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CONTACT: Rainer Kattel, kattel@staff.ttu.ee; Wolfgang Drechsler, drechsler@staff.ttu.ee; Erik S. Reinert, reinert@staff.ttu.ee

Primitivization of the EU Periphery: The Loss of Relevant Knowledge

Erik S. Reinert, Professor, Tallinn University of Technology.

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Introduction

The European periphery – from Greece to Spain and the Baltic States – is hard hit by economic crises in the form of unemployment and falling real wages. The immediate reasons for these crises, 'the straw that broke the nations' back' so to say, are not the same. The countries in crisis may have had irresponsible budget deficits or irresponsible housing and property booms, but – as this article argues – the present underlying problems in the European Union can partly be attributed to ignoring previously well-understood economic insights and wisdom based on the interplay between geography, technology, and economic structure. This ignored knowledge abounds in the German-speaking literature, in this chapter represented by three economists: Heinrich von Thünen, Friedrich List, and Joseph Schumpeter, whose collective lives span from 1783 to 1950. Although all three worked in the periphery of what is normally referred to as *The German Historical School of Economics*, they all centered their analysis on a qualitative understanding of economic phenomena which disappeared from ruling economic theory, and consequently also from the understanding of politicians.

It is argued that the European Union was initially built on principles emanating from a type of geography-based economic understanding with old roots, but that the formalization of economics has led to the fact that this previous knowledge has been lost both to economists and policy-makers. This loss occurred in two overlapping stages: stage one after World War II when German economic theory spanning from The Thirty Years' War (Veit von Seckendorf) to World War II (Werner Sombart)[1] was thrown out with the proverbial bathing water of the Hitler regime, and a final blow with the neoliberal 'triumphalism' starting with the Fall of the Berlin Wall.

The type of economic understanding represented by this qualitative economic tradition, as opposed to the incoming neoclassical tradition, continued to be applied in actual economic policy until and including the slow integration of Spain into the European Union in the 1980s, thus saving and strengthening Spain's industrial sector. Neoclassical principles only entered policy-making after the Fall of the Berlin Wall in 1989, and – we shall argue – with very negative outcomes: a shock therapy resulting in de-industrialization and ultimately de-population.

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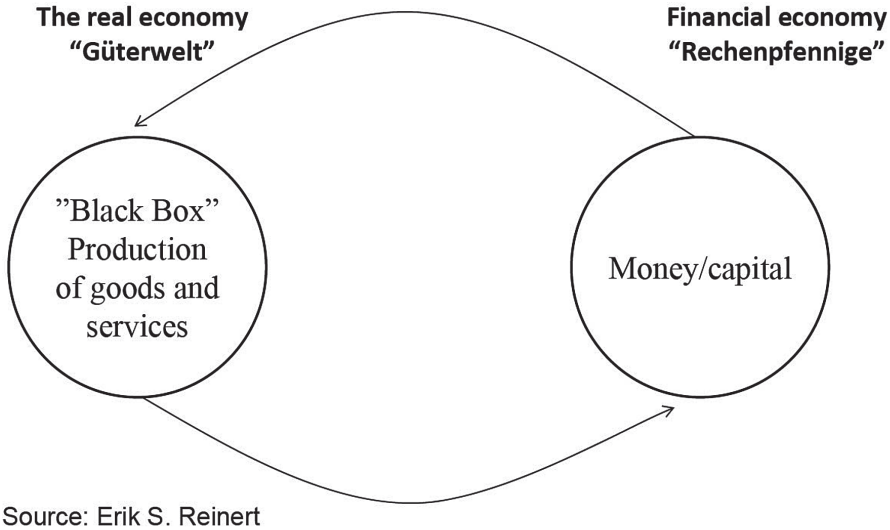
1 I have attempted a brief outline in this in Reinert (2005).

