Shutdown

The Failure of Economic Rationalism

And How to Rescue Australia

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With
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and others
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Singapore

Although Singapore is but a small city-state, it has assumed a disproportionate significance for economic debates throughout the world. It is one of the Asian newly-industrialising countries (NICs), along with Taiwan, South Korea and Hong Kong, to have achieved remarkable economic growth in recent decades. As a result, policy-makers in less-developed countries (LDCs) have been especially interested to learn from Singapore and the other NICs. This has been encouraged by international organisations like the World Bank and the International Monetary Fund which have virtually accorded model status to the export-oriented industrialisation strategy common to the NICs.

But analysts in advanced industrial countries, including Australia, where economic growth has slowed or stagnated, have also started to look to the NICs for insight. In spite of the contrasting stages of development, there is a belief that certain instructive essentials about the growth process can be observed in the NICs. Academic writers, commentators, policy-makers and advisers are drawing on their understanding of the NICs’ experiences to prescribe domestic changes in economic policy.

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This has, however, tended to be a heavily political and ideological exercise. The problem is that, at least within Australia, debate about the NICs is dominated by orthodox neo-classical economics. This theoretical framework not only underestimates or excludes important factors, such as the role of the state and the social and political bases of economic success, but starts from a not unrelated ideological preference for free-market forces. Commentators, politicians and others, often with little or no knowledge of the serious factual and theoretical objections to such analyses of the NICs, quite readily draw on work within this framework to justify a domestic policy agenda that exalts market forces.

As this brief case study of Singapore demonstrates, however, while there may well be lessons for countries like Australia in the experience of the NICs, they are certainly not those generated by neo-classical economic analysis. There may have been a significant free-trade component in the development strategies of Singapore and Hong Kong, and to a lesser extent Taiwan and South Korea, but free trade and free markets are not the same thing.

Indeed, the role of the state has been so pervasive and dynamic in shaping the investment climate in Singapore that we might reasonably question the utility of a theoretical framework that so decisively distinguishes between the two concepts, state and market. If there is a single instructive point to take from the NICs, it is the theoretical and practical falsity of preoccupation with a market/state dichotomy. It would be more useful to take interaction between market and state as given and to devote greater attention to the particular forms this can take and with what consequences. The debate in Australia should be more about the qualitative nature of the state’s interventions — not the degree.

THE MYTH OF COMPARATIVE ADVANTAGE

Neo-classical economic theorists welcome increased global specialisation of production and trade as a rational shift towards greater efficiency in economic activity bringing mutual benefits to all involved. This view derives from 'comparative advantage' trade theory, also known as factor proportions trade theory. In essence, countries with a relative abundance of one factor (land, labour, capital) should specialise in production based on that factor because that abundance will be reflected in lower costs. So a country with a relative abundance of labour should exploit that lower cost in labour and concentrate on labour-intensive production. The theory does not rule out changes in a country’s comparative advantage, but explains these in terms of dynamic market forces. For example, within a given country, economic development resulting from the exploitation of abundant, cheap labour may over time actually result in greater demand for labour, causing a relative scarcity and greater costs. According to this theory, all countries have a comparative advantage: the task is to identify and fully exploit it. In this sense, comparative advantage has the status of a law of economic behaviour.

This theory has been applied to the NICs essentially as follows. The regimes in these countries have paid due attention to the law of comparative advantage. Here the different factors of production have not been distorted by state intervention, either through excessive tariff protection or excessive wage policies. Instead, market forces have largely prevailed. To the extent that the state has been important at all, it has been in support of market forces, not in contradiction of them.

I want to show that this sort of account is invalid for Singapore. Not only has the Singapore state engaged in extensive intervention, but it has helped to define comparative advantage through these interventions, which have taken a variety of direct and indirect forms — some economic, some political and social.

In the economic sphere this has involved direct investments, a centralised wage system, subsidised social and physical infrastructure, below-market and even interest-free loans for investments in preferred areas, and tax concessions for favoured investments. In the political and social spheres the state has played a crucial role in curbing industrial militancy and nullifying the effectiveness of organised labour as an independent force. The state, through specialised institutions, has also provided planning and co-ordination to target specific sorts of investments. These interventions and others, either directly or indirectly, have influenced the price of the different factors of production, and the investment decisions that have ensued.

