Development and Social Goals: Balancing Aid and Development to Prevent ‘Welfare Colonialism’.

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’…just as we may avoid widespread physical desolation by rightly turning a stream near its source, so a timely dialectic in the fundamental ideas of social philosophy may spare us untold social wreckage and suffering.’

Herbert S. Foxwell, Cambridge economist, 1899.

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Stating that creating economic development and employment always has been the best social policy may appear to be a particularly silly statement. However, today – with the Millennium Goals – the world community is approaching the social problems in the poor countries in a way which in my view makes this statement highly relevant. The Millennium Goals are noble goals for a world which sorely needs action to solve pressing social problems. Compared to how the world has solved problems of poverty over the last 500 years, however, the Millennium Goals represent completely new principles, the long term effects of which are, in my view, neither well thought through nor well understood. In this paper I shall attempt to explain why I do not think the Millennium Goals represent a good social policy in the long run.

The novelty in the Millennium Goal approach lies in the large emphasis on foreign financing of domestic social goals rather than developing/industrializing countries so they themselves, internally, can solve their own problems of redistribution. Disaster relief used to be of a temporary nature. Now, with the disastrous lack of economic development in many countries, disaster relief finds a more permanent form in the Millennium Goals. In countries where already more than 50 per cent of the government budget is financed through foreign aid, huge additional resource transfers are planned. One big question mark is to what extent this approach will put a large group of nations permanently 'on the dole', a system similar the 'welfare colonialism' which will be discussed at the end of the paper. The question is similar to that of starting foreign wars: what is our exit strategy?

Several UN Development Decades were only of limited success. In this perspective the Millennium Goals may appear as the United Nations institutions abandoning the project of developing the world poor, abandoning the effort to treat the *causes* of poverty and instead concentrating on an effort that to a large extent attacks the *symptoms* of poverty. In this paper I shall argue that in my view too much of the development effort has been abandoned: to a considerable extent *palliative economics* has taken the place of *development economics.* Indeed the balance of development economics – radically changing the productive structures of poor countries – and palliative economics – easing the pains of economic misery – is, in my view, the key issue, and I think we are planning for a serious imbalance where the extremely high costs will be much less important than the long term negative effects. There is little debate around key issues. It is unfortunate that the Millennium Goals have acquired the proverbial status of motherhood and apple pie, institutions that no one in their right mind will speak against. I shall still make an attempt.

How we used to deal with problems of development.

In spite of a distance of less than one generation, the contrast between the type of economic understanding behind the Marshall Plan on the one hand, and the type of economic theory behind today's multilateral development discourse and the Washington Institutions on the other hand, is abysmal. The Marshall Plan grew out of recognition of the poverty and misery caused by its forerunner, The Morgenthau Plan, in Germany. While the goal of the Morgenthau Plan was to de-industrialize Germany (to prevent further wars), the goal of the Marshall Plan was to re-industrialize not only Germany, but to establish a *cordon sanitaire* of wealthy nations along the borders of the communist block in Europe and Asia, from Norway to Japan.

In terms of the number of nations and number of people lifted into relative wealth, this re-industrialization plan was probably the most successful development project in human history. The fundamental insight behind the Marshall Plan was that economic activities were qualitatively different, those of the countryside (which we could call diminishing returns activities, or agriculture and raw materials) differed from those of the cities (which we could call increasing returns activities, or industry). In his famous June 1947 speech at Harvard, US Secretary of State George Marshall (who was later to be awarded the Nobel Peace Price) stressed that 'the farmer has always produced the foodstuffs to exchange with the city dweller for the other necessities of life'. This division of labour, i.e. between increasing returns activities in the cities and the diminishing returns activities in the countryside, was 'at the present time…threatened with breakdown'. He then made a remarkable recognition of the cameralist and mercantilist economic policy of previous centuries: ***'This division of labor is the basis of modern civilization'.*** Civilisation requires increasing returns activities, something that economists and politicians from Antonio Serra (1613) to Alexander Hamilton, Abraham Lincoln and Friedrich List had already been saying for a long time. The principles behind the toolbox used by nations going from poverty to wealth through the creation of 'city activities' (Appendix 1) have been surprisingly stable from they were first used by Henry VII of England starting in 1485 until their use in Korea in the 1970s. I claim that many of today's problems are due to the conditionalities of the Washington Institutions classifying the toolbox needed to create increasing returns activities – a toolbox employed by all countries that developed after Venice and Holland – as 'illegal activities'.

After World War II, the toolbox did not produce the same success in every country. The most successful countries temporarily protected new technologies for the world market under competition.(e.g. Korea). The least successful permanently protected mature technologies for often small home markets under limited or no competition (typically the small countries of Latin America). However, the key fact here is that – from Mongolia to Russia and Peru – this inefficient industrial sector produced *higher real wages* than these same countries enjoy today when this structure has been considerable weakened[1] (See figure 1). For centuries it was understood that having an 'inefficient' industrial (increasing returns) sector produced higher real wages than no industrial sector at all, and that this 'business inefficient' sector ought to be made more efficient rather than being closed down.

In its most simple form this argument is born out of the inclusion of both increasing and diminishing returns in trade theory, as the starting points respectively of virtuous and vicious circles of growth or poverty. A praxis ignoring these mechanisms may cause factor price polarization rather than factor prize equalization. Increasing returns, virtuous circles, and large economic diversity were first established as necessary elements for wealth by Serra (1613), who specifically says these mechanisms are not available in the agricultural sector. The

[1] This analysis is complicated by the fact that wages and the income of the self-employed as a percentage of GDP are falling in most countries, whereas the FIRE sector (finance, insurance, real state) increases. In Norway this wage/self employed share of GDP has been close to 70 per cent, in Peru it was around 23 per cent when the national statistical office stopped publishing this figure in 1990.

principle thus created was understood almost continuously – with brief interruptions – up until and including the Marshall Plan, but was in practice abandoned with the Washington Consensus. Deindustrialisation used to be something one would impose on a vanquished enemy, like on France after the Napoleonic War. Since the 1980s, 'structural adjustment' produced this same effect in many poor countries. Ruling theory at the time said this would not matter, to the contrary, a free trade shock would – in the vision of first WTO Secretary General, Renato Ruggieri – unleash 'the borderless economy's potential to equalise relations between countries and regions'.