1. Knowledge Lost: A Brief Aside on the Financial Crisis

Although this article concerns the geography of production, it is relevant to look at a similar case of *Relevant Knowledge Lost* which occurred in the financial sector leading to the financial crisis. Until after World War II financial crises – and the consequent need to control the financial sector – were well understood over the whole political spectrum from left to right: Marx – in volume 3 of *Das Kapital* – clearly understands financial crises, Lenin sees the end of capitalism when finance capital becomes dominant over industrial capital. Politically conservative writers like Schumpeter and Keynes also had a good understanding of crises, although they differed in their policy recommendations. Schumpeter's differentiation between *Güterwelt* (the world of goods and services) and *Rechenpfennige* (the accounting units or tokens that inhabit the world of the financial sector) shaped Hyman Minsky's understanding of financial crises. He considered them as results of mismatches in the innovation capacity of the two spheres of economy, i.e. the innovative capacity of the financial sector far outstrips the ability of the real economy to use these funds in a profitable way.



Source: Erik S. Reinert

Norwegian-American economist Thorstein Veblen (1857-1929) differentiated between wealth created through what Veblen himself called *idle curiosity* and the *instinct of workmanship* (newly created wealth), and wealth created from a *predatory instinct* (appropriating wealth that had already been created, by harvesting where others had sown). Veblen's heroes were the innovative entrepreneurs, like Henry Ford, and he disapproved of businessmen making money by 'withdrawing efficiency' – i.e.

by creating obstacles to economic innovations and change – and of the vested interest of the financial sector.

In the United States evolutionary and institutional economics, both improbably founded by Thorstein Veblen, played the same role as the historical schools played in Europe. The financial crisis of the 1970s (commonly called the Oil Crisis) was solved when Veblen's student's student Arthur F. Burns (1904-1987) was at the helm of the Federal Reserve until 1979. Burns solved the crisis by keeping wages and demand up and creating an inflation which made it very unprofitable to hold idle cash balances, thus forcing speculative capital back into the real economy. In other words: Burns carried out the opposite of the austerity policy being carried out today. So, also in terms of understanding financial crises, there was a lag between the teaching on neoclassical principles and their application in real policy (after 1979).

2. The Ignored Knowledge of von Thünen, List and Schumpeter

This chapter looks at the insights provided by three German speaking economists from the same historical period who explicitly and implicitly worked with economics in geographical space: Heinrich von Thünen (1783-1850), Friedrich List (1789-1846), and Joseph Schumpeter (1883-1950). It is argued that a main cause of the problems of the European periphery is that these nations have been voided of the core economic area of von Thünen's *Isolirte* [*sic!*] *Staat*, that the three core theses of Friedrich List's model for the diffusion of free trade have been violated, and that the qualitative distinction between what we call Schumpeterian and Malthusian activities has been abandoned. Taken together, Thünen, List and Schumpeter provide a qualitative understanding of economic development in space and time, a type of understanding which reigned in Europe until the end of the 1980s, including the policy which integrated Spain into the European Union. The economic ideas which subsequently integrated the former Eastern Block countries had completely lost the insights from von Thünen, List, and Schumpeter. Yet, the utmost importance of including the insights of these three economists shall be discussed in the following.

2.1. Von Thünen's Model of Concentric Circles

While economists have recently attempted to reintroduce geography – a process which has seen Paul Krugman as a major contributor – Heinrich von Thünen (1783-1850) is considered an early protagonist in the field of economic geography. Thünen drew a map of civilized society with four concentric circles around a core of increasing returns activities – the city.

Moving outwards from the city core, the use of capital and advanced skills gradually decreases and the use of nature gradually increases. Near the city the most perishable products are produced, such as dairy products, vegetables, and fruit; grain for bread is produced further out, and in the periphery there is hunting in the wilderness. Economists today have rediscovered Thünen's approach to economic geography, but many miss the crucial point he stresses, namely what stands on the lines on the first page of the *Isolirte Staat*: ‚Man denke sich eine sehr große Stadt in der Mitte einer fruchtbaren Ebene gelegen'. Since von Thünen was a farmer and mainly interested in the improvement of agriculture, he does not pay too much attention to the factories in the city, even though they are also mentioned in his book. It was the common sense of the day that the increasing returns on city activities needed tariff protection in order to get the entire system to function, there was no need for von Thünen to argue for or against that established practice. Thünen did not argue against the accepted knowledge of the time that a state needed manufacturing industry. Underlying what happened in Thünen's outer circles was a development machine at the core of the concentric circles – the urban increasing returns industries (manufacturing) – which, for a time at least, needed targeting, nurturing, and protecting. In other words, the presence and state of development of the core city would also determine the standard of living in the rest of the country, in these outer circles.