To establish the above points, let us examine the distinct phases of development in Singapore since the adoption of an export-oriented industrialisation strategy in the mid-to-late 1960s. What we see is that the state’s role has undergone some change of emphasis over time, but that it remains central to the development process.

THE INITIAL INDUSTRIAL PHASE

In the early 1960s, Singapore’s policy-makers pursued an industrial strategy premised on the expectation of a political merger of the city-state with the Federation of Malaysia. This, it was expected, would provide a sizeable domestic market for manufactured goods. But the merger was brief and unsatisfactory, lasting only from 1963 to 1965.
With its collapse, and the prospect of a common market largely dashed, circumstances suddenly forced policymakers to consider export-orientation as the basis for industrialisation. Fortuitously, international companies were at this time seeking alternate, lower cost sites for labour-intensive manufacturing production intended for markets in the advanced industrial centres. Taiwan, Hong Kong and South Korea had already attracted investments on this basis.

It should be understood that this swift change of strategy by Singapore’s policymakers was greatly aided by an unusually high degree of immunity from domestic political forces linked either to capital or labour. The business community had alienated itself from the nationalist People’s Action Party (PAP), with its close colonial links, which came to office in 1959. In the 1950s and 1960s, the left-wing labour movement provided strong support for the PAP. But it was not able to break the hold over the party executive exercised by Lee Kuan Yew and his middle-class cohorts, and in 1963 formed a separate party, the Barisan Sosialis (Socialist Front). Lee did not hesitate to employ the full power of the state to negate the Barisan and all other political opponents within the labour movement and beyond.

The adoption of the new economic strategy by the PAP was premised on the attraction of foreign investment. To achieve this, dramatic interventions in industrial relations were undertaken, crystallised in two major pieces of legislation. First, there was the Employment Act of 1968 which significantly reduced employees’ wages and conditions, and increased the standard working week by five hours. Second, there was the Industrial Relations (Amendment) Act which considerably expanded the powers and prerogatives of management.

By expanding the rights of management and limiting the opportunity for resettling collective agreements, the PAP intended to greatly weaken the scope for industrial action. Collective bargaining was seriously undermined and a corporatist ideology was imposed on industrial relations: the traditional role of unions as legitimate interest groups was finished. Before long the PAP had succeeded in co-opting organised labour through the state-sponsored National Trades Union Congress (NTUC), and was harnessing trade unions to PAP-defined development goals. This was reflected in the statistics on industrial stoppages. In 1961 there were 116 stoppages involving 43,584 workers and the loss of 410,889 days. In 1969 Singapore was free of any stoppages due to strikes. Since then Singapore has been nearly strike-free.

When inflationary pressures in the early 1970s threatened to bring instability to industrial relations, the government took more direct control over wage levels. In 1972 it formed the National Wages Council (NWC), a tripartite body comprising representatives from government, employers and the NTUC. In practice, the government held the whip hand since senior NTUC appointments were invariably PAP cadres or strong party sympathisers. The guidelines set by the NWC soon came to be widely adopted.

The point here is that these political relationships forged by the state were integral to the economic strategy. They were designed to curb industrial action, weaken bargaining power, and hence to reduce the cost of labour. This was part of an active attempt to foster export-oriented industrialisation led by foreign investment which needed disciplined, low-cost, semi-skilled labour.

Other measures taken by the state to create a climate conducive to export-oriented industrialisation in this period included the provision of special institutional support, tax incentives and other concessions, direct government investments and accelerated infrastructural development.

The state’s economic intervention since self-government can be traced to the First Development Plan, 1961–64. Included in this plan was the establishment of an Economic Development Board (EDB) as a statutory body to centralise and co-ordinate relations between government and investors, and to implement various investment incentive schemes. At this stage, the EDB also had the responsibility to develop special industrial estates (known as export-processing or free-trade zones) comprising extensive, subsidised infrastructure and utilities. Taiwan and South Korea also placed emphasis on such estates in the initial stages of their industrial programs.

By 1968, the EDB had invested S$136 million (in fixed assets) in industrial estates. So rapid was the expansion of these estates and so important their function that in 1968 the Jurong Town Corporation (JTC) was formed to specialise in the provision of industrial estates. This led the EDB to concentrate more on investment promotion and co-ordination. The JTC’s investments expanded with Singapore’s industrialisation — it invested S$161 million in 1974 alone.