In the 1930s, placing the gold standard (Keynes' 'barbarous relic') and budget balances as the untouchable core of economic theory and practice locked the world into a sub-optimal equilibrium, for a long time preventing Keynes' policies to be carried out with the approval of mainstream economics. In a similar way, placing free trade as the ideological centrepiece of development policies – *to which all other goals become subservient* – since the fall of the Berlin Wall has locked the non-industrialized countries into a very sub-optimal equilibrium. In my view, rather than continuing world policies based on the most simplistic version of mainstream trade theory, we must again take the conflict between free trade and real wages in non-industrialised countries seriously. A specialisation in diminishing returns activities with increasing population pressures also has serious environmental consequences.[2]

In my opinion the poverty we can observe in so many countries in the Third and former Second World is not caused by transitory problems, but by permanent features of nations having different economic structures. When the US started industrialising, few (although some) had the ambition for the country to be as wealthy as England. They just wanted to create a less efficient copy of the kind of production structure they could observe in England. This required tariffs. Successful industrialisation under protection, however, carries the seeds of its own destruction. By the 1880s US economists – using the same arguments based on scale and technology that were used to protect US industries in the 1820s – now argued for free trade. The same tariff that for a while created manufacturing industry, was now hurting the same industry. [3] This is why List, the protectionist, was also the first visionary of global free trade: when all countries had achieved a comparative advantage outside the diminishing returns sector.[4] The disagreement is not over the principle of free trade as such, only over its timing.

If one, instead of accepting Adam Smith as an icon of free trade and laissez faire under any circumstances, reads what he says about economic development at an early stage, one will find that he is very much in line with classical development economics, where industrialization is the key recommendation. In his early work, *The Theory of Moral Sentiments* (Smith 1759/1810), Adam Smith argued passionately for 'the great system of government' which is

[2] Reinert, Erik S. 'Diminishing Returns and Economic Sustainability: The dilemma of resource-based economies under a free trade regime.' Published in Hansen, Stein, Jan Hesselberg and Helge Hveem (Eds.), *International Trade Regulation, National Development Strategies and the Environment: Towards Sustainable Development?,* Oslo, Centre for Development and the Environment, University of Oslo, 1996.
[3] Schoenhof, J. *The destructive influence of the Tariff upon Manufacture and Commerce and the figures and facts relating thereto*. New York, published for the New York Free Trade Club, 1883.
[4] Reinert, Erik 'Raw Materials in the History of Economic Policy; or, Why List (the Protectionist) and Cobden (the Free Trader) Both Agreed on Free Trade in Corn.', in Parry, G. (editor), *Freedom and Trade. 1846-1996.* London, Routledge, 1998.

helped by adding new manufactures. Interestingly, Smith argued that new manufactures are to be promoted, neither to help suppliers nor to help consumers, but in order to improve this 'great system of government'.

In fact, it is possible to argue that Adam Smith was also a misunderstood mercantilist, someone who firmly supported the mercantilist policies of the past, but then argued that they were no longer necessary for England. In other words, Adam Smith played the same role later played by Schoenhof (see above, footnote 3) in the United States. He praises the Navigation Acts protecting English manufacturing and shipping against Holland, arguing 'they are as wise… as if they had all been dictated by the most deliberate wisdom' and holding them to be 'perhaps, the wisest of all the commercial regulations of England' (Smith 1776/1976: I, 486-487). All in all, Smith described a development that had become successfully self-sustained, a kind of snowballing effect, originating in the wise protectionist measures of the past. Only once did Smith use the term 'invisible hand' in the *Wealth of Nations*: when it sustained the key import substitution goal of mercantilist policies, when the consumer preferred domestic industry to foreign industry (Smith 1776/1976: 477). This is when 'the market' had taken over the role previously played by protective measures, and national manufacturing no longer needed such protection. If one cared to look, Adam Smith also argued for tariff protection at an early stage as a mandatory passage point to development as did Friedrich List. Studying economic policy without discussing the context is one of the destructive vices of economic practice.

The praxis of economic development has been to assimilate and produce less efficient 'copies' of the economic structure of wealthy nations. The key features of the economic structure of wealthy nations have been a large division of labour (a large number of different industries and professions), an important increasing returns sector (industry and today also knowledge–intensive services). This understanding was made into economic theory by economists who codified what actually took place in wealthy countries: Antonio Serra (1613), James Steuart (1767), Alexander Hamilton (1791) and Friedrich List (1841). These principles are at times unlearned when the natural harmony of physics-based economics totally takes over, as in France in the 1760s, in Europe in the 1840s, and in the world in the 1990s. These periods come to an end because of the great social cost they create. Physiocracy in France created shortages and scarcity of bread, and started the process that led to the French revolution.[5] The free trade euphoria of the 1840s met its backlash in 1848 with revolutions in all large European countries, with the exception of England and Russia. Every time Ricardo's trade theory is proven wrong when applied asymmetrically to increasing and diminishing return industries[6], Ricardo is proven right that the 'natural' wage level is subsistence. The free trade euphoria of the 1990s has again backlashed and created widespread poverty, but this time our response is wrong. We are too much attacking the symptoms rather than the causes of the problem.

The situation today.

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[5] See the works of Steven Kaplan, e.g. *The Bakers of Paris and the Bread Question, 1700-1775*, Durham, Duke University Press, 1996.

[6] This asymmetry is the core of the argument in Frank Graham's 1923 article, a basis for Krugman's New Trade Theory.