Thünen drew a version of the traditional stage theories (*Stufentheorien*) in economics – what in later German literature came to be called *Wirtschaftsstile* – onto a map where the most 'modern' sector, manufacturing, formed the city core, and the most 'backward' sector, hunting and gathering, formed the periphery furthest from the city. Moving outward away from the city, the use of nature as a factor of production increases and the use of capital decreases. Only the city will have authentic increasing returns, free from nature's flimsy cyclicality and supply of resources (land, minerals) of different qualities.

As one moves from the city towards the periphery, man-made comparative advantage (subject to increasing returns) gradually diminishes and nature-made comparative advantage (subject to diminishing returns) increases. As we move outwards in the circles, the carrying capacity of the land in terms of population also diminishes.

The importance of the linkages and synergies for agricultural development, seeing the benefits accruing to agriculture from the proximity of manufacturing, was perhaps the most important new insight in economics during the early 1700s. This was also reflected in English literature at that time: 'Husbandry … is never more effectually encouraged than by

the increase of manufactures,' says David Hume in his *History of England* (1767, Vol. III).

Thünen's model pictures all the stages of development inside one nation-state, one labour market, one school and university system, and one social security system. The synergies that David Hume points to are partly the result of an equal access to basic institutions and government services accruing to the 'hunters' in the outermost circle as well as to the city dwellers. The local city market does to national agriculture what an international market can never do. Proximity to a city in the same labour market, rather than abroad, assures employment for the second and third son on the farm. The wage pressure from the city activities makes labour more expensive in the countryside, allowing for technological change that would never be profitable with low wage rates. The proximity to the city gives access to advanced technology and expertise that a rural-only nation would never achieve. All in all von Thünen's model provides a useful picture for development as a synergy between town and countryside.

The free trade shock to which the former Soviet Block countries were subject following 1989 thoroughly upset von Thünen's model, killing off a manufacturing sector which had been created in all countries. The most advanced sectors in the least advanced countries died out, not only the European part, but the whole former Soviet Block and its division of labour based on the COMECON trade area was severely de-industrialized. More skill- and capital-intensive activities at the core of the once *Isolirte Staat* died out, and were replaced by activities which take place in the outermost circle, offering much nature and little capital and skills. Hand-peeling of shrimps in Holland was moved to locations with cheaper labour like Poland. The Baltic countries closed down their heavy industry and got a formidable comparative advantage in activities like picking wild mushrooms. Today, even outside the EU – in Norway and Switzerland – there are hardly any *Eierschwämme*[2] picked locally any longer. These products, typically from the most nature-intensive and least capital-intensive outermost circle in von Thünen's system, now all come from Eastern Europe. This represents a primitivization of the economies of those countries.

The European periphery has been subject to what I have called the Vanek-Reinert effect: When two nations at widely different technological levels integrate, the first casualty is the most advanced economic activity in the least advanced nation. I argue that this Vanek-Reinert effect represents one of the mechanisms of primitivization that accompany free-trade shocks and premature globalization. This effect in turn contributes to fall-

2 Chantarelles, a type of mushroom.

ing employment for skilled people, to falling wages and factor price polarization, and consequently to migration of skilled labour. For example, Southern Italy was subject to this effect with the unification of Italy during the late nineteenth century: industry died out and migration resulted. A more current example can be observed in Latvia: more than 20 % of the population has left Latvia since the country joined the EU in 2004.[3]

While neoclassical economics have no tools to comprehend and describe this phenomenon, it can easily be explained in von Thünen's framework where economic activities are qualitatively different, subject to more capital and less nature (economic progress), or, conversely, with less capital and more nature (economic retrogression). Von Thünen established a framework that enables the study of economic primitivization which occurs when his concentric circles are being hollowed out with the loss of the core city activities.