It is worth noting that the EDB had its parallels in Taiwan with the Council on International Economic Co-operation and Development (CIED), and in South Korea with the Economic Planning Board (EPB), both of which were established in the early 1960s. In each case, these organisations have been important mechanisms for the co-ordination of a comprehensive range of plans and discriminatory policies in favour of export production.

Heavy state outlays in infrastructure were characteristic of Singapore throughout the 1960s, enacted through public monopolies such as the Public Utilities Board (PUB), the Telecommunications Authority of Singapore (TAS), the Port of Singapore Authority (PSA) and the Housing Development Board (HDB). Once committed, however, to an
export-oriented manufacturing program, the government established a variety of new state institutions in addition to the JTC. These included: the Development Bank of Singapore (DBS) which was to provide long-term finance at low interest rates for preferred investments; Neptune Orient Lines (NOL) to expedite foreign trade and ensure lower freight rates for Singapore-manufactured goods; and the International Trading Company (Intaco) to develop overseas markets and trade with centrally-controlled economies. Again, Singapore's policy-makers took the initiative to shape the investment climate and the conditions affecting profitability.

The expansive role of the public sector was facilitated to a large extent by the government’s ability to appropriate a large portion of domestic savings. It did this through a compulsory employee superannuation scheme, the Central Provident Fund (CPF), and the government-owned Post Office Savings Bank (POSB).

Clearly the economic strategy was grounded in a conscious attempt to cultivate investments by multinational corporations engaged in export production, and to that extent it relied upon a liberal global trading regime. But Singapore’s policy-makers were not ideological purists on this issue. Preferential tariff treatment remained for local vehicle assemblers, as did import duties on a broad range of foodstuffs and consumer goods.

The government also engaged in direct productive investments in this early industrial phase. This was partly in response to the withdrawal of British military operations and personnel, which had serious implications for the dockyards in particular. Thus, companies such as Keppel Shipyard, Singapore Shipbuilding and Engineering, Jurong Shipbuilders, Bethlehem and others were established.

The strategy achieved quick and substantial results. Foreign investment, which stood at just S$157 million in 1965, jumped to S$995 million by 1970 and rose progressively to S$5.242 billion by 1978. Unemployment, which was 5 per cent in 1965, fell to 4 per cent by 1974. Indeed, during the 1970s many firms were experiencing serious labour shortages.

THE "SECOND INDUSTRIAL REVOLUTION"

Throughout the 1970s there was a gradual increase in the technological sophistication of production being undertaken by international companies in Singapore. Alongside the assembly operations in electrical/electronics and various other low value-added operations, middle-level technologies involving precision engineering in a range of industries were emerging. Encouraged by this, and with a political preference for stemming the considerable expansion of guest labour – imported temporary labour contracted to approved companies – required to service Singapore’s rapid economic growth, the government developed a comprehensive set of policies to usher in the so-called "Second Industrial Revolution.”

The idea was to accelerate Singapore’s transition to a more technologically sophisticated economy – one that could sustain higher living standards and at the same time reduce reliance upon guest labour. This marked a new high in the state’s interventionist approach to development. The two-pronged strategy behind the Second Industrial Revolution involved measures to discourage unskilled and labour-intensive production on the one hand, while cushioning the costs of raising skills and enhancing higher value-added production on the other.

It was a collection of carrots and sticks. The chief stick was undoubtedly the government’s high-wage policy introduced in 1979, referred to as the ‘corrective’ wage policy because it was intended to undo the effects of the previous low-wage policy enacted through the NWC. After three years the total NWC-recommended wage bill for employers had increased by between 54 and 58 per cent. Of this, employers were required to increase their contribution to the CPF by 4 per cent and to add another 4 per cent to the employee contribution. A further 4 per cent of the wage bill went into a newly-established Skills Development Fund (SDF) which employers could draw on to upgrade the skills of the workforce.

Obviously hardest hit by these increases were those labour-intensive firms of marginal profitability. Government ministers publicly declared that, where possible, such firms should automate and mechanise to stay competitive, but failing that they should either relocate outside Singapore or shift investments into higher value-added areas.