Today's standard economics tends to see development as largely being driven by ***accumulation***, by investments in capital physical and human.[7] Standard economic theory which underlies today's development policies is normally unable to recognise qualitative differences between economic activities. I have argued elsewhere that globalization in the periphery therefore has had the effect of a Morgenthau Plan in many of the world's small and poor countries: 'removing the basis of modern civilization'. If we look at the list of today's failed or failing nations, we will find that they all fail George Marshall's test for what creates modern civilisation: They have very weak manufacturing sectors, unable to create the virtuous exchange between city activities and countryside activities that Marshall recognised. They also have a very limited diversity in their economic base, a very limited division of labour, and are specialised in diminishing returns activities.

Historically, modern democracy was born in the nations where the civilising trade between urban and rural areas had already been established, in the Italian city states. A key feature of the most successful city states was that power was not in the hands of the landowning (diminishing returns) class. The scarcity of arable land made this easy in Venice and The Dutch Republic, and the fact that the few islands of wealth in Europe also geographically tended to be islands was not lost on the early economists. In other areas this was only achieved through constant political fight. In Florence, 40-odd landowning families had been banned from political life already in the 13th century, enabling what we later in this paper shall call Schumpeterian cronyism: political and economic interests 'colluded' in a way that created widespread wealth. Dependency on raw materials would create feudalism and/or colonialism, neither of these situations leading to political freedom. If we wish to establish genuine democracies, we may also here at the moment be starting at the wrong end of the problem, attacking symptoms rather than real causes of political freedom. The US Civil War was essentially a war between landowners with vested interest in agriculture and cheap labour (the South) and those with a vested interest in industrialization what the most visionary of the 19th century US economists called 'a high wage strategy' (the North). The history of Latin America is in many ways the history of a group of countries where the South won the Civil War.

The alternative paradigm, which we could broadly call evolutionary and historical – which I refer to as The Other Canon of economics – the key force in development is ***assimilation***: learning to do what more advanced countries are doing, 'copying' not only their institutions, but more importantly their economic structure.[8] In fact institutions like patents and protection, scientific academies and universities, were key elements in the strategy to change national economic structures in order to assimilate that of the wealthier countries. In this tradition, economic growth tends to be ***activity-specific***, tied to clusters of certain economic activities exhibiting increasing returns and rapid technological progress. This process requires capital, but the difficulty lies in transferring and mastering the skills and, above all, in creating a viable market for the increasing returns activities in nations where the absence of purchasing power

[7] This discussion builds on a recent paper by Richard Nelson, 'Economic Development From the Perspective of Evolutionary Economic Theory', draft, Sept. 18, 2004.
[8] Historical evidence for this practice in the European theatre is found in my paper 'Benchmarking Success: The Dutch Republic (1500-1750) as seen by Contemporary European Economists', in *How Rich Nations got Rich. Essays in the History of Economic Policy.* Working Paper Nr. 1, 2004, SUM - Centre for development and the Environment, University of Oslo. Downloadable on http://www.sum.uio.no/publications

and massive unemployment tend to go hand in hand, each factor reinforcing the other in a deadlock. By generally insisting on using models assuming full employment, the Washington Institutions avoid facing a key factor in the mechanisms that lock nations into poverty: the lack of formal employment. Historically, since 16th century Holland and Venice, only nations with a healthy manufacturing sector have achieved anything close to full employment combined with a lack of sizable rural underemployment.

Today's reigning economic theory represents what Schumpeter called 'the pedestrian view that it is capital *per se* that propels the capitalist engine': development is seen as largely driven by the accumulation of capital, physical or human. 'The premise of neo-classical theory is that, if the investments are made, the acquisition and mastery of new ways of doing things is relatively easy, even automatic', as Richard Nelson says. Even more important, the core thesis of standard economics, albeit seldom expressed, is that economic structure is irrelevant, capital *per se* will lead to economic development regardless of the economic structure into which the investment is made. In the alternative Other Canon theory, economic activities exhibit very different windows of opportunity as carriers of economic growth. An intuitive example: Bill Gates is not likely to have achieved his present economic success specializing in herding goats or growing broccoli: the technological wave that created Microsoft is not replicable in a company or country specialising in goat herding or growing broccoli. In other words we have to get rid of what James Buchanan calls 'the equality assumption' in economic theory, probably the most important and the least discussed assumption.[9] The ability to absorb innovations and new knowledge – and consequently ***profitably to absorb investments*** – at any time varies enormously from one economic activity to another.

> **The problem**: As a result of seeing capital ***per se*** as the key to growth, loans are given to poor nations which their productive/industrial structure is unable to absorb profitably. Interest payments will often very fast exceed the rate of return on the investments made. 'Finance for Development' may therefore take on the characteristics of a pyramid game or a chain letter fraud: the only ones to gain are those who started the scheme and are close to the door.[10] Correspondingly on the human side: Investments in human capital are made without corresponding change in the productive structure that creates a demand for the skills acquired. As a result education may tend only to promote emigration. In both cases Gunnar Myrdal's 'perverse backwashes' of economic development will be the result: more capital – both monetary and human – will flow from the poor to the rich countries than the other way around. My claim, based on the study of 500 years of history's laboratory, is that the main explanation for this lies in the type of economic structure – locked into a vicious circle of lack of supply and lack of demand and the absence of increasing returns – that characterises poor nations. This circle cannot possibly be broken unless we again listen to 500 years who speak in favour of the set of policies listed in Appendix 1. Abraham Lincoln stands out as a proud representative of this type of national economic strategy, and US

[9] At its core, the Enlightenment project was one of ordering the world by creating taxonomies or classification systems, of which that of Linnaeus is the best known. Neo-classical economics achieves its analytical accuracy precisely because it lacks any taxonomy: everything is qualitatively alike. Therefore its conclusions, like factor-price equalization, are essentially already built into the assumptions.

[10] See Kregel, Jan, 'External Financing for Development and International Financial Stability, UNCTAD G-24 Discussion Paper Series , No. 32, October 2004. Downloadable at www.unctad.org

industrial policy from 1820 until 1900 is the best example for the Third World to follow today until – as the US was towards the end of the 19th century – these nations are ready to participate fully in and benefit truly from international trade.