2.2 Friedrich List's Economic Principles

Even though Friedrich List (1789-1846) is largely ignored in today's economics textbooks, his economic principles not only industrialized Continental Europe in the 19th century. List was also a very early visionary of a united Europe, and inspired European integration from the early 1950s until and including the successful integration of Spain and Portugal into the EU in 1986. The European Union followed the Listian policy of opening up for free trade between *symmetrical partners* all with a *healthy industrial fabric*. A slow pace of integration, slowly building down tariff barriers, was done with the preservation and strengthening of the industrial symmetry in mind. So, for a certain period of time, the academic division of labour in Europe was clear: Friedrich List ruled the field of practical policy, while neoclassical economics ruled in the economics textbooks. Slowly, starting with the free trade shock after the Fall of the Berlin Wall, and continuing with the integration of ten new EU countries in 2004, List's principles were abandoned in favour of the same textbook economics that dominate the Washington Consensus.

A worrying aspect of this is that even the countries that are hailed as success stories of the recent European integration have serious problems of social cohesion: apparently successful urban administrative centres contrast starkly with rural poverty. With my Estonian colleague Prof. Rainer Kattel, I attempted to create a rough index for regional inequality. Based on the monthly rent of a city apartment of 100m^2 in the national capital, we measured the distance to the area where, with the same

3 This was the provisional result of the last Latvian population census.

amount of money, you can purchase a whole house. In Norway this 'monthly rental to full ownership index' lies at around 2.000 kilometers, from Oslo to Vardø at the Arctic Sea in the extreme North. In Estonia, this distance is down to less than 100 kilometres from Tallinn. In spite of its success in high-tech innovations Estonia is one of the nations in Europe with the worst income distribution and where the demographic development suggests that the population will be halved by 2050. Unfortunately, instead of facing up to these problems, Europe's present mood is to gloss over reality and present Estonia as an unmitigated European success story.

Below are three of List's key principles contrasted with standard textbook economics.

Table 1. Listian Principles vs. Opposing Neoclassical Principles

Listian Principle	**Opposing Neoclassical Principle**
The preconditions for wealth, democracy and political freedom are all the same: a diversified manufacturing sector subject to increasing returns (which would historically mean manufacturing, but also includes a knowledge-intensive service sector).	All economic activities are qualitatively alike, so it does not matter what you produce. Ideology based on 'comparative advantage' allowing nations to specialize in economic activities that require little knowledge, operate under perfect competition and diminishing returns, and/or lack any scale economies and technological change. In other words: making it possible for a nation to specialize in being poor.
A nation first industrializes and is then gradually integrated economically into nations at the same level of development.	Free trade is a goal per se, even before the required stage of industrialization is achieved.
Economic welfare is a result of synergy. Investments in infrastructure, education and science are an integral part of this type of policy.	'There is no such thing as society', Margaret Thatcher (1987).

The present neoclassical economic principles must be abandoned in favour of the old Listian principles. Just as with von Thünen's insights described above, these Listian principles cannot be captured by the tools of the ruling economic paradigm. Understanding List requires understanding qualitative differences between economic activities, diversity, innovations, synergies and historical sequencing of processes. These are all blind spots in standard economics, especially in their interacting and cumulative totality. The failure to understand the wisdom of the Listian principles which previously upgraded the common interests of Europe has produced an economic and social race to the bottom.

The vision of WTO's first director Renato Ruggiero on the operation of the world market may stand as a prototype for the new view that also penetrated European Union thinking. This global vision was centered around 'the borderless economy's potential to equalize relations between

countries and regions'. 'At the global level', Ruggiero says, 'old divisions between North and South are being superseded by new distinctions – between those countries embracing technology and globalization, and those that remain behind …' (Ruggiero 1998: 130-131). As I see it, the European Union strategy is too simplistically based on this view: an abstract and empirically ungrounded view that technology and innovation are enough to solve most problems, regardless of context.