In a complementary move, the government abolished preferential tariff treatment for local vehicle assembly, leading to the closure of all foreign companies in the industry and of the country’s sole tyre manufacturer, Bridgestone. Import duties on various other products were abolished. Industries the government was previously prepared to protect were now seen as anachronistic in this new development phase.

To offset the pressure exerted on manufacturers in lower value-added areas, however, a host of incentives were provided for those heading in the desired direction, and considerable sums were invested in social and physical infrastructure to underwrite the technological transition.

Even before 1979 significant assistance and incentives were available for higher value-added investments, including exemption from the 40 per cent company tax for up to ten years (with a possible renewal).
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After 1979 these schemes were extended and given a sharper focus. Research and Development (R&D) was specially targeted and included double tax deductions for R&D expenditure and an investment allowance of up to 50 per cent of capital investment in R&D.

Capital allowances for plant and machinery were also liberalised, enabling firms to invest more after-tax earnings in mechanisation and automation through speedier depreciation. Finance for existing schemes like the Product Development Assistance Scheme and the Capital Assistance Scheme was also greatly increased. Training costs to employers could be significantly defrayed through the SDF. For instance, between 30 and 70 per cent of training costs were subsidised through the SDF for preferential projects in electronics.

Long-term, fixed rate loans at concessionary rates were also boosted for priority projects, and became an even more important element in the EDB's industrial promotions. Probably the biggest single breakthrough in the period of the Second Industrial Revolution was the attraction of the Italian electronics company SOS-Atex to establish a semiconductor wafer diffusion plant. Managing Director, Guido Zarzini, maintained that government incentives were a significant lure in deciding the location of the plant. Indeed, the company received a ten-year tax holiday, subsidised training costs and a substantial concessionary loan from the EDB.

In a concerted effort to generate a workforce to sustain the technological shift in the economy, government expenditure on education was increased by over 1,000 per cent from $33 million in 1978/79 to $375 million in 1982/83, with special emphasis on the supply of engineers. In addition, a number of technological institutes were set up in collaboration with various donor governments, including the German-Singapore Institute of Production Technology, the Japan-Singapore Institute of Software Technology, the French-Singapore Institute of Electro Technology and the Japan-Singapore Technical Institute. Through these and other initiatives the state played a critical role in raising the skills of workers so essential to any accelerated industrial restructuring.

Massive new state investments in physical infrastructure through the JTC were important too. One estimate of the cost of the JTC Ten Year Master Plan (1980-90) was $52.5 billion. The plan included specialisation facilities to encourage investment in targeted industries, including: the reclamation and development of the Southern Islands as an international petrochemical manufacturing and distribution centre; the development of Loyang as the first aviation centre; and an engineering base to support offshore oil and mineral exploration.

Singapore

Direct government investment was another significant aspect of the new industrial strategy. Since the 1960s, the pattern had been for direct government investments to expand and diversify. By 1983, the government had invested in fifty-eight companies with a paid-up capital of $3 billion. The majority of investments were channelled through the government's three holding companies: Temasek, Sheng Li and MND.

The advent of the Second Industrial Revolution saw the strategic use of such investments to promote higher value-added industries and processes. Towards this end, for example, the Sheng Li-owned companies were grouped together in 1983 to form the Singapore Technology Corporation (STC). The intention of STC was to pool resources to develop and market high technology products made in Singapore. It was established with a S$200 million capital base. The government was also a substantial investor in a series of joint-ventures which put together a S$2 billion fully integrated petrochemical complex – the first in Southeast Asia.

One of the more interesting initiatives, however, was the establishment of the Government of Singapore Investment Corporation (GSIC) in 1981 to manage Singapore's massive foreign reserves – officially S$16 billion at the time. Through the GSIC it was hoped that, through overseas investment, greater access to the technology of the world's leading companies could be secured.

Quite clearly, then, the Second Industrial Revolution involved not just a consolidation of the state's economic intervention, but a refinement of its forms. In particular, the state engaged in both aggressive and negative discrimination in its industrial policies.

Again, as in the earlier industrial phase, the state engaged in social and political intervention in the service of an economic strategy. Most notable in this regard was the change in institutional control over organised labour. The country's two largest trade unions, the Singapore Industrial Labour Union (SILU) and the Pioneer Industries Employees' Union (PIEU), were broken up into nine industry-based unions. Enterprise unions were also introduced, despite some worker resistance.

