the Order of Australia in 1983 for his services to journalism.

AUSTRALIA'S ECONOMIC FUTURE

MAX WALSH

I suspect I'm on fairly safe ground when I say that probably none of you in this room recognises the name Lincoln Steffens. That's not surprising. Steffens was a journalist in the United States around the turn of the century. He was the founding father of that class of journalists called 'the muckrakers'. It was Teddy Roosevelt who called them the muckrakers. He meant it as a pejorative expression and down to this day politicians discomforted by journalistic expose's tend to employ the description of muckraking to diminish or dismiss damaging revelations. In their time, however, the muckrakers were primarily concerned with exposing the political corruption then common throughout America and the anti-social behaviour of the various trusts which dominated corporate life in America. They documented the way in which monopolistic power was deployed with the connivance of politicians to gouge consumers, destroy competitors and sweat labour.

Steffens was a courageous and quite powerful and popular figure in his day. However, when he is remembered today it is for one sentence. Steffens went to Russia to report on the Bolshevik revolution in 1917. When he returned he proclaimed 'I have seen the future and it works.' These words were to have a powerful resonance throughout American liberalism for the next three decades. But by 1991 Lincoln Steffens wouldn't even convince a Kremlin hardliner. Consequently, the record of journalistic forecasts as to the future or anybody else's for that matter has to be treated with care and a dash of scepticism. The collapse of communism when it came was rapid and dramatic.

By way of a rescuing of the reputation of journalistic forecasts, I could point to the book *Blood in the Streets*, written by a friend of mine, Jim Davidson in the mid eighties. The title is a little misleading. It refers to Nathan Rothschild's remarks after he had made a killing on the stock market after the Battle of Waterloo in 1815. Rothschild's communications system was superior to anybody else's in London and he was the first to learn of the outcome of the Battle of Waterloo. He immediately began selling stock, sending the market into a panic as it concluded that Napoleon had carried the day; that the days of the British Empire were at an end. Then when the market was on its knees his agents began soaking up stock. Rothschild reputedly made a million pounds out of that exercise. He explained his market killing in the following words: 'The time to buy is when blood is running in the streets.' Mind you, it takes some nerve. Davidson the joint author of *Blood in the Streets* was a Renaissance scholar when he went to Oxford from America to do a post graduate degree. His tutor at Oxford told Jim: 'If you wish to understand the Renaissance you have to understand theology. But if you want to understand the twentieth century you have to understand economics.' This is a proposition to which I wholeheartedly subscribe.

Another friend of mine, Professor Barry Hughes, once told me that I would never make a serious economist because I didn't understand regression analysis. True. Then again, I have never aspired to be that sort of serious economist who is constantly preoccupied with the trees and never aware of the woods.

I have not had your experience of the last few days, having returned to Australia only today. In fact I flew in this afternoon from Argentina. It was supposed to be this morning but we were on Argentinean time and dropped off for a long rest in New Zealand. If Steffens could go to the USSR in 1917 and say 'I have seen the future and it works', then I can say that having been to Argentina, if that's the future, it sucks. Last week they published the inflation rate for June. It was down to three per cent. That's for the month, bringing the year to date to something over 100 per cent. That's a big improvement since the Menin government came to power. Inflation was running at over 2,000 per cent two years ago. In fact the Menin government is considered to be popular and successful by Argentinian standards. Although the country is still going backwards, it is not doing so at the same rate. Since 1982, average per capita real income in Argentina has fallen by 24 per cent. There are signs that it is coming to its senses. The success of its neighbour Chile and the way in which Bolivia is beginning to restore its economy are bringing some genuine discipline to Argentina. It's not my purpose to talk about Argentina tonight but it always helps to know that there is somebody worse off than yourself.

While I was not able to attend your conference until this evening, I can see that by looking at the subject headings of the various papers, it is clear that you have heard a great deal about specific aspects of the Australian and global economies — especially in the short term. My impression is that you have had a pretty good tour of the current state of the Australian economy and our progress, or lack of progress, in engineering needed structural reform. Knowing most of the people who addressed you, I have a fair idea of what they would have said. I suspect I would disagree with very little of their content. I do not want to go over that ground once again. I suspect that you have overdosed on Australian structural reform. However, I hope that I can build on those earlier papers to put the subject of structural reform in a wider and in some ways rather unorthodox context; to provide a broad brush attempt at examining the need for structural reform against the backdrop of the longer term global environment. At least that is what I will attempt to do this evening.