At the global level, the most populated nations on the planet – China and India – had followed for more than 50 years a Listian economic policy protecting industry. They could benefit from globalization, while many small nations in Latin America, in Africa, and in Asia were de-industrialized. Yet, Ruggiero further talks about 'the potential for eradicating global poverty in the early part of the next century – a utopian notion even a few decades ago, but a real possibility today.'

2.3 Schumpeter's Concept of Innovation and Creative Destruction

Joseph Schumpeter (1883-1950) was born one hundred years after von Thünen (1783) and also passed away one hundred years after von Thünen did (1850). Adding Schumpeter to our discussion creates a long sequence of visions that are internally consistent and complementary visions to the problems of Europe today. They stand in sharp contrast to neoclassical economics – individually and as a group of theories.

Schumpeter is increasingly known today for his perspective of 'creative destruction': The idea that economic progress is achieved through incessant innovations which makes older technologies obsolete and unprofitable. However, the perspective in Europe today has shifted to a neoclassical view where all economic activities are assumed to be qualitatively alike. If we instead superimpose Schumpeter's world view on a theory based on Heinrich von Thünen and Friedrich List, we get an entirely different picture and entirely different policy recommendations.

Economic activities are not alike; however, neoclassical economic theory implicitly claims exactly the opposite. The table below explains by which mechanisms some economic activities create more wealth (the Schumpeterian activities listed on the left side), while others make nations stay in poverty (the Malthusian-type economic activities listed to the right). Schumpeterian activities are those which produce the dynamic imperfect competition of creative destruction; innovations which create higher profits, higher wages, higher tax incomes, and higher living standards. Malthusian activities are those which are void of these characteristics, therefore not providing increased welfare but poverty and population pressure.

Table 2. Schumpeterian vs. Malthusian Economic Activities.

Characteristics of Schumpeterian activities (= 'good' export activities)	**Characteristics of Malthusian activities (= 'bad' export activities if no Schumpeterian sector present)**
Increasing returns	Diminishing returns
Dynamic imperfect competition ('rent-seeking')	'Perfect competition' (commodity competition)
Stable prices	Extreme price fluctuations
Generally skilled labour	Generally unskilled labour
Creates a middle class	Creates a 'feudalist' class structure
Irreversible wages ('stickiness' of wages)	Reversible wages
Technical change leads to higher wages for the producer ('Fordist wage regime')	Technical change tends to lower price for the consumer
Creates large synergies (linkages, clusters)	Creates few synergies

Source: Reinert 2007.

The present European understanding of innovation tends to apply the term inside a neoclassical framework with an underlying assumption that all economic activities are qualitatively alike. An example shall explain why this approach is wrong: assume the employees of a Berlin hospital are placed in two different 'countries'; the surgeons and other highly qualified personnel are put in one country and the people washing the hospital floors are put in another. If we open up for 'free trade' we will find that the country where the surgeons live will have much higher wages and a much higher standard of living than the country where the people who wash the floors live. The experiment would result in *factor-price polarization* rather than *factor-price equalization*.

Modern European Union policy would prescribe 'innovation' as the solution to the nation of floor washing. Apply more capital per employee and employ only people who have Ph.Ds in washing floors could be a start. The problem is that people who wash floors are poorer precisely because there is no way one can profitably add much more capital to that activity, and that for the exact same reason there are just no Ph.Ds in washing floors. The same applies to cleaning shrimps or picking *Eierschwämme*. These are – at the moment – technological dead-ends, corresponding to the outermost circle of von Thünen's concentric circles, corresponding to the kind of economic activities which Friedrich List understood must be complemented with high-tech industrial activities in order to make a country rich, and void of the criteria that inhabit Schumpeterian economic activities as outlined above. The factor-price dilemma created cannot be understood in the present mental framework of the

European Union, but may be understood in the frameworks of von Thünen, List, and Schumpeter.