There were two reasons for this reconstitution of trade unions. First, the new structure better accommodated the industrial restructuring envisaged. Second, SILU and PIEU covered 90,000 workers collectively. Restructuring would inevitably involve retrenchments and other inconveniences for workers. Large unions, even if penetrated by the ruling party, had greater potential to resist such developments.

In addition, the PAP embarked on various ideological campaigns to instil in workers an understanding of the methods and objectives of economic restructuring. The constant theme was the need for 'team
work to increase productivity. Inspired by the Japanese model, a form of company well-being was introduced to encourage workers to identify more strongly with the goals of the companies employing them.

Social engineering was another element of the economic strategy. According to Lee Kuan Yew, the demands of Singapore's changing economy necessitated policies to encourage more university graduates to marry each other and reproduce. Otherwise, according to Lee, the country's genetic stock would decline, there would be a short-fall in the pool of intelligent people to occupy the most demanding and skilled positions, and the country's potential for economic transformation would be compromised. Accordingly, tax and other incentives have been introduced and a Social Development Unit established to promote graduate marriages and procreation.

In short, the Second Industrial Revolution amounted to a comprehensive and integrated plan of social, political, and economic intervention.

BEYOND THE SECOND INDUSTRIAL REVOLUTION

The period of the Second Industrial Revolution witnessed some significant gains. Foreign investments rose substantially from S$6.349 million in 1979 to S$12.717 million in 1985. During this time, value-added per worker, a measure of productivity and technological sophistication, increased from S$23,992 to S$42,436. Industries like electronics, machinery, chemical and aerospace underwent substantial technological upgrades. Yet, by the mid-1980s, it was also evident that there were structural limits to the economy's reliance upon the manufacturing sector as a basis for growth. By contrast, the potential of the services sector was especially promising in view of projected demand within the fast-growing Asia-Pacific economies.

Furthermore, as the 1985 recession dramatically demonstrated, an acute dependence on electronics manufacturing and on the United States market rendered the economy vulnerable to sharp downturns. In that year, Singapore's economy actually contracted by 2 per cent—the first negative growth since self-government.

Against this background, and following a report released in 1986 by the Ministry of Trade and Industry entitled The Singapore Economy: Future Directions, Singapore's economic strategy has taken another turn. Greater emphasis is now being devoted to sectors outside manufacturing, particularly to the exploitation of Singapore's potential as a 'total business centre' which encompasses banking, finance, transport, communications and intellectual service industries.

The economic reassessment has also produced public statements by the government about the need to reduce economic intervention and allow greater space for local entrepreneurs. These pronouncements should, however, be scrutinised against the actual strategies and policies recently adopted to promote Singapore's economic diversification and regional economic integration. An examination of the 'Growth Triangle' concept now being vigorously pursued provides such an opportunity. It neatly encapsulates the aims and approaches in Singapore's new development phase.

The Growth Triangle concept was first outlined by Goh Chok Tong, now Prime Minister, in late 1989. The idea is for Singapore, the neighbouring Malaysian state of Johor and the nearby Riau Islands of Indonesia to form a complementary division of labour and one unified investment zone. The hierarchy of the relationship has Singapore supplying the capital and knowledge-intensive industries and services, Johor the intermediate level technologies, with the Riau Islands concentrating on lower value-added, labour-intensive industries. Goh also foresees the triangle as a 'Caribbean tourist playground', with Johor and the Riau Islands providing resorts and Singapore the shopping facilities.

The concept was not simply dreamt up but has a basis in observations about existing investment trends and potentials in the region. But Goh and his colleagues firmly believe the state must play a leading role in these developments to be realised. The most conspicuous involves direct investment. Two government-owned companies, Singapore Technologies Industrial Corporation (STIC) and Jurong Environmental Engineering (JEE), have combined with two Indonesian conglomerates with Suharto family connections, the Salim group and the Bimantara group, to establish a 500-hectare industrial park in Batam in the Riau Islands at a cost of S$400 million. STIC is also forming a joint-venture with the Salim group to develop and manage an even more costly 4,000-hectare industrial estate on the adjoining Bintan Island. The first stage alone of this project will cost an estimated S$200 million. Another STIC venture involves teaming up with the Singapore company Wah Chang and the Salim group to develop a multi-million dollar resort in Bintan comprising the development of 19,000 hectares of land.