Jim Davidson, who I mentioned a few moments ago, has another book scheduled to be published in October. It's with the same co-author as his *Blood in the Streets* Lord Rees-Mogg. This book will be called *The Reckoning*. Davidson you might gather is decidedly bearish about the short to medium term. He told me that they originally thought of calling the book *The End*. Not only was that too absolute in its implicit judgement. It left no room for a sequel. But it did remind me of a long feature article I wrote for the *National Times* back in 1980 following the second oil shock. The first oil shock of 1973, which saw a quadrupling of crude oil prices, led to recession and then stagflation.

The World Economy in the 1980s

In late 1979 crude oil prices were doubled by OPEC. While we were not going to have a replay of the post 1973 period it was obvious that the same forces experienced in 1973 had once again been unleashed. I explored the various possible scenarios, all involving some pain, at least in the short run. The editor decided to do a poster on the article. You can usually get away with a touch of hyperbole on a poster. You want to tease people into buying your publication but not leave them feeling they have been misled. The *National Times* poster that week:

'THE END OF THE WORLD'

That was in bold 144 point type. In much smaller type — indeed you had to get pretty close to read it, was the additional line:

'as we know it'

Curiously this was quite a successful edition. I claim no responsibility for that poster — just the reverse — but it was not lacking in prescience.

The second oil shock, building on the first oil shock, did change the world as we knew it. In Europe and Japan the response to the second oil shock was to adopt a policy stance that gave absolute priority to preventing a re-ignition of inflation similar to that which occurred after the first shock. This meant, in the case of Europe, being prepared to live with higher levels of unemployment than had been considered politically acceptable for some thirty years. Unemployment was to remain high throughout the 1980s through most of Western Europe. The response of the United States, the world's largest economy, to the second oil shock was largely dictated by the political cycle. Jimmy Carter faced re-election in 1980. He was carrying the political burden of the hostage crisis, gas lines and high inflation despite a money crunch in 1979. Ronald Reagan was elected at a time of high inflation which led Paul Volcker at the Federal Reserve to impose a tight money policy in 1981. This had to be tighter than anything previously experienced because President Reagan actually brought down an expansionary budget. Sky-high interest rates and a rapidly slowing US economy were a disaster for the over-borrowed countries of Latin America which depended on the US import markets to finance their high interest bills.

In August 1982 Mexico was the first of a string of Latin American countries to seek a moratorium on its debt. This was the beginning of a decade of depression for the Latin American continent. Volcker eased US money policy while Reagan kept the fiscal accelerator to the floor. Within the space of three years the United States had moved from being the world's largest creditor country to being the world's largest debtor country- the full implications of which are still not appreciated. The beneficiaries of Reaganomics were not the Americans, although the expansion of the economy saved a number of banks from going under. The beneficiaries were the Asian countries, primarily Japan, which expanded its exports to the United States.

Australia in the 1980s

For Australia it was also a whole new ball game in the 1980s. We entered the decade with a very low level of foreign debt and with Prime Minister Malcolm Fraser telling us that the second oil shock represented the dawn of a new development boom based on our deposits of steaming coal. At his urging the various state electricity authorities began borrowing in big licks from abroad to finance expansion of their power capacity. They had well and truly managed to hock themselves up to the hilt when the world went into recession. The debt crisis in Latin America, which had the international banking community searching the globe for credit worthy borrowers, co-incided with the de-regulation of the Australian banking system and the admission of sixteen foreign banks all anxious to lock up as large a share of the local market as possible. In 1980 Australia's gross foreign debt was $13.5 billion — at the close of 1990 it was more than $155 billion. In 1980 our interest bill absorbed 4.1 per cent of our export income. In 1990 the figure was five times that — 20.3 per cent.

The eighties actually felt better for most Australians than the seventies. In some ways it was almost as good at the sixties -the decade of development. It was all done with credit. The grim fact is that we have now just about reached the limits of our credit-worthiness. In fact, for all but a small handful of private sector borrowers the foreign markets are now closed. It was Treasurer Keating's claim throughout the eighties that critics of our burgeoning foreign debt were panic merchants — that these funds were going into productive investment that would expand our export potential in the future. In fact a very large proportion of these funds went into the stock market casinos where overpriced takeovers funded a boom in asset prices and into the Australian property markets. This spilt over into a residential and office construction boom. This speculative bubble has now burst, pricked by government monetary policy. But such a bust was inevitable. This really is the recession we had to have. And for some Australians it is going to be a long, long recession. The existence of that foreign debt will impose a very low ceiling on the rate of growth the Australian economy can accommodate as it is presently structured.

The US, which is still the key to global economic performance, also has its structural problems. They are nowhere near as daunting as those facing Australia but they are of such magnitude that a sharp rebound in the US would simply set that economy up for back to back recessions. Australia's structural problem is well known to you. We are excessively dependent on commodities for our export income and we have a high demand elasticity for imports that can no longer be financed with foreign borrowings. Our dependence on commodity exports places Australia in a unique position for a member of the industrialised first world club.