Recommendation: *As was the case with the Marshall Plan, financial funds must be matched with the establishment of industrial and service sectors that profitably can absorb both the physical and human investments. A diversification out of raw material production is absolutely indispensable in order to create a basis both for democratic stability and increased welfare. Initially these sectors will not be able to survive world market competition. As this process always has required, since England's ascent to industrialization starting in 1485, this incipient industrialisation needs special treatment of the kind the Marshall Plan afforded after 1947. This requires interpreting the Bretton Woods agreement as it was done in the post-WW II era, not as it is presently interpreted.*

Part of the problem also lies in neo-classical economics' poor understanding of successful business. It is almost curiously amusing that at the core of the economic theory behind capitalism is a situation of perfect competition and equilibrium, a situation where no one makes any money to speak of. In standard economics successful businessmen like Bill Boeing and Bill Gates – who both contributed importantly to the wealth of Seattle – are 'rent-seekers', generally an odious term. In fact it is the poverty-stricken Third World that most closely corresponds to the conditions assumed in international trade theory, diminishing returns and perfect competition. The rich countries, whose export items are produced under Schumpeterian dynamic imperfect competition, are 'rent seekers' whose rents, spreading through society as higher wages and a higher tax base, are what we call 'economic development'. This failure to understand development as Schumpeterian imperfect competition is at the root of the present arguments against an industrial policy. Anything which causes imperfect competition tends to be seen as 'cronyism'.

Keynes saw investments resulting from what he called 'animal spirits'. Without this 'animal spirit' – without the initiative to invest in uncertain conditions – capital is sterile, both in the world of Joseph Schumpeter and in that of Karl Marx, each representing one side of the political spectrum. The motivating force behind this animal spirit is to make profits, to break the equilibrium of perfect competition. *From this businessman's point of view the very simple explanation for the lack of investments in poor countries is the lack of profit opportunities*. He does not invest because he sees no opportunity to make profits outside the extraction of raw materials. This lack of opportunities for profitable investments is largely tied to the extremely low purchasing power and the very high unemployment rate. Subsistence farmers do not represent profitable customers for most producers of goods and services. Tariffs create incentives to move production into the labour markets of the poor. Historically, this has been seen as a conscious tradeoff between the interest of man-the-consumer and man-the-producer. The idea that industrialization would cause a rapid increase in employment and wages that more than offset the temporary higher cost of manufactured goods was at the core of the Prebisch import-substitution industrialization, but also of US economic theory around 1820.[11]

[11] See e.g. Raymond, Daniel, *Thoughts on political economy*, Baltimore, Fielding Lucas, 1820.

The idea that greater 'openness' in any way should improve the situation of the poor countries is both counterintuitive and contrary to historical experience. If anything, the first effect of sudden 'openness' in a backward society is likely to kill off what little manufacturing activity that might exist, making the situation worse.[12] In effect historical experience shows that opening up for free trade between nations of very different levels of development tends first to destroy the most efficient industries in the least efficient countries (The Vanek-Reinert Effect), from the unification of Italy in the 19th century to the integration of Mongolia and Peru in the 1990s. Figure 1 visualizes how the highly successful export increases that followed the opening up of the Peruvian economy were accompanied by falling real wages. In Peru, as in many other Latin American countries, real wages peaked during the period of 'inefficient' import substitution. The ports, airports, roads, power stations, schools, hospitals, and service industries that were created by this inefficient industrial sector, led by rent-seekers, were *real* and could not have been created without the demand for labour and infrastructure that this inefficient industrial sector generated.[13] Economic theory must again open up to understanding synergies of this type, where temporary 'business inefficiency' in certain sectors activates more efficient activities and/or the upgrading of human capital in other sectors, in the end leading to increased welfare.

The timing of the opening of an economy is crucial. Opening up the economy too late will seriously hamper growth. Opening up an economy too early results in de-industrialization, falling wages[14] and increasing social problems. An anonymous traveler who in 1786 observes the effects of economic policy in different European countries reaches this same conclusion: 'Tariffs are as harmful to a country after manufacturing industry has been established there, as they are useful to it in order to introduce this industry'.[15]

In Southern Mexico we can observe the destructive sequence of de-industrialization, de-agriculturalization[16] and de-population. That large numbers of subsistence farmers should be made 'uncompetitive' by subsidized First World agriculture is a relatively new, but alarming, trend that may persist even if the subsidies are removed. There are around 650 million farmers in India, and a large proportion of them are as 'uncompetetive' as their Mexican colleagues if and when free trade opens up, but without the possibility to migrate to the US. In the poorest countries today a tradeoff exists between maximizing international trade – which is what present policies achieve – and maximizing human welfare (Figure 1). In my view we must address this tradeoff in a different way than trying to compensate the losses of the poor countries through increased aid.

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[12] I have showed this effect in 'Globalisation in the Periphery as a Morgenthau Plan: The Underdevelopment of Mongolia in the 1990s', in Reinert, Erik (editor), *Globalization, Economic Development and Inequality: An Alternative Perspective*, Cheltenham, Edward Elgar, 2004. See also my paper 'Increasing Poverty in a Globalised World: *Marshall Plans* and *Morgenthau Plans* as Mechanisms of Polarisation of World Incomes', in Chang, Ha-Joon (editor), *Rethinking Economic Development*, London, Anthem, 2003.

[13] I am grateful to Carlota Perez for having formulated this insight.

[14] But not necessarily falling GDP/capita. See footnote 1.

[15] Anonymous (1786). Relazione *di una scorsa per varie provincie d'Europa del M. M.... a Madama G.. in Parigi*. Pavia: Nella Stamperia del R. Im. Monastero di S. Salvatore. p. 31. I am grateful to Sophus Reinert for this reference.

[16] As imported and subsidized US food takes over from local maize and wheat production.

