'Economic rationalism' is under siege. To many of its opponents, it seems like high time to break the stranglehold of economic thinking. Greg Mahony disagrees. He argues that its critics can't avoid the real economic problems which the reign of 'rationalism' has highlighted.

A film sound man recently told me of the difficulties of choosing where to splice or dub cicadas into a soundtrack. Whether they be of warning or pleasure, the noises emitted by these emblems of our summer come in such overlapping waves that any point of entry or exit into the recorded sound creates an unwanted dissonance on the sound track. For a sound editor it's difficult to capture that interior sense of being caught in the swarm of sound, and then difficult to break out of it.

If my lyricism has seduced you this far then you should be warned you are into yet another article on economics by an economist. This can be your last one for the year; then you can get back to that David Malouf novel that you promised yourself for the summer.

However, let me first explain the purpose of my opening metaphor.

I want to argue here for the necessity that economic theory inform the current political debate on social and economic policy. Yet trying to say something useful about that at the moment is a bit like that sound editor's problem. We now hear so many attacks on something known as 'economic rationalism' from members of federal cabinet, caucus, trade unionists, and academic sociologists, that the sound is becoming deafening—and the chorus may yet be joined by a disaffected ex-treasurer. Even dissident Liberals like Jeff Kennett have one foot on the cart. John Button and John Dawkins have certainly lost the faith; perhaps only someone as dogged as Ralph Willis could hang in there for so long. (Maybe someone should tap him on the shoulder.)

Yet most of these noisy objections to economic rationalism seem not to differentiate between economic ideas they dislike and a plain rejection of the objects of analysis of
economics in general. Many of the critics mistake a vulgarised version of the conventional economics (otherwise known as 'marginalism' or 'neoclassical economics') with the whole corpus of economic thought. So we are being asked to dispense with the central concerns of economic theorising in general along with a particular, unpopular theory.

This seems to me foolish. I want here to set out some economic reasons why intervention in the market is perfectly rational, as are arguments that this intervention should encompass industry policy. While I believe that highbrow economic theory can and needs to be part of this debate on market intervention and its forms, here I'll try another way of splicing into the soundtrack. My arguments will attempt to appeal to your practical side rather than threatening you with those much feared abstractions of theory.

Certain objective conditions confront the Australian economy and by implication civil society in Australia for the foreseeable future.

Our basic economic conundrum is that the level and structure of productive capacity does not match the level and composition of demand generated by the level and distribution of our national income. In other words, producers are unable to produce enough domestically to provide for our consumption needs.

This in itself should present no insurmountable difficulties to a national economy so long as there is a steady and sustainable export performance to service the demand for imports, both of consumption and capital goods. But Australia also has problems with its terms of trade—in other words, with the relative prices of exports and imports. Both the prices Australians pay for imports and those Australian firms receive for their exports are volatile—and many argue that there is a secular tendency for the former increasingly to outstrip the latter. For example, the truckloads of wheat Australia exports get steadily cheaper in terms of electronically aided machinery that is imported. These characteristics of Australia's economy mean its ability to generate sustainable growth from whatever source—in other words, to generate growth which doesn't drag in more imports than it generates exports—is heavily constrained. Furthermore, it is transparent that the economy is not in the process of any significant structural transformation of domestic (i.e. Australian) production that could serve to favour im-
proved living standards. Lastly, no significant redistribution of income or property seems politically achievable. It should also be obvious from this litany that even an egalitarian collectivist Australia would face most of these economic problems.

If we can all agree that this is a reasonable summary of the country’s position, then I see only three paths to follow which might help remedy our plight—unless we believe the Australian economy can grow sustainably as manna falls from heaven. Governments can:

Argument 1: Change the composition of demand for imported goods. In other words, they could try to reduce the demand for certain types of imported goods—such as capital goods, machine tools, intermediate goods and some luxury goods.

Argument 2: Alter the structure of existing productive capacity to provide more adequately for domestic demand. In other words, ensure that domestic producers produce more of what domestic consumers actually consume, but which they currently consume in the form of imports.

Argument 3: Shift resources to the export sector and increase the proportion of tradeable goods to non-tradeable goods—or, in other words, increase the relative and absolute amount of resources in export industries. In short, increase net exports.

How would Australia be without industry policies of some sort now and in the past?

For the most part Argument 1 is undesirable because it affects Australia’s capacity to produce goods for export, and because it militates against industrial restructuring. The prospects of our significantly reducing imports of luxury goods seem politically unlikely and, in any case, the economic gains from this kind of political courage would not be so very great. If there is an argument for reducing luxury consumption per se it is best addressed through the tax system.

Argument 2 provides little room to move unless we increase the absolute size of Australia’s productive base. Some important sectors of the economy, such as manufacturing, are already small by international standards—especially in comparison with countries with solid performances in trade and growth.

It is easy to find problems with the existing productive capacity and then fiddle at the edges with microeconomic reform, ‘restructuring’ and some rationalisation of costs and charges. But in the final analysis the gains are probably small and even ephemeral. Another way of putting the same point is to say that the so-called efficiency gains from the reallocation of resources to more efficient ends are hard to identify and to quantify. Any general proposals for restructuring require an appropriate and coherent theoretical foundation and this is sadly lacking in all quarters, from the Industry Commission and its fellow-travellers to the Caucus Left.

Argument 3, on the other hand, is desirable because it aims to increase both the share of exports in national output and the absolute size of the export sector.