Four countries could be said to have achieved equivalent first world status as commodity exporters at the turn of the century. These were the so called countries of new settlement — Canada, Argentina, Australia and New Zealand. Canada has successfully made the transition to a broad based exporting economy. This is largely due to its proximity to and now integration into the populous and affluent US market. That's not the sole reason — Canada's dependence on wheat created economic linkages — especially in railway and related development — which Australia did not enjoy because of its wool oriented export production at the turn of the century. Where Canada has been successful Argentina has been spectacularly unsuccessful. It has well and truly slipped out of the ranks of the first world.

Argentina failed to make the transition from commodities to a broader base of exports for a whole host of political and economic reasons. Had Australia been settled by Spanish colonists with their feudalistic political system then we would be in a much sorrier state today than we actually are. One important reason for Argentina's failure does have particular relevance to Australia in 1991. Argentina was hurt by its exclusion from particular export markets in the pre war and post war period. The Ottowa agreement on 1932, in the middle of the Depression, saw Argentina's grain excluded from the important UK market where it was displaced by the Commonwealth producers — Australia and Canada. Argentina did manage to maintain some beef exports to the UK but the price extracted by the British in terms of trade and tax concessions was both high and humiliating. Then after World War II the European recipients of Marshall Aid were told that they could not spend those dollars on Argentinian wheat and meat. This was America's retribution for the anti-American pro-Axis stance of Peron through the war period. Argentina responded to both these episodes with policies which aimed at making it more self sufficient in manufacturing. It erected protectionist walls and turned inward.

The relevance for Australia is that we are confronting a situation where de facto trade blocs are forming in Europe and in the American hemisphere which carry long term threats to Australia's ability to export its commodities around the globe. As luck would have it — and it is largely luck — this is happening at a time when we have belatedly recognised the impediments to economic development imposed by a regime of industrial protection. It was Paul Keating's proudest boast that he had set in place the conditions for internationalising the Australian economy. Certainly his years in power which saw the deregulation of the financial system, the floating of the exchange rate, a commitment to reducing tariff protection, and the recognition of the absolute necessity of micro-economic reform have seen Australia become more international than at any time since Federation. It's true that the situation was forced on Keating and his colleagues. We had reached the stage where we could no longer earn enough from our commodity exports to subsidise a life style based on political utopianism rather than market forces. The end of that era came at the end of the seventies. We have financed our struggle to maintain the impossible by borrowing from abroad. At the same time we have sold off increasing lumps of our heritage. We can continue to sell off the farm paddock by paddock, declining into genteel and then none too genteel poverty. The loss of political and economic sovereignty to stronger or richer external forces is nothing new.

Two hundred years ago we displaced the Australian aboriginal with the power of the musket. Manhattan was purchased in 1626 by the Dutch West India Company for 40 guilders in beads and trinkets — worth around $24. While I do not believe that this is to be our fate — of being dispossessed, it is certainly a worst case scenario that should be kept at the back of our minds. Australia's future depends on its ability to respond to a global environment which is changing both rapidly and unpredictably. We have quite a lot running for us. This is a very richly endowed part of the world and we have a solid export base to build on. Our problem is to accept the fact that our export base is no longer capable of delivering to our total population the standard of living they are accustomed to enjoying. There are substantial obstacles in getting this message across. Democracies are difficult systems when it comes to structural change. Politicians have a natural reluctance to impose pain even if they know it is for the good of the community.

In all modern societies, but especially in a relatively small one like Australia there are organised interest groups which are able to exert a degree of leverage which can defy the market forces which would exist in your text book free market. A large proportion of our private sector is organised along oligopolistic lines. Labour is organised and disciplined in defending what it sees as hard won terms and conditions of employment. If Australia was caught in a cyclical recession which is probably what many if not most still think is the case, then the prospects of engineering the required basic elements of change would be remote. I believe we are caught in a much more serious and extended structural recession, something I have warned as coming for some time. Our domestic condition is well known. Recovery is dependent on a resurgence in global growth. However, that recovery will be limited by our appetite for imports and by our access to foreign borrowings both to roll over existing debt and to make up the chronic shortfall in national savings.

Global Economic Cycles

First, take the outlook for global growth. Now I suppose Nikolai Kondratieff is slightly better known to you than Lincoln Steffens. Kondratieff was a Russian economist. Unlike Steffens he did not look at the USSR and declare that it was the future and that it would work. He was rather more clear sighted, and for his vision he was liquidated by Stalin. But in 1922 Kondratieff published an essay on 'Long Economic Cycles' based on the examination of economic data going back to the eighteenth century. This data led him to conclude that capitalist systems exhibited quite identifiable long run economic cycles with each wave of between 40 and 60 years duration, each consisting of three basic phases — upswing, crisis and recession. Kondratieff's long waves have a certain seductive symmetry about them which has led some to use his findings as a predictive tool.