More than five centuries of history – from England's ascent starting in 1485 – show that there is only one point where the complex deadlock of vicious circles of poverty and underdevelopment can effectively be attacked: by changing the productive structure of the poor and failing states. This means increasing diversification away from the diminishing returns sectors (traditional raw materials and agriculture) into an increasing returns sector (technology intensive manufacturing), creating a large division of labour and the synergies and social structures which emerge from this structure. This is also the only way to make it possible for subsistence agriculture to break away from its chains: creating an urban market for their goods, which will induce specialization and innovation, bring in new technologies and create alternative employment. Foreign markets cannot play the same role, they break economies into advanced and backward sectors and regions: the key to cohesive development is a national[17] interplay between increasing and diminishing returns sectors.

The arguments against industrial policy: Malthusian vs. Schumpeterian cronyism.

2005: A Filipino sugar producer uses his political influence in order to achieve import protection for his products.

2000: Major Daley in Chicago does not listen to the Chicago economists, but provides subsidies to already wealthy high-tech investors through an incubator.

1950s and 1960s: Swedish industrialist Marcus Wallenberg uses his close political contacts with Labour Party Minister of Finance, Gunnar Sträng, to achieve political support and favours in order to carry out his plans for companies Volvo and Electrolux.

1877: Steel producers in the United States use their political clout to achieve a 100 per cent duty on steel rails.[18]

1485: Industrialists use their political connections to King Henry VII in order to achieve subsidies and an export duty on raw wool that will increase the raw material prices for their competitors on the Continent, slowly killing the wool industry elsewhere, e.g. in Florence.

These are all blatant examples of crony capitalism, very far from the nice perfect level playing field we are all supposed to prefer. These are all rent seekers that purist economic theory tends to abhor. There is, however, a crucial difference between the first example and the rest. The Filipino crony differs from the other cronies in that he gets subsidies in a diminishing return raw material that competes under perfect competition on the world market. He is a Malthusian crony leading his country down the path of diminishing returns (in spite of technological change which counteracts this). The others are Schumpeterian cronies, producing under what Schumpeter calls historical increasing returns (a combination of both increasing returns and fast technological change). If we couple this to trade theory we see that the tilted playing fields providing Schumpeterian cronyism produce widely different results than those of the Filipino crony.

[17] Essentially within the same labour market.
[18] Taussig, F.W. *The Tariff History of the United State,* New York, Putnam's, 1897, page 222.

Bismarck used to say that there are two things whose production process one should better not watch: sausages and government budgets. We should probably add industrial policy to this group of aesthetically unpleasant production processes. We can live without sausages, but not without government budgets or industrial policy. And, as Keynes said, 'the worse the situation, the less laissez-faire works'. If we insist that we cannot have industrial policy because moving away from perfect competition will cause some cronies to get rich, we have totally misunderstood the nature of capitalism. Capitalism ***is*** about getting away from perfect competition; this is what people spend years at business schools learning.

Economic development is caused by structural change which breaks equilibrium creating rents. Insisting on the absence of rents is insisting on a steady and stationary state. This is the reason why tariffs in many ways are the least crony-friendly of the policy tools. However, there is still the need to choose which activities to protect, which almost by definition will create cronies. Abraham Lincoln protected the steel cronies, and he was very proud of it. He saw that by paying a little more for steel[19], he managed to create a huge steel industry with many jobs paying high wages that also provided a base for government taxation. Economic development strategy is about getting the public interests of the nation lined up with the private vested interests of the capitalists. As stated above, the failure of standard economics to understand the dynamics of the world of business is a serious problem. This also leads to a failure to understand the economic essence of colonialism. At its economic core colonialism is a technology policy: the colonies were not allowed to have manufacturing industries. The economic activities with high potential for economic growth and mechanization were to remain in the metropolis, the diminishing returns activities went to the colonies.

The immense transfers that accompany The Millennium Goals process will necessarily also lead to cronyism. Some people will get wealthy through this initiative, and a huge aid industry-cum-lobby is working very actively. Crony-free economics only exists in neo-classical models. My choice is that we go for Schumpeterian cronyism more than aid-based cronyism, because in this way we also make it possible for the poor countries to free themselves from economic dependency. Is it because the apparent motivation of the businessman is greed and avarice, while the apparent motivation of the aid lobby is charity that the presently preferred solution tilts so heavily in favour of charity rather than development? Again we may have unlearned our basic Adam Smith: it is not by the charity of the baker, but by his greed that we get our daily bread.

We also seem to have unlearned the logic behind policy tools for economic development. Patents and modern tariffs were created at about the same time, in the late 1400s. It is crucial to understand that these rent-seeking institutions were created by the very same understanding of the process of economic development. To create protection and rents in order to produce new knowledge (in the case of patents) and to make it possible to move the new knowledge in order to produce with this new knowledge in new geographic areas (the case of tariffs) are two aspects of the same understanding of Schumpeterian economic dynamics. From the point of view of those who think that perfect competition is the ideal economic situation, both patents

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[19] That the steel tariff later got as high as 100 per cent, was a result of technological change and rapidly falling prices in a situation where the tariff was not based on value, but determined in dollars per ton.

and tariffs represent legalized rent seeking in order to promote goals that are not achievable under perfect competition.

I suggest looking at this set of problems as the poor countries might look at them. Why is the rent seeking and crony argument not applied also against patents, only against tariffs and other policy instruments used in poor countries? Why does the economic profession accept legalized rent-seeking by pharmaceutical companies and by Bill Gates, but abhor the rent-seeking of an industrialist who tries to set up a small business in Lima, Peru? The poor countries may, with some justification, say that the wealthy countries are establishing rules that legalize constructive rent seeking in their own countries, but prohibit them in the poor countries. Over time industrialization has proved as beneficial to mankind as many highly protected drugs.

The Washington Consensus and sequential single issue management.

