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Failed and Asymmetrical Integration: Eastern Europe and the Non-financial Origins of the European Crisis

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Abstract

This chapter argues that the crisis in the Baltic countries can be properly understood only in the context of the dramatic de-industrialization and structural change that took place in these countries, and other Eastern European economies, following the fall of the Berlin Wall. It is argued that with the Eastern enlargement, climaxing in 2004 with formally admitting Eastern European economies into the Union, the European Union gradually abandoned its previous strategy of symmetrical integration – based on principles surviving from the Post World War II era, inspired by Friedrich List – integrating the region’s economies into a structurally asymmetrical relationship that has common elements with colonialism. Once the real-estate bubbles collapsed, this underlying structural weakness became evident, causing wage collapse and outward migration. We show that the Eastern enlargement – along with financial architecture of the euro zone – also undermined the success of previous waves of enlargements, particularly that of Spain. In the Baltic countries the effect of the crisis was, as could be expected, a massive redistribution of income: wages as a percentage of GDP (the share of “the 99 per cent”) plummeted by some 6 percentage points while profits and rents (the share of “the one per cent”) rose correspondingly. We also discuss whether the Estonian case actually deserves to be called an ‘internal devaluation’, and indicate that what apparently dampened the crisis were not local policy initiatives but forces external to the region. The chapter also presents two different scenarios from the crisis in the 1930s – the US and the German ones – and asks if this crisis is likely to follow the US or the German pattern of income distribution. It is argued that the pattern likely to be followed is the German rather than the US one, which in the present context is likely to produce a long crisis and at worst make EU wage reductions permanent.

1. Introduction

This article is a third incarnation of our discussion of the European enlargement processes.¹ In 2004 we published a paper titled “The Qualitative Shift in European Integration: Towards Permanent Wage Pressures and a ‘Latin-Americanization’ of Europe?”. Here we argued that the pro-

¹ What follows builds on our previous published work, Reinert and Kattel 2004, and Reinert and Kattel 2007. For a detailed analysis of how Eastern Europe and the Baltic countries dealt with the crisis of 2008-2010 in detail, see Kattel 2010 and Kattel and Raudla 2013. The authors are grateful to Jan Kregel for his comments. The usual disclaimer applies.

cesses leading up to the Eastern enlargement² (liberalization of markets, mostly) large parts of Eastern Europe started to look more and more like Latin-America used to look in the 1980s and 1990s: a picture dominated by a few (high tech or other) export enclaves surrounded by relatively simple industries/services. A region with such characteristics will experience gradual primitivization through increased global competition which creates downward pressures on overall living standards, and increases income polarization, i.e. the effect of integration was factor-prize polarization rather than the expected factor prize equalization (Reinert and Kattel 2004).

In other words, we argued that despite impressive growth numbers in exports and foreign direct investments, Eastern European economies failed to develop genuine Schumpeterian dynamics of imperfect competition: industrial and service activities with economies of scale and backward/forward feedback linkages that stimulate learning and technological change (embodied in changes in the nature of work) and a hugely increased division of labor in a wide number of sectors, a type of dynamics which simultaneously increases productivity, profits and wages.

In 2007 we picked up similar themes in a paper called “European Eastern Enlargement as Europe’s Attempted Economic Suicide?” and furthered our argument that the Eastern enlargement in 2004 represented a substantial qualitative shift in EU integration, and that this new *asymmetrical* modus of integration (enshrined in the so-called Maastricht criteria and other conditionalities agreed upon in 1992) of including new countries with significantly lower development levels into a common market – and eventually into a currency union – was a highly perilous strategy that could bring down the entire Union. (Reinert and Kattel 2007) Now, almost a decade after our first attempt and with the EU in the midst of a profound and, as many would argue, systemic crisis, we take a fresh look at European enlargement processes.

In 2004 and 2007 our main argument rested on the assumption that economic integration, similarly to capitalism, can take many forms, some of them more conducive to development than others. Colonialism was probably the earliest form of international economic integration. Intuitively, we understand that what the European Union initially attempted

² In what follows we use Eastern Europe to denote all 8 countries that joined the EU in 2004 (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia), and Southern Europe to denote the three countries that joined the EU in the 1980s (Portugal, Spain and Greece); in some discussions below we differentiate between Central Europe (Czech Republic, Hungary, Poland, Slovakia and Slovenia) and the Baltics (Estonia, Latvia and Lithuania). We do not discuss Bulgaria and Romania that joined the EU in 2007.

to achieve is something qualitatively very different from colonialism. Successful economic integrations are win-win-situations that extend and develop dynamic capitalism into new areas. On the other hand, unsuccessful ones are forms of integration where one or both parties lose – or are prevented from achieving – the wealth-enlarging Schumpeterian dynamics described above.

In our previous articles we argued that the integration of the European South (Portugal, Spain and Greece) in the 1980s was fundamentally based on *symmetrical integration*: countries with similar levels of development joining into a common economic area (although the Greek industrial sector was relatively weak). Integration was slow, in some cases tariffs were gradually lowered over a period of 10 years, while massive funds were made available for industries in the joining countries to gear up to the technological level of the core countries before free trade was introduced. The Eastern European enlargement followed an instant free trade shock after the fall of the Berlin Wall, which had virtually deindustrialized the ex-Soviet periphery. Integration was consequently very asymmetrical: poorer nations were integrated into a common economic space with much wealthier economies. In what follows we aim to show that the asymmetrical Eastern enlargement turned the previously symmetrical integration of the South also into a much more asymmetrical integration, as competition from low-wage Eastern European economies undermined the upgrading of many South European companies. Increasing competition from China and East Asia strengthened the cumulative negative effects inside the European Union.

As we see it such asymmetrical processes of integration created huge structural imbalances within the EU, which for almost a decade were offset by the convergence of interest rates resulting from common currency. This convergence produced declining interest rates in Southern and Eastern Europe, as well as in Ireland that fuelled public and private asset bubbles the funded growing demand and increasing imports of goods and services of the core European economies, chiefly Germany. (Kregel 2011) However, with highly peculiar financial structure of the euro zone – a single currency but segmented sovereign and private capital markets, no uniform deposit guarantee scheme and the absence of a real lender of last resort – as well as with a highly uneven national economic restructuring in terms of presence or lack of Schumpeterian dynamics, such imbalances were bound to lead to huge problems as the Union essentially became a mix of a Ponzi scheme (sustaining private sector income growth by increased borrowing) and beggar-thy-neighbour policy, in the form of German wage constraints throughout the 2000s.

The present blame-game of “irresponsibility” from the core of the EU towards the Southern periphery fails to capture and understand the origins of the underlying mechanisms. After decades of terrorism from the right and from the left – the period Italians call *gli anni di piombo* or the „leaden years“³ – social peace was achieved only through compromises that would only be fulfilled through increased inflation: the government made more commitments that could be met with domestic resources, given the constraints of the then ruling Exchange Rate Mechanism. Inflation was, in a real sense, the price of democracy and peace. Those with experience in Latin America will recognize this as a typically democratic phenomenon: the countries which early experienced high inflation were Chile and Costa Rica, the most democratic countries of all. Dictatorships – like Alfredo Stroessner’s in Paraguay – never saw problems of inflation.

Before EMU (Economic and Monetary Union) was converted into the straightjacket enforced by the Euro – the „irresponsible“ inflationary systems in Southern Europe had their own dynamic logic: inflationary budget spending led to falling exchange rates and to depreciation within the ERM. In this way the intra-European competitiveness of the real economy was saved. Government debt also tended to be issued in local currency, so government debt was devalued with the currency. In Latin America these mechanisms would lead to a default on debt in foreign currency, so frequent devaluations and defaults on debt were necessary correction mechanisms in the „cycles of irresponsibility“. Flexible exchange rates were an integral part of keeping the system going. Introducing the Euro – i.e a fixed exchange rate – had the effect of completely sealing the safety valve in the system. In the EU periphery the choice is now either to force down real wages further, which will cause more migration, or to devaluation and Sovereign default. Sooner or later „something’s gotta give“, either the population or the exchange rate. As in any Ponzi scheme, the default will eventually have to come anyway, the question is how much damage and human suffering will be caused before default is admitted.

The internal dynamics of Europe is in some ways a microcosm of the same type of problems confronting the entire global economy governed by WTO rulebook and, perhaps even more importantly, bilateral free trade agreements: the key problem of uneven development in the productive structure, especially if the de-industrialized or non-industrialized peripheries, is marginally – if at all – addressed. Similarly to the European situation, flaws in the productive structure are temporarily ‘offset’ by financial inflows and/or asset bubbles, engendering Ponzi-scheme like dynamics where further growth relies on continuing inflow of foreign

³ [http://en.wikipedia.org/wiki/Years_of_Lead_\(Italy\)](http://en.wikipedia.org/wiki/Years_of_Lead_(Italy)), accessed April 6, 2013.

savings. (Kregel 2004) The poorly developed industrial structure in respective peripheries fails to create the necessary demand that would create a high value-added service sector. Economic problems in the peripheries are solved by the migration of labor, rather than by addressing their structural and financial requirements for development. Contrary to mainstream discourse in economic integration that predicts a convergence towards 'factor-price equalization', asymmetrical integration may lead to 'factor-price polarization' – that is, increasing gaps in real wages and growing inequality.