The world did have major depressions in the 1840s, 1890s and 1930s, which on Kondratieff's reasoning sets us up for another in the nineties. While believers can argue that Kondratieff does help you read the future I am not one of them. What Kondratieff did demonstrate is that history since the dawn of the industrial revolution has shown that long waves of economic activity have been present. Short run cycles excite no controversy in economics. We can see them all around us: overbuilding of office space leads to a glut, a crisis, a recession in the local development industry and eventually the cycle starts again.

The concept of long term cycles was taken up by Joseph Schumpeter in his study of business cycles. He developed a theory of displacement where the sharp rise in the price of an important commodity, the application of a new invention, new methods of production, new sources of supply, new trade routes, Schumpeter saw the defining character of capitalism – the essential fact of capitalism, as he described it being what he called the 'gales of creative destruction' where it is technological innovation which drives the long upswing of the cycle. But as Schumpeter wrote: 'The more an innovation becomes established, the more it loses the character of an innovation and the more it begins to follow impulses, instead of giving them.'

Looking backwards it is relatively easy to identify the innovations that were associated with the upswing of the Kondratieff long waves. The first began in the late 1780s with the industrial revolution, the adaption of many new inventions, the development of canals, roads and bridges and the development of banking. This upswing ended with the depression of 1836 and the second wave got under way in the mid 1840s with the railroadisation of America, the gold discoveries of California and Australia and the development of water transportation. The cycle ended with the long depression which began in 1873 and the next wave began in the mid nineties with the second industrial revolution that saw the advent of mass production techniques, commercial chemical production, low cost steel, the telegraph and the electric generator. That wave crashed in 1929. The world came out of World War II with an array of innovations which were progressively developed over the next few decades. Although the first computer was built in 1946 it was nearly thirty years before we saw the advent of the personal computer. The aviation industry was also building innovation upon innovation until the era of the Boeing jets heralded mass air transport. Japanese production techniques led to the democratisation of the motor vehicle and in communications the marriage of satellites to computers revolutionised the global financial industry.

There is an accumulation of evidence that these innovations have now reached Schumpeter's condition where they are no longer driving the world economy but responding to impulses from that economy. The computer industry, the airline industry, the motor vehicle industry and the financial industry are all characterised by excess capacity. 1990 recorded huge financial losses in all of these industrial sectors. Nowhere, it must be said, is the degree of excess capacity greater than in Japan and by the Japanese. One of the extraordinary features of the second half of the eighties was the way in which the major Japanese companies playing what they called *zaitech* raised huge sums of money in the global financial markets by issuing bonds with warrants attached. The warrants were ultimately convertible to equity and because the Japanese stock market was booming these warrants enabled the Japanese to raise bond finance at next to nil interest rates — sometimes it was nil and on more than one occasion it was virtually a negative interest rate. This cheap money financed an unprecedented investment boom by the Japanese both domestically and by Japanese companies in foreign markets. The stock market bubble which attracted all this cheap money also underwrote a property boom in Japan. That property boom is now unravelling. As those bond raisings of the eighties mature with worthless warrants, Japanese manufacturers face a massive refinancing problem. The warrants are not going to be converted to equity and the funds which came interest free are going to be rolled over at competitive interest rates. The prosperity of Japan and Asia through the next few years and well into the nineties depends on the ability and willingness of the United States and European markets to absorb exports from these markets.

Australia's Future in the World Economy

It has taken eleven months of recession in the United States combined with strong economic growth in the export markets of Europe and Asia for the US to bring its trade deficit towards balance. This suggests that the medium term sustainable position of the US is either a very weak recovery which does not revive imports or a depreciation in the US dollar to lift its competitiveness. It will probably be a mix of the two. To the extent that economic growth continues to slow down in Asia and Europe the weaker will be the US recovery and the dollar. Japan is going to have to work through its asset inflation and excessive investment. This will inhibit, as it already is, the economic growth of Asia. Apart from the ability of the European and American markets to absorb Asian imports we have the question of willingness. In both economic blocs we see rising resistance to Japanese imports based on short term political considerations.