By the time of what The New Yorker appropriately called the 'triumphalism' following the fall of the Berlin Wall, neo-classical economics with its variations had become the only game in town. The logic of the post-WW II years that had built wealth along the belt bordering communism, from Norway to Japan, was gone, and economics had fossilized into a war between two utopias: the communist utopia that promised that each should give according to ability and receive according to need, and the neo-classical utopia that promised that under capitalism everyone would receive the same wages world-wide (Paul Samuelson's *factor-price equalization*). Both of these theories, the communist planned economy and neo-classical economics, were based on David Ricardo's theories (1817). Ricardo and his successors show a disregard for economic structure, for technology and innovations, for entrepreneurship and leadership, and for the fact that economic activities are qualitatively different as carriers of economic welfare. In both its communist and its liberalist forms Ricardian economics sees no need for a state (Marx' 'withering away of the State').

However, neo-classical economics was, to use Nicholas Kaldor's term, an *un-tested theory*. Neo-classical theory had provided an effective ideological shield during the Cold War, but no nation had ever been built on this type of theoretical framework. In its most extreme form, as it was practiced around 1990, the only predicament was that nations should 'get their prices right' and economic growth would follow automatically, disregarding economic structures. Because it is so counterintuitive (why should stockbrokers and shoe-shine boys get the same wages just by being put in different nations??), Paul Samuelson's theory of factor-price equalization had long not been the pride of the economics profession. Now, by 1990, policy recommendations were formulated as if this 'law' of factor-price equalization was comparable to the law of gravity. This neglected not only important theoretical contributions pointing elsewhere (Krugman, Grossman, Helpman, Lucas, etc.), key insights of the founding father of neo-classical economics, Alfred Marshall, were also neglected. Alfred Marshall not only describes taxes on diminishing returns activities in order to subsidize increasing returns activities as a good development policy, he also emphasizes the importance for a nation to produce where most technical change is found, and the role of synergies (industrial districts). These are the principles behind all successful catching up since Henry VII started the industrialization of England by taxing diminishing returns activities (an export tax on raw wool) in order to subsidize industry manufacturing woolen cloth. These elements, representing first successful practice and then sound theory over more than 500 years, have disappeared from the policy space.

In the 1990s, as the world economy failed to deliver results corresponding to the crudest version of Samuelson's law of free trade, the search began for other explanations. This search was, and still is, always based on the premises of neo-classical economics, the search is for a factor which *in addition to* neo-classical economics would set free the magic of the market in providing factor-price equalization with instant global free trade:

- 'get the prices right'
- 'get the property rights right',
- 'get the institutions right',
- 'get the governance right',
- 'get the competitiveness right'
- 'get the national innovation systems right'
- 'get the entrepreneurship right'

The vision of 'the borderless economy's potential to equalise relations between countries and regions' was based on the wrong theory. This theoretical fantasy developed into a practical nightmare in many poor countries. None of the sequential focuses on single issues will unleash a magic of factor-price equalization under instant free trade, this never existed in history nor will it ever exist. Economic growth is by the very nature of things an uneven process, and only wise political intervention can even out the factor-price polarizations which are the natural results of an unrestrained market. The latest fad in the sequence, attributing poverty to a lack of entrepreneurship, comes across as being particularly uninformed. As contrasted to most people in the wealthy countries who can safely live within their mostly routine jobs, the poor of the world have to prove their initiatives and entrepreneurship every day in order to ensure physical survival for themselves and their families.

The problem is that the sequence of theoretical fads for policy fails to address the fundamental blind spots of neo-classical economics: a) its inability to register qualitative differences, including the different potentials of economic activities as carriers of economic growth, b) its inability to register synergies and linkages[20], and c) its inability to cope with innovationsts and novelties, and how differently these are distributed among economic activities. Together, these blind spots of present-day mainstream economics prevent many poor countries from developing. The successful ones, like China and India, have, both for more than fifty years, followed the recommendations of the Marshall Plan: creating a division of labour between urban and rural activities.

Learning is a key element in development, but learning may spread in the economy also simply as falling prices to foreign consumers. The key insight of Schumpeter's student Hans Singer

[20] The slogan 'get the national innovation systems right' proves an exception, because it does refer to a synergetic phenomenon. However, this does not lead very far because of the theory's inability to recognize the different windows of opportunity for innovation in Microsoft, under hugely increasing returns, and in a goat herding firm in Mongolia, under critically diminishing returns. In standard analysis Schumpeterian economics tends to be added like a thin icing on a thoroughly neoclassical cake.

was that learning and technological change in the production of raw materials, particularly in the absence of a manufacturing sector, tend to lower export prices rather than to increase the standard of living in the raw material producing nation.[21] Learning tends to create wealth to producers only when they are part of that finely knit network that was once called 'industrialism': a dynamic system of economic activities subject to increasing productivity through technical change and a large division of labour. The absence of increasing returns, dynamic imperfect competition, and synergies in the raw material producing countries are all part of the mechanisms that perpetuate poverty. Part of the explanation is also that only 'industrialism' gives the necessary critical mass and political clout to create the countervailing power of labour unions. What the French Regulation School economists call 'fordism', that workers' pay raise parallel to productivity improvements, was an important part of industrialism.

Further explorations along the mainstream route taken since 1990 are in my view rapidly running into diminishing returns. Huge resources are employed by well-intentioned governments along a largely sterile path of inquiry, a main problem being that radically different alternative theoretical approaches are not financed or explored. In my opinion the only way to raise the standard of living in the poorest countries of the world is to follow the only successful formula that ever worked, from England in 1485 to Europe and the Asian Tigers in the 1960s and 70s and China today. This formula is included as Appendix 1. The best social policy is to create development, not by the rich creating subsidized reservations where the poor are kept, largely underemployed and 'underproductive'. The Indian reservations in North America are sad examples of a policy of the kind that subsidizes without changing productive structures. In short, the Millennium Goals are in my view far too much biased towards palliative economics rather than structural change, towards treating the symptoms of poverty rather than its causes. I am not denying they could be an unavoidable emergency measure under the present critical conditions, but without confronting the deeper roots of the problem it is simply poor social policy.

Conclusion: Are we creating 'welfare colonialism'?