If our argument is correct – that asymmetrical economic integration is undermining evolution of Schumpeterian dynamics in the European periphery – then it also follows that European Union cannot recover from its current crisis without significantly rethinking some of its basic ideas in terms of what policies regions and countries with lower income levels and less dynamic economic structures should pursue and how these policies should be financed. We think it is safe to argue that the European integration through the 1980s was still constructed in the post WW II logic of “transnational mercantilism”[2]: every country needed a sector of Schumpeterian dynamics (“industrialization” for short) in a system of symmetrical integration. Integration after the fall of the Berlin Wall was marked by neoliberal triumphalism – seeing markets as the great equalizer – and wishful political thinking. But this approach was applied in name only as the German government intervened to influence labour market conditions and reduce wage growth so as to enhance German competitiveness within the EU through a beggar-my-neighbour wage policy. The mindshift from the initial plan that saw the Euro as a currency for the strong economic core only, to also including the Southern periphery as “an act of solidarity” towards the South shows the utter ignorance of basic economic phenomena among the European political elites and, also, among their economic advisors. Indeed, returning to the pre-neoliberal mindset and a renewal of industrial policy, rather than interference in the labour market, in some form or other – with domestic development finance – seems to be a *conditio sine qua non* for European recovery.

2. Setting the stage: integrating Eastern European countries into the capitalist economy

Perhaps the key assumption behind how Eastern European countries should go about reforming their economies after the 1989 fall of the Berlin Wall was the belief that, as Martin Wolf argues, “new opportunities were at last opening up for developing countries to export manufactures and a range of relatively sophisticated services competitively” (Wolf

2007). Indeed, it can be argued that economists of almost all persuasions seemed to share one common view: globalization in the form of global financial markets and trade liberalization would greatly benefit the Eastern European countries. Globalization was seen as the main factor in delivering fast economic restructuring spurred by global capital in form of foreign direct investment (FDI) inflows.

This enthusiasm was largely based on the classical Ricardian assumption of comparative advantage defined, in a classic textbook formulation, as follows: "trade between two countries can benefit both countries if each country exports the goods in which it has a comparative advantage." (Krugman and Obstfeld 2005:26) Krugman's work in the 1990s that included economies of scale into the Ricardian framework, assumed that the mutually beneficial trade takes place between countries possessing increasing returns activities. (See Krugman and Obstfeld 2005:110-146; and Krugman 1996) Thus, as Eastern European countries exhibited high levels of industrialization at the end of the 1980s (comparable to East Asia), it seemed correct to assume that globalization would indeed greatly help these economies to restructure the industry and to become vastly more efficient in production through trade and increased competition. (See also Radosevic 1998 and Guerrieri 1998 for a discussion).

However, the augmented Ricardian framework failed to take into account two phenomena: first, the 1990s saw the onslaught of what has been termed a new techno-economic paradigm that completely changed the nature of industrialization and essentially stripped many maturing and increasingly foot-loose industrial activities of significant (dynamic) scale economies (Perez 2002, 2004 and 2006); second, the Ricardian framework assumes that all economic integrations are qualitatively alike (integration works always through comparative advantages) and consequently provide the same economic strategy in all contexts and any points in time, i.e. 'the equality assumption' or 'one size fits all'. (Reinert 1980, 1994, 2007)

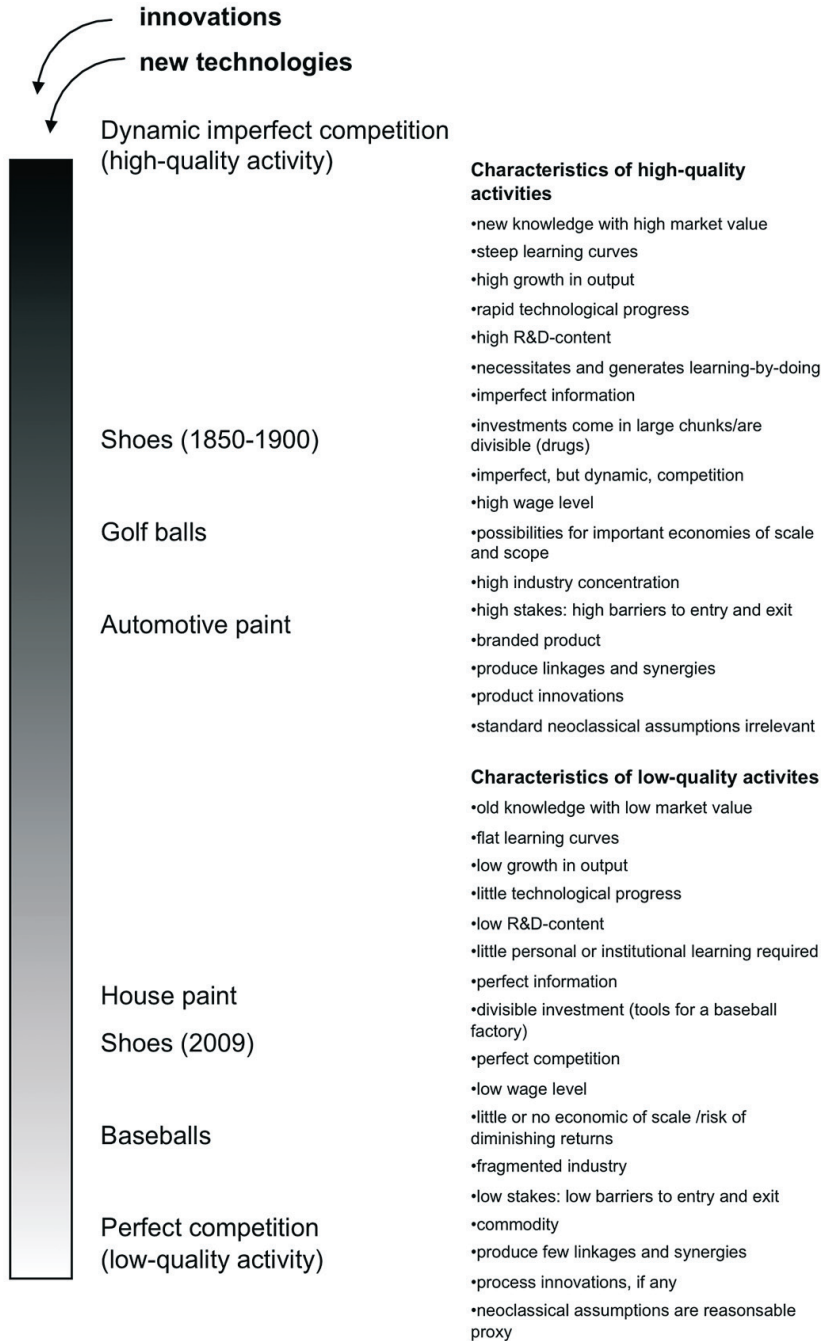
The new ICT-based techno-economic paradigm, coming to full force in the 1990s, has engendered key changes in production processes in almost all industries (including many services and agriculture): it gave rise to outsourcing and the resulting geographical dispersion of production functions. This is based on significantly enhanced technological and organizational capabilities in introducing "modularity" into production processes and networks (Berger 2006). These changes have enabled very fast growth in FDI inflows into developing countries as well as industrialization (e.g., in terms of growth rates of manufactured and high-tech exports), at least on the surface, in many developing countries. Conse-

quently, particularly in the late 1990s it seemed as if the Ricardian gamble was paying off for Eastern European economies: technology-intensive exports were growing, and catching-up seemed dynamic (see for empirical data and discussion, e.g., Landesmann 2000; Hotopp, Radosevic and Bishop 2005).

However, in many cases the outsourcing activities do not exhibit the same dynamics that used to be associated with them in the originating countries: fast and sustained productivity growth, raising real wages, forward and backward linkages, but rather the opposite. (See for detailed discussion and data, e.g., Palma 2005, Cimoli, Ferraz and Primi 2005, Tiits et al 2008, Kattel 2012) The underlying cause why so many policy analysts and economists missed what is going on in these activities is hidden in the very nature of modularity in production. What is statistically captured as a high technology product may in reality be very different in nature: it can be touch screens for iPhones or it can be assembled mobile phones for any brand mobile producer. Both show up as high technology statistics, yet the former is a product at the beginning of its life cycle – or at least was so when it was introduced in 2007 – and the latter has clearly reached maturity. Thus, the key assumption of comparative advantage trade models and theories fell away: even if high technology exports have been growing in developing countries, this does not mean that we deal with similarly dynamic sectors with significant increasing returns and feedback linkages (See also Krugman 2008).