What I am suggesting is that the prospects for either strong or sustained recovery of the Australian economy in the short term (because they are so dependent on external growth) are poor to dismal. While I am no masochist, this may turn out to be useful in terms of engineering the structural changes which the economy requires to survive. We are fortunate in having a political climate which is close to consensus in defining our problem and in recognising the limited options we face. I do not pretend that there are not considerable differences in terms of emphasis, agenda and priorities. Clearly this is most important in the critical areas of wages policy. But we do not have one major political group canvassing a populist or revolutionary view of society as offering a painless solution to our problems. I do not for a moment suggest that populism has been totally renounced by the body politic but there is a reassuring recognition that our foreign debt imposes a discipline in this area. Australia has no alternative other than to proceed with as much speed as possible to internationalise our economy.

This means the aggressive pursuit of a basket of policies ranging from inflation control; to micro-economic reform; lower barriers to trade and competition; a recognition of the absolute necessity to finance more of our investment from domestic savings. Mainly I suspect through public sector austerity. This will create the pre-conditions for Australia to identify and pursue those areas where we have or can develop a competitive advantage. Each and every one of those policies means economic pain for somebody — and therefore political pain. There would be absolutely no prospect of carrying out such a program if we were enjoying the full employment, high growth, easy credit environment that we have taken as our natural destiny for most of the last forty odd years. And if it all works, the end result is going to be a very different Australia from that which we grew up in. By definition an internationalised Australian economy is going to be very much different from the economy we have known for the last ninety years. To me it is evident that the global political forces are pushing Australia more and more into the Asian sphere of economic activity. We are not going to be frozen out of other markets but the reality is that political imperatives in Europe are going to encourage bi-lateral commodity trading with its eastern neighbours. Only by underwriting those economies can they stop their populations voting with their feet and flooding into the more affluent West. President Bush's push for a free trade agreement with Mexico will, if it succeeds, reinforce the refocusing of US policy that has been under way since the collapse of the cold war. Integrating the Mexican economy into the US will absorb the attention and energy of many Washington administrations to come. As that free trade agreement is extended to cover other Latin American countries, Australia will find itself confronted with increasing discrimination. While Canberra politicians will talk up our alleged special relationship with the US, the reality is that we will count for little in Washington.

A more Asianised Australia, much more Asianised, carries enormous social and political implications that go beyond economics. Nonetheless I believe our Asianisation will be driven by economic imperatives. By Asianisation I do not mean a quantum leap in the Asian population of Australia though clearly that will happen over time. Rather I see Australian economic development as being driven by Asian demands, financed increasingly by Asian investment with Asian management playing an increasingly important role on the ground in Australia. Fortunately this process is occurring. Indeed it is only possible at a time when we are witnessing the industrialization of Asia. Strong economic growth through the eighties has been reflected in fast rising per capita incomes throughout the region. However, even in countries like Singapore and Hong Kong which have average per capita incomes approaching that of Australia the distribution of those incomes is set more by market forces than society standards. Inevitably a process of convergence will occur. To put it at its bluntest, this will not be anywhere near as pleasant a place in the future as it has been in the past for unskilled workers.

The more we 'slow walk' microeconomic reform, the more we believe our commodity exports alone can finance a first world life-style with a large public sector and welfare structure, the more we believe that economic policies should be skewed towards consumption and not saving the greater the chances are of being marginalised by the world in general and by the Asian region in particular. That carries all sorts of implications for social cohesion and therefore national survival.

Conclusion

Let me say in conclusion that from here on in Australia really will be fighting to preserve the best elements of the culture that it has created in this part of the world. It is not going to be able to preserve all the elements of the Australian 'way of life.' You will not hear much mention of egalitarianism. Darwinism will be a more appropriate description. In many ways that's a pity. But that's the nature of things. When you look at it carefully each days marks the end of the world as we know it. The secret of success is learning from past mistakes, the first lesson being that there are no easy solutions.

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ABBREVIATIONS

ABARE	Australian Bureau of Agricultural and Resource Economics
ABS	Australian Bureau of Statistics
ACI	Australian Consolidated Industries
ACTU	Australian Council of Trade Unions
AGSM	Australian Graduate School of Management
ARS	award restructuring
AUD	Australian dollar
AUSTRADE	Australian Trade Commission
BIE	Bureau of Industry Economics
CAD	current account deficit
CIA	Central Intelligence Agency
CIS	Centre for Independent Studies
CP	Communist Party
CSIRO	Commonwealth Scientific & Industrial Research Organisation
CSOs	community service obligations
EMTRs	Effective Marginal Tax Rates
EPA	Environmental Protection Agency
EPAC	Economic Planning and Advisory Council
ETMs	Elaborately Transformed Manufactures
FIFS	fight inflation first strategy
GATT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
GNE	Gross National Expenditure
GTE	Government Trading Enterprise
HEC	Higher Education Council
IRC	Industrial Relations Commission
MITI	Ministry of International Trade and Industry
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of Petroleum Exporting Countries
PR	Public Relations
PSBR	Public Sector Borrowing Requirement
R & D	Research and Development
RULC	Real Unit Labour Costs
SPC	Shepparton Preserving Company
SRPC	Short Run Phillips Curve
UN	United Nations
UNS	Unified National System
XCE's	ex-command economies