So, of the three possible paths available, only the third one (increasing exports) offers a viable course for policy—again assuming no other sources of growth.

Now let’s examine two different stories of how to improve export performance. Two things presumably underpin such enhanced export performance. The first is improved productivity in order to produce things better. The second is a higher rate of profitability in the tradeable goods sector than in the economy as a whole; this is important in order to sustain the shift in resources to it or to maintain the relatively higher rate of growth. So, just how is this increased productivity and this ‘differential profitability’ (as it is termed) to be effected?

Story 1

The conventional story stresses the need to ‘get prices right’. In other words, appropriate relative prices for different inputs to production, and for products, are meant to generate efficiency in the choice of what to produce and how to produce it. But this stress on the importance of relative prices seems unconvincing. In particular, it seems to overemphasise the importance of the role of prices in the choice of technique. Or, to put it another way, it overestimates the importance of prices in redirecting investment to transform the industrial structure. For example, a cut in wages relative to capital will not in general lead to more mechanised or less ‘labour intensive’ production.

‘Getting prices right’ is really an avatar of the dominant principle of substitution in conventional economics—in other words, the principle which says that, in production, prices act as the most important signal for enterprises when choosing between different forms of production; and, in consumption, that prices are a reflection of the sovereignty of the consumer. For instance, ‘getting prices right’ underpins the theory of international trade which claims that nations tend to specialise according to their ‘comparative advantage’. Yet if relative prices aren’t crucial to the choice of technique, as I indicated above, then they are just as inadequate as signposts for structural change.

In this story, then, structural change is an essentially passive response mechanism, a reflection of a change in prices that in turn is thought to be generated by a change in tastes. In this story structural change is not a dynamic force in itself, nor is it a result of diverse social and historical processes. Rather, the thrust of this story is twofold: ap-
propriate relative prices will create the solution to the net exports problem, and thence to reducing Australia's foreign debt; and this 'solution' will also generate conditions of full or near full employment.

This is a brief and critical snapshot of what I see as the basis of today's accepted policies.

Story 2

I subscribe to a different story, which I'll outline in a series of assertions (all of which can be supported by fuller economic argument than I have space for here):

Assertion 1: There is a need for the government to manage the level of effective demand — and this means the government devoting its attention not just to the amount, but also to the composition of investment. This assertion is based on the view that the market mechanism will not deliver full employment, and that the economy tends towards levels of equilibrium which have no necessary correlation with full employment of the labour force or productive capacity. At the more concrete level, attention to the composition of investment involves sectoral policies — policies devoted to particular sectors of the economy — and these in turn imply industry policy.

Assertion 2: As I suggested earlier, 'correct' relative prices will not do the job. It is not simply that they are abstractions and unattainable in the real world; the point is rather that relative prices do not serve the function in a market economy ascribed to them in Story 1. They are neither indexes of scarcity nor easy indicators of efficiency. They do matter greatly, but more as indicators for the allocadon economy ascribed to them in Story I. They are neither suitable should therefore not be the primary focus of capital than as the means of restructuring the economy. Relative prices do not serve the function in a market and unattainable in the real world; the point is rather that will not do. It is not simply that they are abstractions and unattainable in the real world; the point is rather that relative prices do not serve the function in a market economy ascribed to them in Story 1. They are neither indexes of scarcity nor easy indicators of efficiency. They do matter greatly, but more as indicators for the allocation of capital than as the means of restructuring the economy. They themselves should therefore not be the primary focus of policy — rather this place should be accorded to the accumulation of capital and the creation of economic growth.

Assertion 3: The historical development of the Australian economy militates against the view that 'the market will take care of it'. Rather, I'd argue that sectoral policies are needed today, just as they have been needed in the past. Today these policies are identified with terms such as: priority sectors, leading sectors, clusters or industrial districts — in other words, with a vocabulary of terms suggesting local and locally-coordinated initiatives, and not necessarily grand plans.

Assertion 4: For an industry to be successful it is likely that a critical mass is required, both in terms of market size and in terms of interlinkages of production within the economy. This is the real and pervasively dynamic nature of the concept of economies of scale.

Assertion 5: This is not so much an assertion as one or two rhetorical questions. How would Australia be without industry policies of some sort now and in the past? And how will we describe the economy in the early part of next century, especially if the 1990s are to be the decade of Hewson's scorched earth policies?

In arguing the specifics of proposals that may be associated with Story 2, the litmus test of their viability should be the aforementioned requirement that more favourable rates of productivity growth and profit prevail in the favoured sectors or industries, at least in the medium term. The exact types of market intervention and industry policy are outside my scope here. I can only draw attention to the need for them, and for this need to be supported by a range of arguments including the theoretical.

That other fairytale I'm thinking of goes something like this: a team of well meaning social scientists, activists and 'program directors' takes advantage of the discrediting of 'economic rationalism' to club together and cobble together something resembling a coherent government policy on social and economic matters that will purport to allow equity and some prosperity for the mass of working people in Australia — and all without having to pay heed to the economic concerns outlined here. I'm sure this fairytale has mass appeal to those people sick of a decade of economic arguments and rationales, and nostalgic for an imagined past of wise-minded mandarins. It's just the consequences of this particular fairytale which horrify me.

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Flood Relief

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Massive damage was caused to two provinces in southern Vietnam when a typhoon hit in early August. Tens of thousands of homes were destroyed, with paddy fields, schools, hospitals and roads being damaged. Estimated damage was US$8.6 million in one province alone.

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