We argue that due to changing techno-economic paradigms, Eastern European (and other developing) countries seem to have specialized in activities that on the surface exhibit 'high quality' characteristics, but in reality often fall under the 'low quality' characteristics in the dynamic Quality Index of Economic Activities in Figure 1.

Figure 1. The Quality Index of Economic Activities



Source: Reinert 1994 & 2007.

Yet, from the early 1990s until today the policy environment for industrial restructuring and how it is financed in Eastern Europe assumes the opposite: that the region is firmly on the path of convergence via increasing specialization into what appears to be dynamic high quality Schumpeterian activities. One of the key reasons for such a view is the assumption held by mainstream economic discourse that economic integrations are all more or less alike and that the way integration takes place is not as important as are domestic reforms and policies.

3. A Taxonomy of Economic Integrations

It can be argued that much of the pre-Smithian history of economic thought is filled with treatises trying to understand why certain types of trade with certain regions bring beneficial results and other types do not, i.e. in effect being extremely concerned with the dangers of asymmetrical integration. The clearest early statement of this theory is found in the first pages of Charles King's three-volume work (1721), a compilation of works published in the previous decade, which was to enjoy unique authority for decades. It is important to note that his theory is based on a possible discrepancy between the interest of the merchant and the interest of the nation itself: "There are general Maxims in Trade which are assented to by every body (*sic*). That a Trade may be of Benefit to the Merchant and Injurious to the Body of the Nation, is one of these Maxims." (1721:1) This is, of course, very different from the later teachings of Adam Smith, who assumes an automatic harmony of interests between merchant and nation. In King's scheme, the normal pre-Smithian scheme, the vested interests of some economic actors will coincide with those of the nation-state – mainly those of the manufacturers – while the vested interests of other economic actors will be at odds with the interests of the nation-state. Yet, it is precisely this crucial link between the interest of the state (higher wealth) and that of industry that is essential to the success of modern nation-states in Europe and North-America (a point made already by Schmoller in 1884). Development – in short – required that the vested interests of the capitalists were forced in line with the vested interest of the nation-state itself. Import tariffs on 'good' economic activities – encouraging higher value added activities – and export tariffs on 'bad' economic activities⁴ – making raw materials more expensive to foreigners than to domestic industry – were the main tool used in achieving this.

⁴ It can be argued that the "Tudor Plan" of Henry VII and Elizabeth I, gradually increasing the export tariffs on raw wool while encouraging domestic manufacturers of cloth, both laid the foundation for later English success and ruined the Italian woolen industry (Reinert 2007).

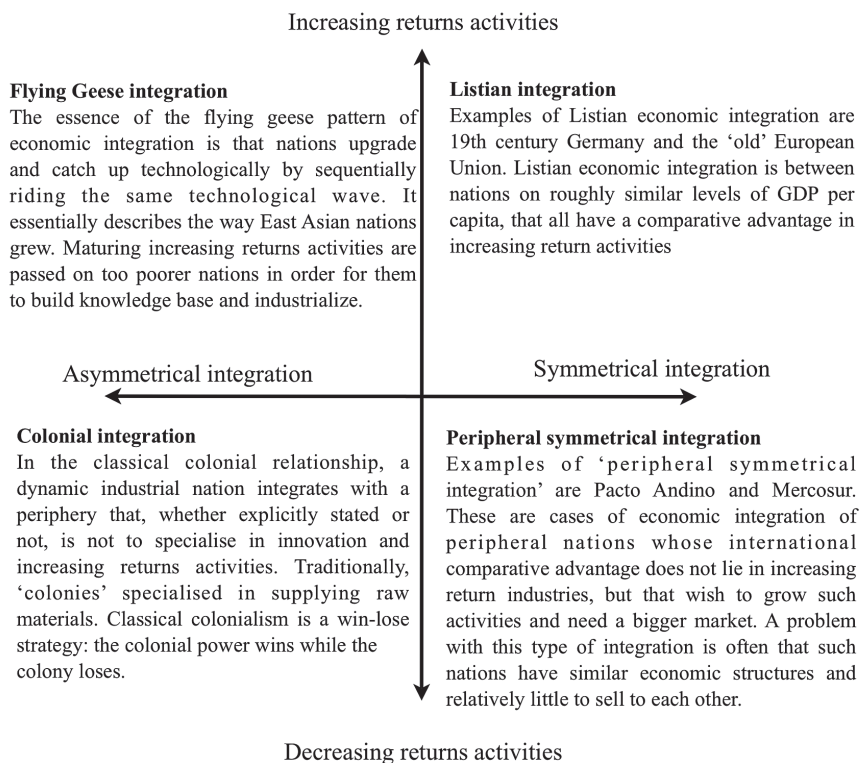
This pre-Smithian taxonomy of 'good' and 'bad' trade was based on the observation of the obvious urban bias of economic development that was found everywhere in Europe. The taxonomy is based on the fundamental understanding that economic development is activity-specific, at any point in time available in some economic activities rather than in others. (See also Figure 1 above) Development was seen as a goal created by increasing returns and innovations and an ever-increasing division of labor in manufacturing which could not be achieved in agriculture, where stagnant productivity, diminishing returns, monoculture, and the absence of division of labor and of synergies prevented growth. Key examples from pre-Smithian literature are Giovanni Botero (1590), Antonio Serra (1613) (see Reinert 2007 and S. Reinert 2011 for in-depth discussions).

This accumulated wisdom was taken over in the economics of Friedrich List (1841), who was the theoretical economist behind the industrialization of continental Europe. List is conventionally regarded as a protectionist, but this is mistaken on two accounts. First, inside Germany he is seen as the great free trader, he broke down the tariff barriers among the more than thirty German states which existed at the time, and secondly he was the first visionary of European economic integration once all nations had achieved a comparative advantage in manufacturing (increasing returns industries) (see Reinert 1998). List quotes Serra, and sees manufacturing synergies as being the very basis for civilization, rather than trade:

Let us compare Poland with England: both nations at one time were in the same stage of culture; and now what a difference. Manufactories and manufactures are the mothers and children of municipal liberty, of intelligence, of the arts and sciences, of internal and external commerce, of navigation and improvements in transport, of civilization and of political power. They are the chief way of liberating agriculture from its chains ... The popular school [i.e., Adam Smith and J. B. Say, authors' note] has attributed this civilizing effect to foreign trade, but in that it has confounded the mere exchanger with the originator. (List 1841:142)

As a continuation of King's principles, and with the experience of 300 more years of economic history, we can establish the taxonomy – based on 'ideal types' – of economic integrations (see Figure 2). There are two main types: symmetrical free trade areas (i.e., integration among nations at a similar level of economic development and economic sophistication), and asymmetrical free trade areas (i.e., integration of nations with widely different economic structure at different levels of development).

Figure 2. Taxonomy of Economic Integrations



Source: Reinert and Kattel 2007, modified.

There are two further, essentially mixed types of integration: First, the welfare colonialism type of integration. Second, there can also be an integrative and asymmetrical type of economic integration. This is a type of economic integration that differs from the classical colonial version above in that it attempts to integrate the asymmetrical partners – countries at different levels of economic development – into a welfare state. We discuss the taxonomy briefly below.

3.1 Symmetrical free trade areas

3.1.1 Listian Integration (From Friedrich List)

Examples of Listian economic integration are 19th century Germany and the 'old' European Union (up to 1992, the year of the Maastricht Treaty that laid the groundwork for the euro zone and enlargement conditionalities). Listian economic integration is between nations on roughly similar levels of GDP per capita, that all have a comparative advantage in increasing return activities. This insures that economic integration will not de-industrialize, de-skill or create large-scale unemployment in any of the

partner countries. Large Listian areas can, however, absorb small units of relatively more backward countries to the benefit of all parties. An example of this is the integration of Portugal in the old EU, where mature and labor-intensive industries could be farmed out to Portugal, increasing real wages both in Portugal and in the rest of the EU (see also Priewe 2006: 160-162 on waves of European enlargement). In this case integration can be seen as a variant of the flying geese type (see below).

Two main variables determine the ability of a Listian integration to absorb poorer partner countries to mutual benefit. Firstly: the Schumpeterian dynamism of the core (wealthy) countries; i.e., the more dynamic the core countries, the more mature industries they can farm out to the poorer partners without hurting their own employment and wage level. This is also related to the stage in which the region finds itself in the dynamics of techno-economic paradigms (Perez 2004). The second variable is the size of the poorer country/countries to be integrated; i.e., the smaller the pool of people to be integrated, the easier the integration becomes.