GLOSSARY

allocative efficiency	obtaining a mix of goods and services that maximises society's welfare.
apparatchiks	communist party bureaucrats and party functionaries. Especially applicable to technical specialists of politicians or political bodies.
asset price boom	inflation of real estate, share prices and the like in the mid 1980's due to heavy investment by speculators.
award restructuring	process of changing awards to enhance labour productivity by improving efficiency and reducing costs.
balance of payments	accounting record of all current and capital transactions between Australian residents and the rest of the world.
capital account	that part of the balance of payments which records private (non official) and government (official) capital transactions.
capitalism	an economic system based on freedom of enterprise, personal liberty and private property rights.
centralised wage fixing	where minimum wage levels are determined by a central wage fixing authority such as the Industrial Relations Commission.
commodity exports	primary resources such as wool, wheat, minerals, beef and fruit which are sold in foreign markets.
competitive neutrality	creation of a level playing field for privately owned and publicly owned enterprises. Any special advantages and disadvantages applying to government and private trading enterprises are removed.
contestable markets	markets where incumbent firms are threatened by competition from potential hit and run entrants. Previously these markets were considered to be natural monopolies.
contingent valuation	technique used to measure the benefits and costs of environmental resource use by conducting a sample survey of the population, where people are asked questions as to the amount of money

	they would be willing to pay to ensure their use of the environment.
corporatisation	establishing an operating environment for government trading enterprises which replicates the internal and external conditions that successful private enterprises face.
cost benefit analysis	a process of weighing up the benefits of resource use options against the costs and providing information on the relative efficiencies of the options.
current account deficit	a situation in the balance of payments where total payments for imports of goods and services and income transfers remitted to the rest of the world exceed total receipts from exports of goods and services and income from the rest of the world.
debt financing	raising borrowings through the issue of debt instruments such as bonds and fixed interest securities.
decentralised wage determination	wage determination carried out at the enterprise level which may or may not be ratified by an industrial tribunal.
depreciation	the loss of purchasing power of a nation's currency in relation to other national currencies.
deregulation	a process whereby direct government regulatory controls over market forces are removed.
domestic demand	total spending in the economy equivalent to the sum of consumption expenditure, investment expenditure and government expenditure.
ecologically sustainable development	economic development which meets the needs of the present generation without compromising the ability of future generations to meet their own needs.
economic growth	real increase in the economy's ability to produce goods and services in order to meet the community's needs and wants.
economies of scale	reductions in units costs of production as output increases. Sometimes referred to as economies of large scale production.
economies of scope	economies achieved by the joint production of two or more products; ie the cost savings generated by combining two or more product lines.

effective marginal tax rates	the amount that is lost in increased taxes and reduced benefits if an extra dollar of income is earned.
effective rate of assistance	the amount of assistance provided to an industry expressed as a percentage of the total value added by the industry's activity.
enterprise bargaining	negotiation of wages and working conditions between employees and employers within individual enterprises.
equity financing	capital raising through the sale of units of ownership in assets e.g. capital raised through a new share issue floated on the Stock Exchange.
export culture	socioeconomic framework geared to international trade.
fiscal policy	way in which the federal government can vary the level and composition of taxation and government spending to influence economic activity. The federal budget can be used to influence resource allocation, income distribution and stabilisation of economic activity.
floating exchange rate	the exchange rate is determined by the free interplay of market forces in the foreign exchange market.
foreign debt for equity swap	recent trend in Australia's capital account whereby foreign borrowings have replaced foreign investment as a major means of financing the current account deficit.
free trade	international exchange of goods and services without the distorting effects of protection imposed by governments.
Garnaut report	paper released in October 1989 by Professor Ross Garnaut, entitled 'Australia and the North East Asian Ascendancy'. The report called for the elimination of all protection by the year 2000.
GDP	the total market value of all goods and services produced in a country in a given period, usually a year. Gross domestic product is taken to be a measure of a country's national income.
general purpose payments	paid by the federal government to the states as reimbursement for loss of revenue from direct and indirect tax revenues.