3. Europe's Failed Response: The Lisbon Strategy as a List of Good Intentions

What brought Europe into the present confusion and disorder is a mainstream economic theory that abdicated from studying key aspects of capitalist dynamics, including the dynamics of technology and financial crises. The failure to understand dynamics led to a 'tyranny of good intentions' that frequently produced disasters. Instead of developing Africa through industrialization – as had been the Post World War II project – well-intentioned aid brought the continent from traditional colonialism into an equally humiliating 'welfare colonialism'. The good intention of including Greece in the Euro project ended in an unmitigated disaster produced by the parallel forces of de-industrialization and a financial setup that prevented much-needed exchange-rate flexibility.

The failure to understand what once were basic economic principles of accepted common sense made it possible for European politicians to create a 'united Europe' on a foundation that could not withstand normal economic gravity. The intentions, although noble, produced the opposite result of what was intended: economic and social disharmony rather than harmony. The noble intention of including the peripheral EU countries – like Greece – into the common currency, has turned out to be an economic nightmare to the Greeks. In both situations noble intentions in a simplistic neo-classical economic framework created disasters. Europe is now stuck with a dysfunctional economic theory that fails to provide the tools that used to make change happen, presently tearing its economic and social fabric apart. Whereas crises previously could be solved through devaluations in the affected nations, this solution is now blocked. Europe has unknowingly accepted the US model which solves problems by moving people rather than by adjusting currencies.

The same unfortunate combination of noble intentions and lack of understanding of real-world economic dynamics also haunts European technology policy. Having been engaged in a project for the EU *Institute for Prospective Technological Studies* (IPTS), my conclusion in the 2006 IPTS report (Reinert 2006) was that the technology policy of the EU essentially was a laundry list of good intentions, which – because the analysis was framed in a neo-classical framework – failed to cope with the real dynamics of world capitalism:

> 'The Lisbon Strategy appears to have been superimposed on the neoclassical economic framework dominating in the 1990s, where the market is a great equalizer and creator of economic order and harmony. In many parts of the global periphery it is increasingly clear that globalization creates more poverty, not less. It is reasonably clear that such trends – exemplified by East Germany – may be found within the EU. As I see it, the further debate ought to be based on an analysis of what went wrong in the past, and it should move away from the neoclassical tradition of discussing policy void of its context. A policy may be excellent in one set of circumstances, but counterproductive in another. I argue for bringing back the Continental European economic tradition that created Rhine Capitalism: a society where the market is a tool rather than a goal in itself, and where economics is defined as the study of the economy as a real object in a specific context, not defined in terms of the adoption of core assumptions and techniques.'

Both in terms of *financial* and of *technological* dynamics the European Union has lived in a fairytale world of simplistic neo-classical economics. Many problems have been evident for a long time, and the specific European Union issues have been covered in detail in two joint papers by an Estonian colleague and myself (Kattel & Reinert 2004 and 2007). There are strong parallels between these failures in the policies of *finance and of technology*. Quoting from my chapter, written for the European Union's own research unit, both discussions appear as 'a long list of good intentions which – it seems implicitly to be assumed – necessarily will lead to success'. In both aspects – in the financial crisis and in terms of its deteriorating ability to employ its population in well-paid jobs (also referred to as 'competitiveness') – Europe has hit a wall. In parallel, the decades of focus on 'limits to growth' have for many Europeans mutated into a belief in 'limits to innovation', at times almost evoking a yearning for some kind of technological retrogression. However, what we measure as GDP and growth is relatively arbitrary. If the clean energy that in the future will substitute oil initially is more expensive than its dirty predecessor, cleaning up the planet will necessarily appear as economic growth.

As Lionel Robbins wrote more than 50 years ago, the basic features of the neoclassical paradigm produce a *Harmonielehre*, a theory where economic harmony is already built into the assumptions on which the theory rests. Today, this paradigm hinders rather than helps our understanding of the reasons behind poverty. As Thomas Kuhn says, 'A paradigm can, for that matter, even insulate the community from those socially important problems that are not reducible to the puzzle form, because they cannot be stated in terms of the conceptual and instrumental tools the paradigm supplies.' (Kuhn 1962: 37)

Any long-term solution both for Europe and for the poor nations of the world will have to rest on a *theory of uneven development* – a theory which addresses these blind spots of economics which obfuscate our collective view. Such a theory once existed at a level complete enough to create successful economic policy for 500 years – from Henry VII's policy in England in 1485 to the integration of Spain and Portugal into the European Union in 1986 – but is now virtually extinct in any faculty of economics.