Present policies run a risk of creating serious imbalances between the efforts to create development and the palliative efforts of aid. What we may be creating is a system that could be described as 'welfare colonialism'. This term was coined by anthropologist Robert Paine to describe the economic integration of the native population in Northern Canada. [22] The essential features of welfare colonialism are: 1) The often observed colonial drain of the old days is reversed, the net flow of funds is to the colony rather than to the mother country, and 2) the native population is integrated in a way that radically changes their previous livelihood, and 3) they are put on the dole.

In Paine's view, welfare colonialism identifies welfare as the potential vehicle for a stable internal 'governing at a distance' through the exercise of a particularly subtle, 'non-

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[21] Singer, Hans W. 'The Distribution of Gains between Investing and Borrowing Countries'. In *International Development: Growth and Change*. McGraw-Hill, New York. 1964 (1950)

[22] Paine, Robert (editor), *The White Arctic. Anthropological Essays on Tutelage and Ethnicity*, Institute of Social and Economic Research, Memorial University of Newfoundland, 1977.

demonstrative' and dependency-generating form of neo-colonial social control that pre-empts local autonomy through 'well-intentioned' and 'generous' – but ultimately 'morally wrong' – policies. Welfare colonialism creates paralyzing dependencies on the 'centre' in a peripheral population, a centre exerting control through incentives that create total economic dependency, thus preventing political mobilization and autonomy. The social conditions in which the native inhabitants of Arctic North America find themselves today, show us that in their case the final effect of massive transfer payments was to create a dystopia rather than a utopia.

We already see aid and transfers creating passivity and disincentives to work in poor nations. My Haitian colleagues point to family transfer payments from the United States creating disincentives to work for a going rate of 30 US cents an hour in Haiti. A Brazilian research project on the highly laudable Zero Hunger project, carried out at different government levels (national, state and local) on different programs targeted to fight hunger, concludes that to a large extent these projects are ineffective, since they treat symptoms of poverty either by distributing food or by subsidizing food prices, rather than creating situations where the poor are converted into breadwinners.[23] These are welfare colonialism type effects: results of treating symptoms rather than causes of poverty.

The idea of nations producing under increasing returns (industrialized nations) paying an annual compensation to nations producing under constant or diminishing returns (raw material producers) is not a new one. It is a logical conclusion from standard trade theory once both increasing, constant, and diminishing returns are included, and this recommendation – a forerunner of the Millennium Strategy – is present already in a US college textbook from the 1970s. [24] Until very recently, however, the favored option was to industrialize the poor countries, even if it meant that for a long time these industries would not be competitive on the world market. Making free trade the linchpin of the world economic system – one to which all other considerations must yield – has made a type of welfare colonialism ***appear*** as the only option. We must compensate the poor for the welfare loss from free trade, seems to be the underlying idea. The other option, to develop the poor world, is not there because we do not wish to abolish free trade as the core of the world economic order. However, the long term and cumulative effects of having groups of nations specializing in pre-industrial economic structures will be staggering. In my view the policies successfully followed between 1485 and the 1960s are – in spite of their being decidedly out of fashion – still the better alternative.

There are also neo-classical tools that could be used with great benefits. The Washington Institutions should stop using models assuming full employment also in countries like Haiti, where only between 20 and 30 per of the potential workforce have a job. By using shadow prices they will find back to the original logic of the Bretton Woods Institutions and their rules as they were interpreted in the 1950s and 60s, making possible the reconstruction of Europe.

[23] Lavinas L and Garcia E. (2004) *Programas Sociais de Combate à Fome. O legado dos anos de estabilização econômica,*.Rio de Janeiro, editora UFRJ/IPEA, Coleção Economia e Sociedade, 2004.
[24] 'Thus the country which eventually specializes completely in the production of X (that is, the commodity whose production function is characterized by increasing returns to scale) might agree to make an income transfer (annually) to the other country, which agrees to specialize completely in Y (that is, the commodity whose production function is characterized by constant returns to scale' (Chacholiades, Miltiades, *International Trade Theory and Policy,* New York, McGraw-Hill, 1978, p. 199; see also Reinert 1980)

This will mean that we *temporarily* must let the principle of free trade yield to the principle of economic development and structural change.

Both after 1848 – in order to solve the perennial 'social question' in Europe – and in 1947, political pressure from the spectre of communism unleashed successful development practices. Few are aware that Karl Marx stated that the only reason he was in favour of free trade was that it hastened the revolution. In 1947, the free traders in Washington had to yield to the political need for protectionist development policy around the communist block. This Marshall Plan was a truly astonishing success. It is perhaps a faint hope that today's terrorist threat will unleash a similar situation where free trade is temporarily abandoned in order to create development as a *political*, rather than as a *social*, goal.

During the Enlightenment civilization and democracy were understood, through the analysis of people like Montesquieu and Voltaire, as products of a specific type of economic structure. We find the origins of this understanding already in Francis Bacon more than 100 years earlier: 'There is a startling difference between the life of men in the most civilised province of Europe, and in the wildest and most barbarous districts of New India. This difference comes not from the soil, not from climate, not from race, but *from the arts*.'[25] When German economist Johan Jacob Meyen in 1770 stated 'It is known that a primitive people does not improve their customs and institutions later to find useful industries, but the other way around', he expressed something which could be considered common sense at the time. We find the same idea – that civilisation is crated by industrialisation – in the 19th century in thinkers across the whole political spectrum from Abraham Lincoln to Karl Marx. Industrialisation 'draws all, even the most barbarian, nations into civilization' as Marx puts it.

We ought to use our understanding of successful policies in past history, which is the only laboratory economics has, in order to create something brand new and adequate for solving today's challenges. We should attempt to create something as brilliant and practical as did the visions and accompanying policy recommendations of Alexander Hamilton and Abraham Lincoln, but firmly grounded in an understanding of the present technological and historical context.