glasnost	open exchange of information. Term was coined after 1985 Gorbachev period in the USSR to describe moves to openness of discussion of ideas for reform of Soviet political and economic life.
household saving ratio	percentage of real household disposable income saved.
industry policy	government microeconomic policy that includes general industries assistance programs like protection policy, specific industry plans (e.g. car plan), targeted assistance measures like export assistance schemes and deregulation and privatisation programs.
inflation	refers to the general rate of increase in the general level of prices accompanied by a fall in the value of money.
infrastructure	fixed capital items in the private and public sectors. Often referred to as social overhead capital in the public sector e.g. schools, hospitals, roads, bridges and airports.
innovation	process whereby entrepreneurs introduce new products onto the market or new methods into the production process.
international competitiveness	cost and non cost advantages enjoyed by local firms over foreign firms in both domestic and international markets.
intra industry trade	trade that takes place between firms in an industry that are not necessarily based in one country e.g. trade between multinational parent companies and their subsidiaries located offshore.
investment	refers to the creation of real capital goods by private and public sector enterprises.
labour productivity	a measure of the contribution of labour inputs to total output over a given period of time.
laissez faire	from the French meaning literally 'leave alone or make do' in reference to the government not interfering with market forces responsible for the production, consumption and distribution of goods and services.
level playing field	a situation where competitive advantages and

	disadvantages bestowed on private or public enterprises are removed e.g. protection of some Australian manufacturing firms versus unprotected manufacturing firms.
market competition	a system of resource allocation based on buyers and sellers interacting to determine market clearing prices and quantities.
market environmentalism	the use of market mechanisms such as property rights and the price mechanism to solve environmental problems such as pollution and over use of non renewable resources.
means testing	eligibility for welfare payments determined by relative income levels of applicants.
microeconomic reform	policies designed to improve the efficiency and productivity of various industry sectors by removing impediments to resource allocation and restoring incentives for economic agents.
monetary overhang	inflationary problem created in the the USSR and Eastern European command economies through the excessive printing of money to fund government enterprises when losses are incurred.
monetary policy	implemented by the Reserve Bank of Australia with the intention of influencing the availability and cost of credit in the economy.
monopolistic competition	market structure characterised by a large number of sellers, easy entry and a differentiated product where each seller has some degree of control over price or output.
monopoly	market structure characterised by one seller of a good or service. Entry into the market is severely restricted and the monopoly firm has the power to control either price or output.
monopsony	market structure in which there is only one buyer. Marketing boards of primary produce are usual examples of monopsonies.
natural monopoly	market structure in which one firm with an optimal scale of plant is able to supply the entire market. Public utilities in the water, gas and electricity industries are common examples. However contestability theory suggests that these industries may be opened up to competition.

net foreign debt	gross foreign debt minus debt by foreigners owed to Australians.
nomenklatura	elite members of the communist party in command economies in receipt of privileges not available to others.
nominal interest rate	the real rate of interest plus the expected inflation rate.
OECD	Organisation for Economic Cooperation and Development formed in 1961 to foster economic growth and development in member countries.
oligopoly	market structure characterised by a few sellers, restricted entry and a differentiated product. Oligopolies are also characterised by the interdependence of rival firms and the uncertainty of action by rival firms.
perestroika	term used to refer to the economic restructuring taking place in the USSR during the Gorbachev era.
perfect competition	market structure which is a theoretical paradigm characterised by unlimited numbers of buyers and sellers, unrestricted entry, homogeneous product and perfect knowledge.
Phillips curve	empirical relationship showing combinations of inflation and unemployment over time in an economy.
poverty trap	situation arising from disincentives of welfare recipients to enter the paid workforce because of high effective marginal tax rates. In other words, potential loss of welfare benefits may dissuade welfare recipients from working and hence they remain on welfare indefinitely.
privatisation	action taken to sell off part or all of a public asset to the private sector. It can also take the form of competitive tendering by the private sector for the right to provide public services or contracting out of services previously provided by the public sector.
priviligentsia	those in command economies in receipt of privileges due to their position or authority not available to ordinary members of society.
productive efficiency	minimisation of the cost of a given level of output.

property rights	individual claims on resources or assets through legal ownership or payment of a contract price.
protectionism	any artificial advantage bestowed by a government on a local industry which is designed to give that industry an advantage over foreign competition e.g. tariffs, subsidies, quotas etc.
public sector borrowing requirement	the total volume of funds sought by all government and semi government bodies from financial markets in one year. It is a measure of the total annual borrowing needs of the public sector as a whole.
Reaganomics	economic policies pursued by successive Reagan administrations in the USA (1980-1988) featuring control of inflation, tax cuts and deregulation of markets in order to boost economic growth and employment.
real interest rate	the nominal interest rare minus the expected rate of inflation.
recession	a downswing in the business cycle characterised by negative economic growth in two or more consecutive quarters.
recovery	an upswing in the business cycle characterised by rising business and consumer expectations and employment and investment opportunities.
regression analysis	simple econometric technique for testing of an economic hypothesis.
rent seeking	obtaining unearned incomes through activities designed to secure political or economic favours from government at the expense of others in the community e.g. recipients of tariff protection.
saving	that part of income not consumed.
seller concentration	extent to which particular markets are dominated by the largest firms operating in that market.
socialism	an economic system based on the collective ownership of the means of production. A central planning authority assumes the responsibility for resource allocation, production and income distribution.