The Singapore government is also the largest shareholder in the Sentosa group of companies which plans to develop another island in the Riau Islands, Karimun, into a heavy industrial centre. It proposes to do this on a joint-venture basis, primarily with Bangunan Utama which is associated with the Salim group. One estimate is that the cost of the proposed ten-year developments would amount to S$1 billion.

The more general strategic use of direct government investments abroad, beyond the Growth Triangle, also continues. The project is now principally conducted through Singapore Technology Holdings (STH).
Sinhala

STH houses fifty-two government companies with an annual turnover in excess of $1 billion and is active in the global search for alliances that either bring relatively advanced technologies to Singapore or secure an interest in the application of such technologies elsewhere. The EEB has also recently set up an investment holding company to bolster its investment activities.

In other measures to foster the Growth Triangle the Singapore government has streamlined customs procedures to facilitate traffic between Riau and Singapore; made SDF grants available to Singapore-based companies operating in Johor or Riau but training workers in Singapore; rendered tax-free income earned by companies in Batam but remitted to Singapore; provided expertise for a training institute in Johor; and linked Singapore’s telecommunications system directly to Batam’s to avoid having to be routed via Jakarta.

Through such initiatives the Singapore state is playing two complementary roles. First, it is playing a direct part in creating the crucial physical and social infrastructure within the other regions of the Growth Triangle that were characteristic of Singapore’s earlier industrial phase. Second, it is actively promoting and cultivating the use of Singapore’s advanced infrastructural, managerial and other systems in the industrialisation of the surrounding region.

Far from seeing a concerted retraction of the state’s involvement in the development process, we are once more witnessing a rationalisation and modification of its role. The various direct investments by the government, some of which are specified above, have been occurring simultaneously with a steady divestment of government shares in various public companies. In the new development phase, policy-makers simply see more important places for investments to be located. They also see a need for new initiatives across nation-states to allow the Growth Triangle to materialise fully.

The unmistakable theme throughout all three development phases, then, is a practical rejection of the notion that state intervention distorts or obscures comparative advantage. On the contrary, policy is consistently guided by the implicit assumption that the state has a necessary and positive role to play in defining and shaping comparative advantage.

CONCLUSION

The above analysis suggests that the orthodox neo-classical emphasis on free-market forces as the fundamental explanation of the rapid industrialisation of the NICs is well wide of the mark in the case of Singapore. There are three major theoretical weaknesses in neo-classical economics that account for this.

First, orthodox neo-classical economics operate within a limited disciplinary framework which is seemingly incapable of acknowledging all the various ways in which states influence market prices, investment decisions and profitability. The social and political influence of the state, most especially in the area of industrial relations, has been pivotal in Singapore’s economic development. This influence cannot be easily measured or quantified. It cannot, with any intellectual honesty, be fitted into a mathematical model. Yet the omission of a systematic analysis of these factors necessarily generates a misleading image of the development process.

Second, the neo-classical concept of the market is flawed. It is based on a false dichotomy of states and markets which can only be sustained in the most abstract analysis of the real world. In practice, investors and managers constantly and unavoidably make judgments about government laws and policies, and how these might influence profitability. This not only takes into account economic policy but can include industrial-relations policy, health policy, transport policy — indeed, depending upon the nature of the enterprise involved, conceivably almost any policy or activity by the state can be relevant. It could not be any other way.

Instead of an ideological insistence that states should limit their influence on markets, it would be more sensible to recognise that states and markets can only be artificially separated by dubious theory. The important task is to understand much more about the different ways in which states and markets are inter-related so that we can, where possible, consciously cultivate relationships between the two that serve specified objectives. None of this denies the importance of markets, it simply rejects the notion of markets as independent forces.

Third, the idea that comparative advantage is something that can be sought out in the modern world is something that policy-makers identify, and respond to, with appropriate supportive measures derives from the false dichotomy referred to above. When state intervention coincides with positive results, neo-classical economists argue that this is because it was basically ‘market facilitative’ and did not contradict market forces. It is impossible within this theoretical framework to concede what is observable in the case of Singapore and the other NICs: that states can and do play a role in actually creating comparative advantage. There are of course objective limits to this, but in Australia we have not even begun to contemplate the possibilities because of the ideological stranglehold of market theory.