A symmetrical Listian free trade area can be converted to an integrated welfare state at a relatively low cost. Listian integration is a typical win-win strategy if it does not deteriorate into a welfare colonialism (see 3.3 below).

3.1.2 Peripheral Symmetrical Integration

Examples of 'peripheral symmetrical integration' are Pacto Andino and Mercosur. These are cases of economic integration of peripheral nations whose international comparative advantage does not lie in increasing return industries, but that wish to grow such activities and need a bigger market. Included in successful schemes of this type are preferences for relative lagging countries, as was planned for Ecuador and Bolivia in the Pacto Andino. The Latin American Free Trade Association (LAFTA/ALALC) is an example of such an integration that failed. Indeed the present problems of Spanish-speaking Latin America may be seen as resulting from going from a highly protected national manufacturing sector directly to global competition. In the logic of Friedrich List an intermediary step of continental integration (i.e. LAFTA) would have been needed in order to strengthen the manufacturing base before exposing it to global competition.

One problem with this type of integration is often that such nations have similar economic structures and relatively little to sell to each other, and the countries remain dependent on foreign earnings to import newer technologies and capital goods. However, this type of regional integration is

probably a necessary stepping-stone before reaching global free trade. Peripheral symmetrical integration is also a win-win strategy if the right dynamics are achieved.⁵

3.2 Asymmetrical free trade areas

3.2.1 'Colonial' and Non-Integrative

In the classical colonial relationship, a dynamic industrial nation integrates with a periphery which – whether explicitly stated or not – is not to specialize in innovation and increasing returns activities. Traditionally, 'colonies' specialized in supplying raw materials, with the 'bad' characteristics listed above.

With the current techno-economic paradigm that enables increasing specialization as well as outsourcing, a more sophisticated neo-colonial division of labor appears as both manufacturing and agriculture sectors split up in high-tech/capital intensive/innovative/high wage segments on the one hand, and low-tech/low capital intensity/non-innovative/low wage segments on the other hand. (Kattel 2012) Mexico is the country where this development is most visible. The old manufacturing sector, containing 'complete' industries is shrinking and being replaced by the *maquila* sector consisting of unmechanizable fragments of a global value chain seeking low wage and low-skilled labor. This development finds its parallel in the Mexican agricultural sector, where highly subsidized US imports of mechanizable grain – produced with exceptionally advanced technology including unmanned tractors using global positioning equipment – are replacing Mexican agriculture not only in wheat but even in a traditional product like corn (maize) while Mexico specializes in exporting unmechanizable agricultural produce, e.g., strawberries and cucumbers. Such changes bring about lower prices and higher gains to consumers, but in this case the consumer is in the US and the producer in Mexico. The benefits accrue to US customers, while the Mexican farmer – working under perfect competition, diminishing returns, and unlimited supply of labor – will not see his income raised. The Mexican national innovation system is deteriorating accordingly, and returning to a center-periphery relationship with the United States (Cimoli 2000; Gallagher and Zarsky 2007).

⁵ It can be argued that the former Soviet economies (COMECON) fell into this symmetrical category because of the emphasis on geographical and national distribution of increasing return activities. Of course, all trade was controlled and thus also, arguably, integration and its results. It can be argued that this understanding survived in the Soviet Union through the insights of Count Sergei Witte (1849-1915) who translated Friedrich List into Russian, and served as Minister of Economy under the last two Tsars.

In asymmetrical trading areas the Vanek-Reinert Effect⁶ starts operating, and the least advanced nation concentrates in the low-skilled and low capital-intensity areas both in manufacturing and in agriculture. In the worst case this can lead to rampant de-industrialization and plummeting real wages (Reinert 2004). In Mexico a deteriorating sequence can be observed: first de-industrialization, subsequently de-agriculturalization (even of the country's most traditional crop, maize) and finally de-population. In many areas of Southern Mexico only the population above 60 years old and below 12 years old is left. The others are working in the United States or further north in Mexico. We find a similar pattern in the European periphery, in Moldova we find a similar demographic pattern to Southern Mexico.

The success of this strategy from the colonizing nation's point of view depends on the same variables as mentioned above. If the Schumpeterian dynamics in the rich country are high enough, and the supply of labor to be absorbed is not too big, or protection can be kept at a point securing employment, the rich country may have all the advantages of producing technologically mature and labor-intensive crops with cheap foreign labor, but not the disadvantages. In other words: the periphery specializes in staying poor.

Classical colonialism is a win-lose strategy: the colonial power wins while the colony loses. However, this is potentially a lose-lose strategy if the colonial power loses control or loses dynamism. Potentially, Mexican real wages may fall while, at the same time, wages fall in the US, when the 'giant sucking sound' hits US employment and real wages as US 1992 presidential candidate Ross Perot used to talk about. If the world moves towards factor-price equalization, this may very well be downwards. One factor keeping wages up was national labor unions which now have lost most of their power. In this sense, David Ricardo may be proven correct that the 'natural' price of labor is close to human subsistence.

3.2.2 Flying Geese, or Sequential Technological Upgrading

The flying geese metaphor for economic integrations first appears in a 1935 article by Kaname Akamatsu, published in Japanese. His views became known to the West in his 1961 article in *Weltwirtschaftliches Archiv*, and during the 1980s Japanese economist and foreign minister Saburo Okita propagated the concept. The essence of the flying geese

⁶ In rapid liberalization of trade and markets between countries/regions with strongly unequal levels of development, the first industries to suffer from competition and to close down are *the most advanced industries of the less developed country/region*. This is a key mechanism in understanding economic primitivization, see Reinert 1980 and 2007 in detail.

pattern of economic integration is that nations upgrade and catch up technologically by sequentially riding the same technological wave. It essentially describes the way East Asian nations grew. The model builds on Friedrich List's stages of integration. Its dynamics are similar to Michael Porter's stages of national development (Porter 1990) and to Ray Vernon's life-cycle theory of international trade (Vernon 1966) and to Jane Jacobs' import-replacing development of cities (Jacobs 1984).

To illustrate the process, follow a product: a hairdryer is produced in Japan and exported to the rest of the world. When Japan upgrades its technology and wage level, the production of hairdryers passes on to Korea and is exported from that country. As Korean production after a while also gets more sophisticated, the production of simple hairdryers passes on to Taiwan, where the phenomenon is again repeated. Hairdryer production moves on to Malaysia and Thailand, and finally to Vietnam. On the way all nations have sequentially increased their wealth and upgraded technologically, all based on the same product.

The flying geese strategy has proved spectacularly successful in East Asia – a true win-win form of economic integration – where Korea moved up from being poorer than Tanzania in 1950. However, the strategy was only possible because it was in the interest of the United States to build a *cordon sanitaire* of well-to-do countries around the communist world. This strategy requires heavy-handed government intervention and is impossible to initiate today under the rule of the Washington Institutions and the WTO. Latin American import-substitution initially contained strong elements of flying geese, creating a win-win situation where US companies prolonged the life cycle of their products by producing in Latin America. However, Latin America failed to move to the next Listian stage – into regional integration – through the failure of LAFTA/ALALC, and lost its dynamics. It should be noted however that even the inefficient manufacturing sectors built up in countries like Peru and Mongolia provided much higher real wages than does global capitalism today.

3.3. Welfare Colonialism

The term 'welfare colonialism' was coined by anthropologist Robert Paine (1977: 1-52) to describe the economic integration of the Arctic population into Canada, and may be applied also to the integration of the Saami ethnic minority in Norway. The essential features of welfare colonialism are: [1] the classical colonial drain 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 destroys their previous livelihood, and they are put on the dole. Welfare colonialism identifies welfare as the potential

vehicle for a stable internal 'governing at a distance' through the exercise of a particularly subtle, 'nondemonstrative' (Paine 1977: 3) 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 'center' in a peripheral population, a center exerting control through incentives that create total economic dependency thus preventing political mobilization and autonomy.

Clearly welfare colonialism is a very expensive form of economic integration, essentially paying people not to work. Not unlike the religious missionary element in traditional colonialism, welfare colonialism is in a sense well-intended, but ends up being culturally destructive. Welfare colonialism is a lose-lose form of economic integration: the periphery loses its traditional livelihood and culture and becomes an economic burden to the colonial power.⁷

3.4 Integrative and Asymmetrical Integration

'Integrative and Asymmetrical Integration' is a type of economic integration that differs from the classical colonial version above in that it attempts to integrate the asymmetrical partners – countries at different levels of economic development – into a welfare state. We argue that the European Union enlargement processes throughout the 1990s and 2000s are largely falling under this heading in terms of economic integration, and it is in fact undermining the previous Listian integrations of the 1980s of the European South. This is a system which may very well disintegrate into a system of *welfare colonialism* which – due to the large populations involved – will be prohibitively expensive in the EU periphery. The future of Greece and Cyprus may lie in this category.