We ought to be as enlightened again in understanding the connection between production and civilization, by moving our theoretical focus away from trade and on to production. Compared to Meyen's statement above, our present understanding has reversed the arrows of causality, and we therefore risk creating an increasing number of failed states. We now ought to focus on how differently technological development hits different economic activities, creating huge variations in the windows of opportunity to innovate, and how this makes it possible for nations to specialize in being poor and uneducated. We should focus more on core issues like economies of scale, scope, speed and specialization, on avoiding the negative effects of diminishing returns and lock-in effects, on the *assimilation of knowledge* rather than the *accumulation of capital*, on changing the economic structures of poor countries so they become more like those of the rich ones. We should read not only Schumpeter on technical change, but

[25] Francis Bacon, *Novum Organum*, 1620.

also Schumpeter's essay on imperialism. Read not only Schumpeter on 'creative destruction', but also open our eyes and minds to the type of 'destructive destruction' that can be observed.

Appendix 1.

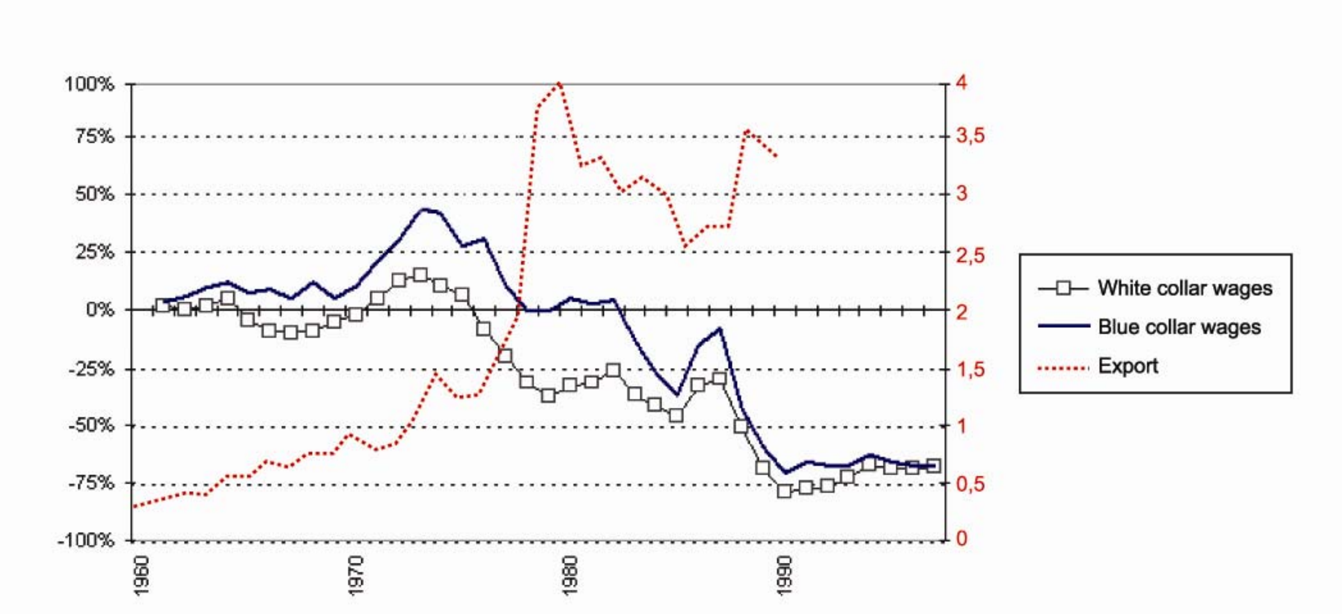
'Mercantilist' Economic Policies of the Generic Developmental State. Continuity of policy measures and tool kit from England in 1485 (Henry VII) to Korea in the 1960's: a mandatory passage point for economic development.

…the fundamental things apply, as time goes by.
Sam, the pianist, in 'Casablanca'.

1. Observation of wealth synergies clustered around increasing returns activities and continuous mechanization in general. Recognition that 'We are in the wrong business'. Conscious *targeting, support and protection* of these increasing returns activities.
2. Temporary monopolies/patents/protection given to targeted activities in a certain geographical area.
3. Recognizing development as a synergetic phenomenon, and consequently the need for a diversified manufacturing sector ('maximizing the division of labor', Serra 1613 + observations of the Dutch Republic and Venice)
4. Empirical evidence accumulated showed that the manufacturing sector solves three policy problems endemic to the Third World in one go: increasing national added value (GDP), increasing employment, and solving balance of payment problems.
5. Attraction of foreigners to work in the targeted activities (historically religious prosecutions have been important)
6. Relative suppression of landed nobility (from Henry VII to Korea). (Physiocracy as a landowners' rebellion against this policy)
7. Tax breaks for targeted activities.
8. Cheap credits for targeted activities.
9. Export bounties for targeted activities.
10. Strong support for agricultural sector, in spite of this sector clearly being seen as incapable of independently bringing the nation out of poverty.
11. Emphasis on learning/education (UK apprentice system under Elizabeth I, Child (1693)
12. Patent protection for valuable knowledge (Venice from 1490s)
13. Frequent export tax/export ban on raw materials in order to make raw materials more expensive to competing nations (starting with Henry VII in late 1400s, whose policy was very efficient in severely damaging the woolen industry in Medici Florence).

Source: Reinert E. & S. 'Mercantilism and Economic Development: Schumpeterian Dynamics, Institution Building and International Benchmarking', in Jomo, K. S. and Erik S. Reinert (editors), *Origins of Economic Development*, London, Zed Publications, forthcoming 2005.

Figure 1. Peru 1960-1990: Diverging Paths of Real Wages and Exports.



NB. The export figures in this draft are, provisionally, in current US dollars, which exaggerates the visual effect.

Sources: Real Wages: Roca, Santiago & Luis Simabuco, 'Natural Resources, Industrialisation and Fluctuating Standards of Living in Peru, 1950–1997: A Case Study of Activity-Specific Economic Growth', in Reinert, Erik S., *Globalization, Economic Development and Inequality: An Alternative Perspective*, Cheltenham, Edward Elgar, 2004. Exports: Webb, Richard & Graciela Fernández Baca, *Perú en Números*, Lima, Instituto Cuanto, 2001.