specific purpose payments	payments to the states from the federal government which are tied to a particular area of expenditure, eg. capital works.
structural efficiency principle	introduced as a wage fixing principle under the Mark IV Accord agreement in 1988. Wage rises were linked to rationalisation of awards, flexibility of work arrangements, multiskilling and broadbanding of work activities.
structural reform	a process fostered by government policy initiatives designed to alter the structure of the Australian economy and make it more efficient, productive and internationally competitive.
sunk costs	costs incurred in setting up a business that are not recoverable if the firm leaves the industry.
sustainable development	economic development which takes into account the renewal of resources and the needs of future generations.
tariff	a tax imposed on certain imported goods. eg. customs duties on imported cars and trucks.
terms of trade	is a ratio of a country's export price index to its import price index expressed as a percentage.
the Prices and Incomes Accord	a consensual incomes policy established between the federal Labor government and the ACTU after the National Economic Summit Conference in April 1983.
traded goods sector	that sector of the economy producing goods and services in competition with foreign producers. The traded goods sector includes the export and import competing sectors of the economy.
unemployment	refers to that part of the workforce not actually in full time or part time employment. Unemployment is usually expressed as a percentage of the workforce.
unified national system	implemented in 1987 by the federal government as a means of amalgamating higher education institutions.
Uruguay Round	commenced in 1986 as the eighth round of GATT talks since 1947. Most notable among the 15 negotiating groups were those focussing on services, trade related intellectual property rights, agriculture and trade related investment measures.

voluntary workplace agreements	negotiated outcomes between employees and employers in the absence of a third party such as the Industrial Relations Commission or state industrial tribunals.
wage tax tradeoff	situation where wage increases are moderated in return for tax cuts. This policy was used in negotiating the Accord Mark IV and VI.
wages policy	federal government initiatives to control wage inflation and restore productivity levels primarily by using the Accord mechanism involving the ACTU.
welfare programs	federal and state government cash payments and benefits in kind to low income earners, the aged, unemployed, the sick and disabled members of society. Note also that welfare is also provided to the needy by many privately operated welfare organisations and charities.

LIST OF ATTENDEES

James Adby	Jesmond High School	NSW
Gerard Alford	The Hutchins School	TAS
Linda Allen Mato	Gladstone State High School	QLD
Alexia Anger	St Hilda's School	QLD
Paul Angus	Xavier College	VIC
Hos Atallah	Newcastle College of Tafe	NSW
Jim Barns	Distance Education Centre	WA
Angela Battaglia	St Brigid's College	WA
A L Beilby	Kenmore State High School	QLD
Margot Best	Presbyterian Ladies' College	WA
Veronica Bondarew	Monte Sant Angelo College	NSW
Del Bower	Prescott College	SA
Mark Bowler	Prescott College	SA
M Brooks	Sacred Heart College	VIC
Heather Brown	Sefton High School	NSW
Phil Brown	Sydney Adventist High School	NSW
Brian Burford	Pembroke School	SA
Allan Cameron	All Hallows' School	QLD
Helen Ceron	St Aidan's School	QLD
Tony Channell	St Catherine's School	NSW
Paul Cheney	Sacred Heart College	WA
Julie Churchman	Ed. Dept of SA Fulham Gdns Curric. Unit	SA
Elizabeth Clark	St Patrick's College	NSW
Jane Clarke	Newtown High Sch.. Performing Arts	NSW
Peter Coffey	St Michael's College	SA
Trevor Collins	St Anne's & Gippsland Grammar School	VIC
Judy Cribb	Wenona	NSW
Elaine Crommelin	S. Margaret's School	QLD
D Davidson	Cabramatta High School	NSW
Laurel Dawson	Victoria College	VIC
Carol Dennison	US Consulate	NSW
Sharon Ditmarsch	Sydney Grammar	NSW
Garth Divola	Kincoppal – Rose Bay Convent	NSW
Michael Donnelly	Marcellin College Randwick	NSW
Peter Duckett	Trinity College	WA
John Duncan	John XXIII College	WA
Margaret Eubank	USIS	NSW
Richard Fairley	Brisbane Boys' Grammar School	QLD
Brent Farquhar	Blackfriars Priory School	SA
Stephen Paul Faulkner	St Pauls School	QLD
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