4. Integration of Eastern Europe into the European Union

Over the past few decades, the European periphery has gone through remarkable changes in economic fortunes. Figure 3 shows dynamics of labor productivity compared to Germany in three European peripheral areas that also coincide with regions the European Union integrated with over the last three decades: Southern Europe (Portugal, Spain and Greece), Scandinavia (here Finland and Sweden) and Central Europe⁸.

⁷ See Reinert (2006) for a European case study of welfare colonialism in Norway.

⁸ Data are available only for Poland, Hungary, the Czech and Slovak Republics; no such long-term data are available for the Baltic countries. In the figures below data are available for all countries in Central Europe and the Baltics, unless otherwise noted.

Figure 3. Labor productivity as % of German labor productivity, 1960-2007 (GDP per Person Employed, in 1990 GK \$).⁹



Source: The Conference Board Total Economy Database, September 2011, <http://www.conference-board.org/data/economydatabase/>, calculations by the authors.

Far from seeing European-wide convergence in productivity – a key assumption behind the European integration processes in the 1990s (see Boyer 1993) – we see different regions faring rather differently. First, after three decades of trailing Germany relatively closely in the post-war era, Scandinavia takes advantage of joining the EU (1995) and of the German reunification shock, and rapidly forges ahead of Germany; second, Central Europe experiences its first lost decade between 1988 and 1998. Then – with the start of the 1998 accession talks – follows sharp increase towards catching up; and third, Southern Europe was steadily catching up with Germany up to the mid-1980s¹⁰, fell behind anew during most of the 1990s and started to catch up again albeit very slowly in the 2000s. In terms of our taxonomy, it can be argued that the integration of Scandinavia was a very successful Listian integration. Our thesis is that the integration of Southern Europe is an interrupted Listian integration and that the interruption results from a combination of the Eastern enlargement and from massive technological catching-up in China without the corresponding growth in wages which used to accompany such technological change in the West.

⁹ Here and after, PSG stands for Portugal, Spain and Greece; Scandinavia is here Sweden and Finland. In all figures, simple averages are used for calculations.

¹⁰ Greece joined the EU in 1981, Spain and Portugal in 1986; single market legislation was introduced in 1986 and in 1992.

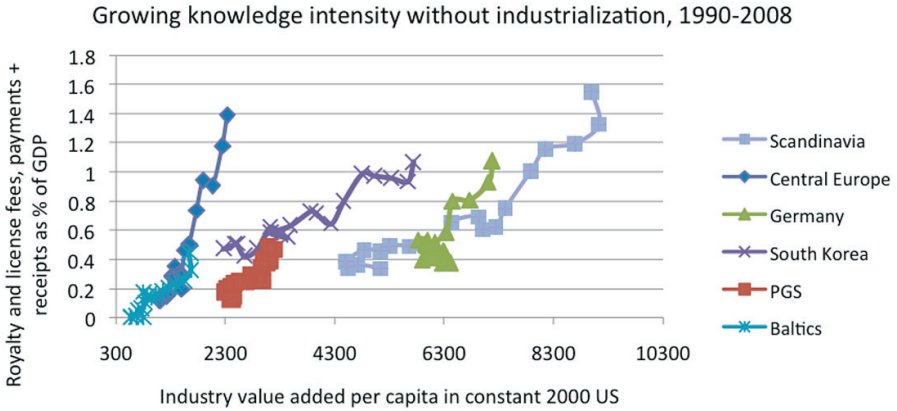
The South European catching-up process stalled with the creation of a common market that, it can be argued, laid the basic groundwork for later enlargements based on the ideology of liberalizing markets and limiting public sector debt and borrowing. Yet, the European Commission's white paper from 1985, titled *Completing the internal market*, sees the main reason for large internal markets in significant enhancement of the EU's "economic and industrial dimension by enabling industries to make economies of scale and therefore to become more competitive" (The European Commission 1985, 6). The underlying assumption behind single market creation was indeed one of symmetrical integration, extending increasing returns activities to the whole territory.

Indeed, it seems relatively likely that without the Eastern enlargement, European integration of the Southern economies would have followed a relatively common Vernonian life-cycle path of maturing industries moving to cheaper locations and in the late 1980s this would have been the South. For instance, think of Fiat and Volkswagen cooperating with Seat in Spain during the 1970s and 1980s respectively. However, with the sudden fall of the Berlin Wall and rapid opening of Central European and Baltic economies, maturing industries in the West had all of a sudden vastly better opportunities in the East. In addition, as argued above, change in the techno-economic paradigm allowed for a rapid breaking-up of the value chain and a consequent dispersion of manufacturing functions (*outsourcing*).

While unlocking the potential of Eastern Europe as destination for Western maturing and outsourcing industries took roughly a decade – that very lost decade we can observe on Figure 3 – it was the European integration processes, starting officially in 1998 with the opening of accession talks, that virtually ensured that the Soviet industrial structure was not slowly upgraded but relatively rapidly replaced – the Vanek-Reinert effect – with Western factories operating within the Western value-chain. The similarities with Mexico are clear here.

Figure 4 starts to unravel some of the dynamics behind these processes. We can take industry value added per capita as a proxy for growing industrialization (i.e., both growing and diversified production with increasing wages, typical signs of development), and royalty and licenses fees can be seen as a proxy for importing new technology and know-how since fee flows are negative – more fees go out than come in – for all developing / catching-up countries (importing technology, typical driver of industrialization).

Figure 4. Knowledge intensity of growth vs industrialization, 1990-2008.



Source: World Bank Online Development indicators, <http://data.worldbank.org/data-catalog/world-development-indicators>; calculations by the authors.

We see in principle three different kinds of economic developments depicted here. Scandinavia, South Korea and also Germany – albeit at a slower pace – become more knowledge intensive and rapidly industrialize as well; Central Europe¹¹ and the Baltics become rapidly much more knowledge intensive, that is they import massively new technology, however their industrialization is relatively slow; Southern Europe is neither here or there, it exhibits much slower processes on both axis. We argue that the growth dynamics of Central Europe and the Baltics reflect the rapid geographic dispersion of Western manufacturing in the East via semi-independent production networks. In other words, Western companies set up their own subsidiaries but also increasingly use outsourced production services. By 2010, Central European countries were massively integrated into the EU via trade, their intra-EU exports reaching to as much as 50% of GDP (in the Baltics it is 30% and in Southern Europe 10%; European Economy 2010, 104-105, see also Fligstein and Merand 2002).

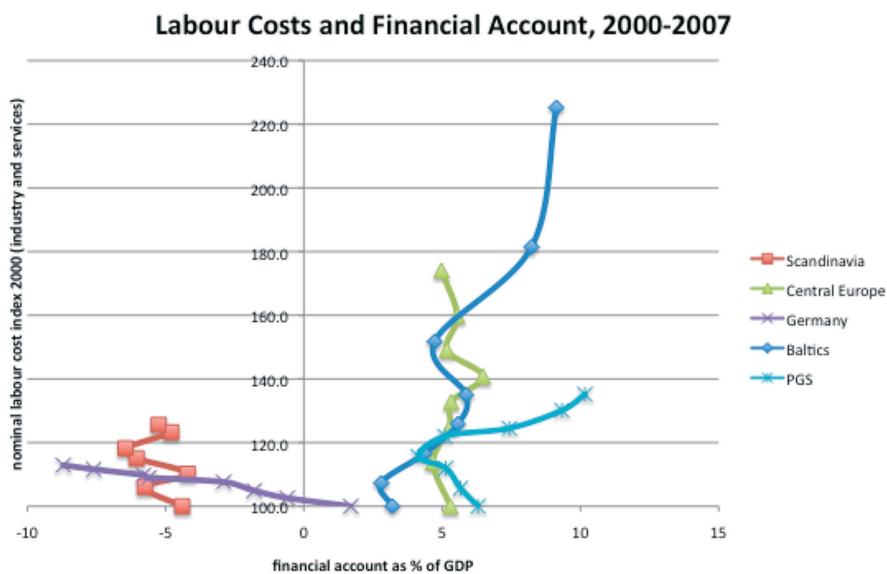
Central Europe and the Baltics became globally one of the top destinations of foreign direct investments during the 1990s and 2000s, investors pouring money into production, and especially into retail and banking. Consequently, the region became quickly dominated by foreign retail chains and foreign bank subsidiaries. (Kattel 2010) As Hyman Minsky had predicted in the late 1980s, when Eastern Europe opted to establish a modern capitalist financial sector for universal banks this would lead to increased com-

¹¹ Central European data is heavily influenced by Hungary that shows very high levels of royalties and license fees in the late 2000s; the rest of the countries in the region are similar to the Baltics.

petition between the banks and consequently to short-termism in their financing decisions. (Minsky 1990) His prediction proved correct: universal banks that dominate the region’s financial sector fuelled consumption and real estate bubbles in the 2000s which led to high current account deficits.