Tensions within the European Community are results of the same economic forces that create poverty in the world periphery. People in the old member states in the European Union feel betrayed because their welfare is being eroded, while people in the new member states feel betrayed because welfare is not arriving as fast as expected. This completely new and unanticipated situation causes people to ask the same way they ask about globalization: what went wrong? The answer lies in the loss of the insights from von Thünen, List and Schumpeter.

4. Conclusion

In the European periphery the advancing financial crisis superimposed austerity and frozen exchange rates on an already advanced process of de-industrialization. In these regions – from Greece to the Baltic states – real wages are falling, both in real terms and as a percentage of GDP. Seen from Heinrich von Thünen's theoretical scheme we can describe what is happening in terms of hollowing out his scheme of concentric circles, killing off the industrial activities of the city which is the nucleus of his system. In terms of Friedrich List's insights, we have neglected the preconditions for successful sequencing of economic integration. As to Schumpeter, we have removed Schumpeterian activities from the peripheral countries. The Listian and Schumpeterian processes of increasing wealth have been put in reverse, now increasing poverty instead of increasing wealth. The sequencing in Greece and Latvia is the same one we recognize from the globalized periphery: first de-industrialization, then de-agriculturization (e.g. death of agriculture), and finally de-population.

What to do? The first age of globalization ended with a return to tariff protection. 'The Rise and Fall of the Free Trade Movement' was the appropriate book title published by Cambridge economist William Cunningham in 1905. Today it is clear that while the world took for granted that the factor price equalization produced by free trade would mean an upward adjustment of real wages for all, there are in reality strong pressures towards a downward factor-price equalization combined with

increased unemployment. This produces a wake-up call both for the global economy and for the European economy.

'Because the private interest of each individual, when it coincides with the public interests, is always the safest guarantor of public happiness', says Pietro Verri (1771: 42). Adam Smith's followers – in fact more than Smith himself – changed this into a system where private interests, by definition and in any context, not only coincided with the public interest, but alone were sufficient to create public happiness. In the triumphalism following the Fall of the Berlin Wall it looked as if Smith had been right, now it is increasingly clear that we have to modify this view.

The conclusions of a 2005 meeting of the European Council correctly and importantly stated: 'Europe needs a solid industrial fabric throughout its territory'. This insight was recently 'rediscovered' and restated by the EU in the fall of 2012. To this industrial vision must also be added the importance of the knowledge-intensive service sector which exhibits the same Schumpeterian qualities traditionally associated with industry. However, solely applying a Schumpeterian 'icing on a solid cake of mainstream theory' is an example for the insufficient use of the combined theories of von Thünen, List, and Schumpeter. In the meantime Asia, particularly China, has incorporated the old European type of industrial policy.

In 1841 Friedrich List gave Continental Europe a theory on how to achieve a balanced growth and how to industrialize against the fierce 'competitiveness' of England. List stated that symmetrical integration of industrialized nations where each industrial structure survives is beneficial to all parties, a typical win-win situation. Today, Europe has created a situation which rather appears as a lose-lose situation to many of its inhabitants, both in the old and new member states. As I see it, these are problems that will require the resurrection of some of the recently abolished tools from the policy toolbox, together with the factually based continental economic theories that created them.