The task of long-term investments – in infrastructure, technological upgrading of industries, etc. – fell to European taxpayers in the form of so-called structural funds (in essence, fiscal transfers) distributed annually by the European Commission and amounting to 3-4% of the recipient country GDP. (Kattel and Raudla 2013; see also Suurna and Kattel 2010) These fiscal transfers meant that as the Eastern European governments typically run fiscal deficits (with the exception of Estonia), the funding from the EU served as additional deficit spending without incurring any cost. Consequently, the current account deficits were financed by EU fiscal transfers, and a growing indebtedness of the private sector as the FDI poured into consumer finance and retail; this led to rapid growth in labor costs, particularly during the 2000s. Figure 5 depicts the dynamics of financial account (indebtedness towards the rest of the world) and labor costs.

Figure 5. Financial account and labor costs, 2000-2007.



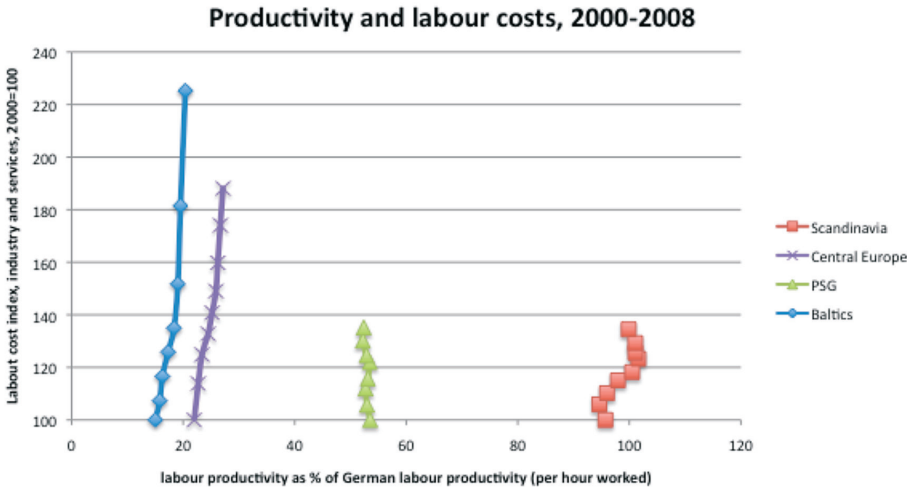
Source: Eurostat.

It is noteworthy that while Central Europe and the Baltics run persistently high levels of indebtedness towards the rest of the world, Southern Europe’s indebtedness rapidly increases throughout the 2000s, being mirrored by German lending. And while German, and to a lesser degree

Scandinavian, labor cost growth remained low, the Central European and Baltic economies were becoming highly fragile as labor cost growth far outpaced productivity growth, witnessed on Figure 6. The Ponzi debt trap is building up – not unlike the subprime debt trap in the US – helped by the ‘benevolence’ of the European Union which incentivized “irresponsibility”: spending more than one could afford.

Already here we see the seeds of welfare colonialism being sowed: while EU transition-help to Spain in the 1980s consisted of a slow lowering of tariffs coupled with loans for technological upgrading, transition-help to 2004 EU extension countries consisted of subsidies to consume and to produce a real-estate asset bubble. When the 2008 crisis hit, the decision not to devalue the three Baltic currencies saved real-estate speculations and penalized local production. Consistently man-the-producer has been sacrificed in order to incentivize man-the-consumer. Since we all play both roles in the economy, this systemic neglect of the production side of the economy is at the very core of the present imbalances and crises.

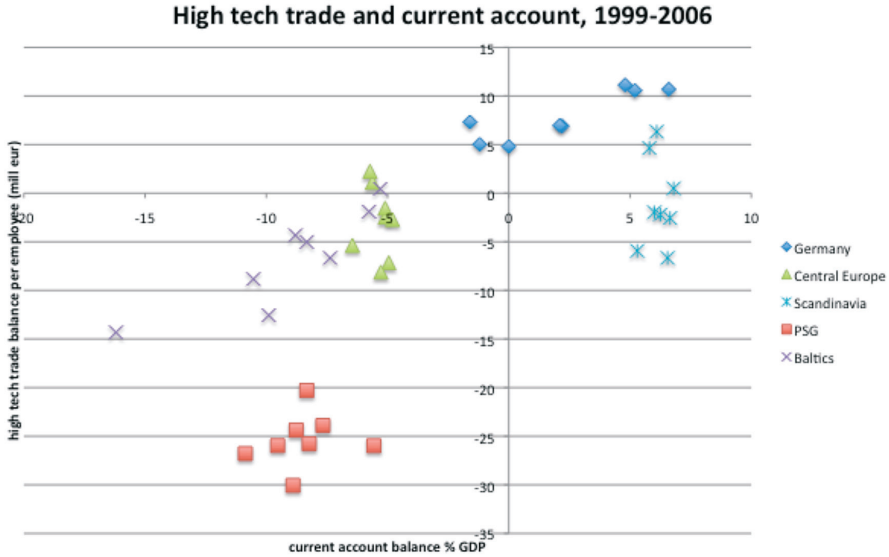
Figure 6. Labor costs and labor productivity, 2000-2008.



Source: Eurostat; calculations by the authors.

Also on the high tech trade balance what we observe is not a convergence between the core and the periphery, but rather a mirroring of the core surpluses and deficits in the periphery, as shown on Figure 7.

Figure 7. High tech trade balance and current account, 1999-2006.

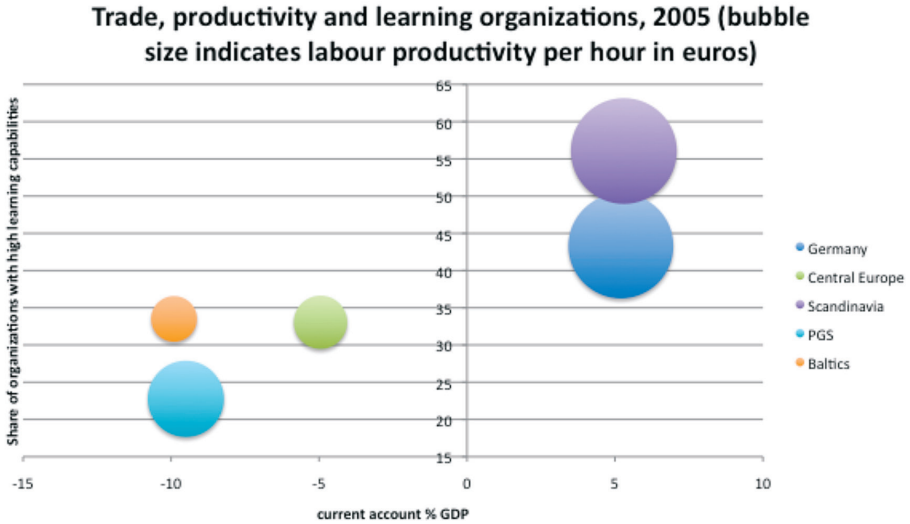


Source: Eurostat.

We can also trace these dynamics on the level of organizational capabilities, as a snapshot on Figure 8 does. Again, we do not see converging but rather diverging processes taking place in the core and in the periphery: in the core significantly more companies exhibit learning capabilities than in the periphery. This means shop level discretion to solve production problems is much higher in the core countries, and these capabilities are arguable at the core of Schumpeterian dynamics. It can indeed be argued that this is the key reason behind slow productivity growth in the periphery.

Remarkably though, Southern Europe lags behind Central European and Baltic companies in learning capabilities or – to put it bluntly – in Schumpeterian dynamics. But we have to remember that this largely reflects strategic production decisions in foreign-owned subsidiaries or foreign contractors which dominate the productive sector in Central Europe and the Baltic. The low-cost labor in these countries is – just like the Mexican *maquila* workers – specialized in low-skilled simple tasks. That is part and parcel of specializing in being poor.

Figure 8. Learning organizations and current account, 2005.¹²



Source: Holm et al 2010 and Eurostat.

If we extrapolate based on Figures 6-8, one rather obvious evolutionary path forward is that companies in Central Europe and the Baltics – being dominantly foreign owned and highly integrated into German and Scandinavian production networks – become slowly but surely more productive as they import new technologies and fulfill more complex production service tasks; at the same time companies in the South need to go through an extended adjustment period of lowering costs (mainly wages) and in essence will fall further behind the core and Eastern economies.