Joseph Schumpeter's contrast of the work of Adam Smith and German economist Johann Heinrich Gottlob von Justi (1717-1771) provides a description of economics which can be suggested for the European Union:

> 'He (Justi) saw the practical argument for laissez-faire not less clearly than did A. Smith. (...) Only he saw much more clearly than did the latter all the obstacles that stood in the way of its working according to design. Also, he was much more concerned than A. Smith with the practical problems of government action in the short-run vicissitudes of his time and country, and with

> particular difficulties in which private initiative fails or would have failed under the conditions of German industry of his time. His laissez-faire was a laissez-faire plus watchfulness, his private-enterprise economy a machine that was logically automated but exposed to breakdowns and hitches which his government was ready to mend. For instance, he accepted as a matter of course that the introduction of labour-saving machinery would cause unemployment: but this was no argument against the mechanization of production because, also as a matter of course, his government would find equally good employment for the unemployed. This, however, is not inconsistency, but sense. And to us who are apt to agree with him much more than we do with A. Smith, his (Justi's) vision of economic policy might look like laissez-faire with the nonsense left out'. (Schumpeter 1954: 172)

There is a cyclical element in economics: in the 1840s the economic wisdom of Verri, Justi and their contemporaries had been replaced by Ricardian economics where the market was seen as producing harmony. Contrary to the predictions of Ricardian economics, what was then called 'the social question' shattered Europe and led to revolutions in all large European countries with the exception of England and Russia. However, Marx' spectre of communism sparked economic reform, where the *Verein für Sozialpolitik*, literary the *Association for Social Policy*, produced economic and social institutions that created the European welfare state. Gustav Schmoller took the leadership of the Verein from the start in 1872. Chancellor Bismarck's support of this line of economic research was key to its success.

Following the 1848 upheavals, timely fact-based, context-specific and problem-oriented economics – rather than Ricardo's assumption-based, context-free and highly abstract theories – chased away the 'specter of communism' and laid the foundations for democratic social market economies. As Keynes wisely said, the real issue was 'not one between collectivism and laissez-faire, but between targeted state action and a socialism which was out of date and contrary to human nature'.

In this long term perspective today's political situation in Europe carries with it a strong sense of déjà vu. Again Europe has fallen victim to the simplicities of Ricardian economics, a theory that – as English economic historians readily used to admit – was created in order to let England keep its world industrial monopoly and convince the rest of the world to accept their roles of suppliers of raw materials. Europe has started to believe in what once was the propaganda version of its own economic theory, while China has understood the games of von Thünen, List, and Schumpeter.

It appears we may be doomed to repeat conflicts that we had previously managed to solve. One important reason for this retrogression is that the triumphalism following the Fall of the Berlin Wall made us collectively forget the wise targeted state actions that modified the pure market economy. If communism failed, so Europe seems to have reasoned in the 1990s, the market had to be perfect. Based on this the 2004 enlargement was agreed.

Compared to the rest of the world, many things are not really that bad. If we compare European productivity data to those of the United States and correct for the hours worked, we find that European productivity is in fact doing well. The biggest – and rapidly growing – problem is self-inflicted, namely the downward pressure on real wages and the welfare system in 'old Europe' coupled with extremely low real wages and huge un- and underemployment in the new member states. These problems are two sides of the same coin. A widely proclaimed success story of the new member states, Estonia's electronic industry, produces hourly wages of about one Euro, which equates to approximately 10 % of the earnings of someone sweeping the streets of Paris or Frankfurt. Tensions are too big and the number of people and vested interests involved is too high for the market alone to create a happy end. In fact what is missing is old-fashioned *Staatsklugheit*, or experience-based wisdom among the political elites.

The present situation of Europe requires more than the Lisbon Strategy's list of good intentions focusing around innovations, it needs to bring back economic thinking and economic tools that had been abandoned in the 1990s. This includes bringing back the earlier focus on employment that dominated the period after World War II. It also means a qualitatively much more profound and differentiated analysis of technology and innovations and their economic consequences on both wages and employment, at company, community, and national level. A framework of equilibrium theory is neither adequate nor effective to study the phenomena that create the economic differences which now haunt Europe. We are instead in a situation dominated by processes of cumulative causation. The now practically defunct continental European tradition of economics is much better suited to tackle such a task. Above all, the discussion of the Lisbon Strategy must be lifted out of the generic and context-free into a context where present problems – caused both by the shock therapies of the 1990s and the challenges from Asia – are recognized as being the real challenges to European Union policy.

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