At the same time, however, because many production companies in the East do not in fact exhibit any serious domestic linkages, industrialization processes in the region remain relatively slow and exhibit clear characteristics of a Latin-Americanization and primitivization. Indeed, the Baltic countries are the European counterpart of the Mexican *maquilas*, although Estonia assembles goods with a much higher score on the Quality Index (Figure 1) than its Southern neighbors do. In addition, Baltic export companies exhibit the same pattern of being isolated economic enclaves, which was considered a sign of underdevelopment already in the 1930s. In addition, since the financial systems in the Eastern economies are dominated by subsidiaries of foreign universal banks, these financial sec-

¹² Holm et al 2010 use European Working Conditions Survey for their taxonomy of organizations and their learning capabilities. We use here as learning organization those organizations in the Holm et al. taxonomy that are “distinctive for the way high levels of autonomy in work are combined with high levels of learning, problem-solving, and task complexity” (6).

tors remain locked into financing predominantly consumption, potentially fuelling anew current account deficits and new boom-bust cycles.

The result of both processes is that during downturns (due to automatic stabilizers of the welfare state, potential banking sector problems, capital flight, etc.) public finances deteriorate – also because under Maastricht criteria, public finances behave pro-cyclically – and without a clear lender of last resort economies in the South and in the East are prone to recurring systemic crisis and without actual significant convergence in living standards with the core economies. This is what we call integrative and asymmetrical integration.

5. The Baltic austerity that never was¹³

Under the conditions of integrative, yet asymmetrical, integration the apparent success of Baltic – and especially Estonian – austerity after the 2008 crisis becomes more understandable. We argue that the recovery in the Baltics is substantially driven by processes embedded in the asymmetrical integration described above and not in austerity measures.

In 2009 crisis hit the Baltic countries with the deepest GDP declines anywhere on the planet. During the crisis the Baltic economies experienced peak-to-trough reductions in GDP of 20% (specify country), 25% (country) and 17% (country) respectively. All three Baltic governments adopted austerity measures amounting to 8-9% of GDP in 2009 and to additional 3-4% in 2010. In response to the crisis, all three countries also relied heavily on European Union structural support funding which in these years exceeded more than 4% of GDP. By 2011, the Baltics were again, as in the mid-2000s, topping European GDP growth charts with 7.6% (Estonia), 5.5% (Latvia) and 5.9% (Lithuania).

With the year 2009, then, the worst seems to have been over for the Baltics. The economies returned to growth and, in the second half of 2010 employment started picking up again. Exports followed the growth trend and current accounts turned into surplus. In the light of these developments, can we say that austerity and internal devaluation really worked?

In fact, a closer look shows that the current Baltic recovery has not resulted from the internal devaluation but rather from other factors not under the control of the Baltic governments. While many analysts hasten to call the internal devaluation successful (e.g. Åslund & Dombrovskis

¹³ The following section is largely based on Kattel and Raudla 2013.

2011), the downward adjustment of prices and wages in the Baltics was relatively modest, especially in the light of how overheated the economies had become by the end of the boom. None of the three countries actually experienced any significant deflation; in fact, in 2010 and 2011, inflation in all three countries resumed an upward trajectory. The reduction of real wages was from peak to trough about 15% in all countries. By the end of 2009, the real effective exchange rates had fallen by 3-5 percentage points from their boom-time peaks.

If not internal devaluations, then what was behind the Baltic recovery in 2011? There are three key factors: massive use of European funds, geographically flexible labor markets, and the integration of export sectors into key European production networks. Flexible labor markets have had two consequences: first, persistently high unemployment, which did not lead to significantly higher social expenditure (automatic stabilizers are relatively unimportant as benefits are low and brief, and active labor market measures are financed largely by EU structural funds); second, while particularly in Lithuania emigration was high already before the crisis, the latter seems to have speeded up emigration in all Baltic states. Lithuania's and Latvia's census in 2011 showed dramatic drops in population numbers; Estonia's census of 2012 showed also a marked decrease in population over the last decade.

The Baltic states are strong in 'simple polities'. This is reflected, inter alia, in low levels of popular unrest and in restrained civic dialogue, *voice* does not seem to be an option for many, and thus *exit* – untypically compared with the *voice* of protests in Southern Europe – becomes the preferred choice for a surprisingly large and increasing number of people. However, both high unemployment and exit produce costs in terms of future social problems and in the structure of the workforce. Those who migrate are typically the best and the brightest, those one would have liked to see staying behind to use their economic energy at home. During the crisis the costs of external devaluation were argued to be higher than internal devaluation (or adjustment, as it is mostly referred to in Baltic debates). However – given the persistently high levels of unemployment and emigration – it remains to be seen whether this is actually so. In any event, choosing internal devaluation instead of devaluation implied a conscious choice to save the speculative financial sector – including the real estate bubble – at the expense of the competitiveness of the productive sectors in all three Baltic countries (there has been no structural change towards industrialization and/or high value-added services). One may speculate to what extent the marked Baltic preference for the exit option – and an implicitly assumed futility of voice – were both in part a heritage from Soviet times, when both options were illegal.

The final result of exit combined with the present financial crisis has led to what Albert Hirschman – exit theoretician per excellence – elegantly called “*an oppression of the weak by the incompetent* (i.e. by the EU politicians) and *an exploitation of the poor by the lazy* (i.e. by the financial sector)” (Hirschman 1970: 59, italics and parenthesis added)

Integration into European networks by a few dozen leading exporters is another key factor explaining the Baltic recovery. This, however, has hardly anything to do with domestic conditions or policy actions. It is rather an increasingly important symptom of the Baltic blend of peripheral capitalism: a *maquila* structure operating as enclave industries. For instance, Elcoteq, until 2012 a Finnish-owned mobile manufacturer and for a past decade a key exporter in Estonia, employs a network of around 200 suppliers in its production. None of these come from Estonia. In other words, one of the key problems faced by Eastern European companies is the low degree of embeddedness of foreign-owned exporting companies, which is reflected in low level of linkages with domestic suppliers and partners, and with higher education and research institutions. While Baltic exports have bounced back to the pre-crisis levels, the problem of linkages remains. In addition, the pre-crisis level of exports is far from sufficient to make up for the lack of foreign financing that used to fuel Baltic growth in the mid-2000s.

In sum, almost all of the above-described factors make the Baltic cases unique and irreplicable in the EU context. Even if the Southern periphery would somehow manage to replicate the above-mentioned political conditions of the Northern periphery – i.e. weaken civil society, retrench welfare state, and relax labor regulations – they would still not display similar economic conditions. A number of economic and structural factors make the Baltics relatively unique. First, high levels of internationalization of the economy (both in exporting and financial sector); second, a high degree of dependence on larger neighboring economies (Scandinavia, Poland) in affairs of trade and finance, and, in the case of Scandinavia, also of technology transfer. All these economies in Scandinavia recovered (Sweden as usual due to devaluations) or, in the case of Poland, a combination of a flexible zloty and a still private and operating agricultural sector absorbing idle labor spared Poland from the crisis (Poland is the only former communist country which never collectivized agriculture).

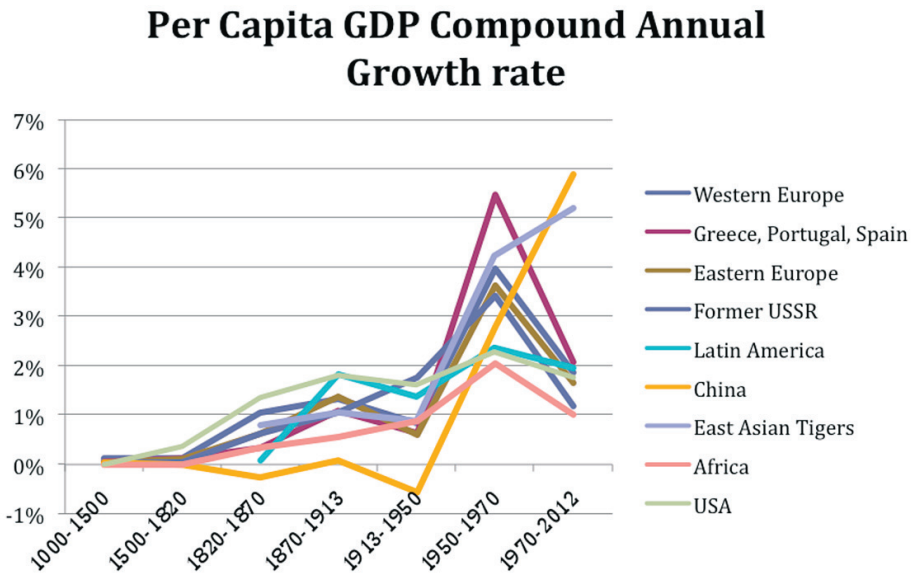
Thus, as Wolfgang Münchau argues, while the EU is more and more behaving as if it was a small open economy where budget discipline is important for convincing investors and markets (2011), the experience of small open economies dealing best with such fiscal policies will be of almost no use to other troubled EU members.

6. Crises and the Distribution of Income

If we look at long-term growth rates it becomes evident that the period of ‘transnational mercantilism’ from 1950 to 1970 – when it was understood that the activities containing Schumpeterian dynamics had to be redistributed to every nation-state – sticks out as a unique period of welfare creation in world history (figure 9 below). This period coincided with the flourishing of the Fordist mass production regime and the Fordist wage regime, the latter term meaning that labor was given its share of productivity increases in the form of wage increases.¹⁴ In other words, the shares of wages and capital in GDP tended to stay fairly constant.

Just as the United States excelled from the early 19th century, China and the Asian tigers excel now. All non-Asian growth rates decline after 1970, but the spectacular performance of the European Southern periphery under what was essentially a period of import substitution until 1970 contrasts particularly sharply with its fate after 1970. Part of the growth of Asia is of course due to *catching up*, but when wages in the EU periphery actually decline as they do now we are also talking about *falling behind*.

Figure 9. Annual per capita growth rate of GDP. Select regions. 1000-2012.



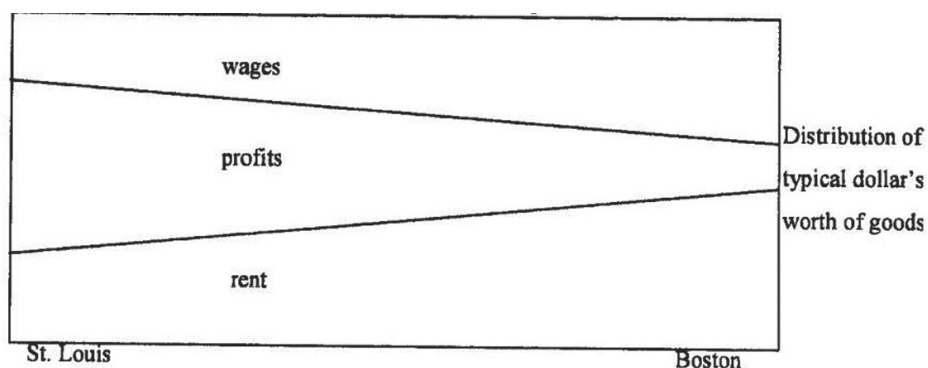
¹⁴ In other words, if labor productivity increased by 4 per cent, there would be a wage increase of 4 per cent. In this way the share of capital and labor kept pace in the economy, insuring the necessary increase in demand. This is the key mechanisms which stopped functioning in the US in the 1970s.

In many ways, the United States can be seen as the prototype successful developmental state. But today surprisingly little attention is paid to the strategy that was actually carried through in 19th century US. Briefly it may be said that it was a blend of Finance Minister Alexander Hamilton’s 1791 “Report on the Manufacturers”, of the extremely insightful writings of Daniel Raymond (1820) and Mathew Carey (1822) to which was added the insights of Friedrich List, who lived in the United States between 1825 and 1833. These ideas were skilfully made into economic policy by Senator Henry Clay (1777-1852) and his American System of Manufactures. Clay was also Secretary of State from 1825 to 1829 which was a crucial formative period for US economic policy.

We mention this for two reasons. The first question is why we appear to be unable to learn much from past successes – like that of the United States (see Hudson 2004) –and in the following we suggest one way to do so, and secondly, is to mourn the absence of politicians of the calibre of Henry Clay who understands an economic vision and has the guts to run with it contrary to the established wisdom of the time (which was David Ricardo, 1817).

Mathew Carey’s son, US economist Henry Carey (1793–1879) insisted that trading too much with Britain would preclude the United States from enjoying the bounties of future technological change. Carey also devised what he called a ‘commodity map’, which illustrates how the presence of a manufacturing sector changes the way income is distributed within a nation. Carey’s map, which could also have been called a ‘development synergy’ or Schumpeterian dynamics map, is an illustration of the centuries-old observation of the effects of a manufacturing sector. We suggest Figure 10 can be used in order to understand the structural change presently taking place in the European periphery.

Figure 10. Henry Carey’s ‘Commodity Map’ (1858)



(Modified from Carey 1858a, iii, p. 187]

Source: Perelman, Michael (2002). “The Comparative Sociology of Environmental Economics in the Works of Henry Carey and Karl Marx”, *History of Economics Review*, 36, Summer: 85-110.

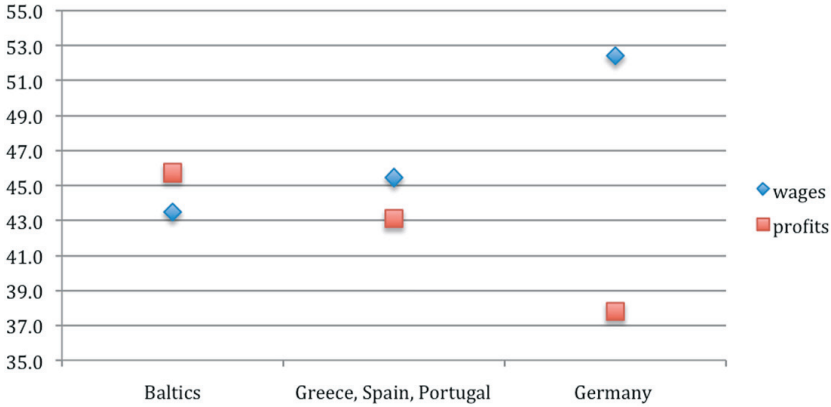
Figure 10 represents the breakdown of a typical dollar's worth of goods, i.e. a proxy for what we would call output or GDP. The height of the graph represents 100 per cent of GDP. Carey shows how different the composition of GDP was in the developed East compared to the then undeveloped West of the United States; the graph indicates how the composition of output changes as one moves gradually from Boston to St. Louis – from right to left in the figure – or vice versa. Economic development – increasing the division of labor and manufacturing – is represented by moving east from St. Louis, Missouri towards Boston. Poverty and backwardness grow as one moves west from Boston to St. Louis. St. Louis thus represents the situation in the undeveloped world or periphery today. Here, raw materials – e.g. cotton or cattle – are produced; land is abundant and cheap, labor is unskilled and cheap, tasks are simple, and the division of labor is limited. Under such conditions, Carey says, profits take up a large share of the GDP.

We argue that the internal dynamics of the EU periphery at the moment represent a movement from the East, Boston, back into the “backward” West. Today Germany represents the developed East, while Greece, Spain and Portugal and the Baltic countries represent two different peripheries on the road to structural primitivization. During past industrialization in the EU peripheries, a multitude of workers combined their efforts within a complex social division of labor to work raw materials into ever more sophisticated products. Shock therapies and financial crises now reverse the positive developments of the past, and the EU peripheries experience a structural economic change that corresponds to travelling from Boston to St. Louis in Carey's diagram.

The risk is that these countries, like Russia, may in a sense be travelling from capitalism back in time towards something resembling feudalism in a post-industrial variety.

Figure 11. Development of share of wages in GDP 1995-2012. Baltic countries; Greece Spain, Portugal; Germany.

Average share of profits and wages in GDP, 1995-2012

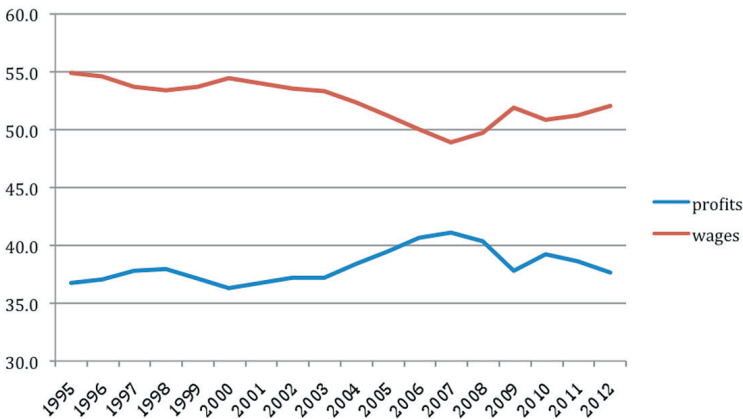


Source: Eurostat; calculations by the authors.¹⁵

We use profit and wages as a percentage of GDP to produce modern versions of his map which shows the road to prosperity and development and back again. As a snapshot for almost two decades of development, we see highly different versions of capitalism at work. The following figures show the dynamics more closely.

Figure 12. Germany: Share of wages and profits in GDP. 1995-2012.

Germany



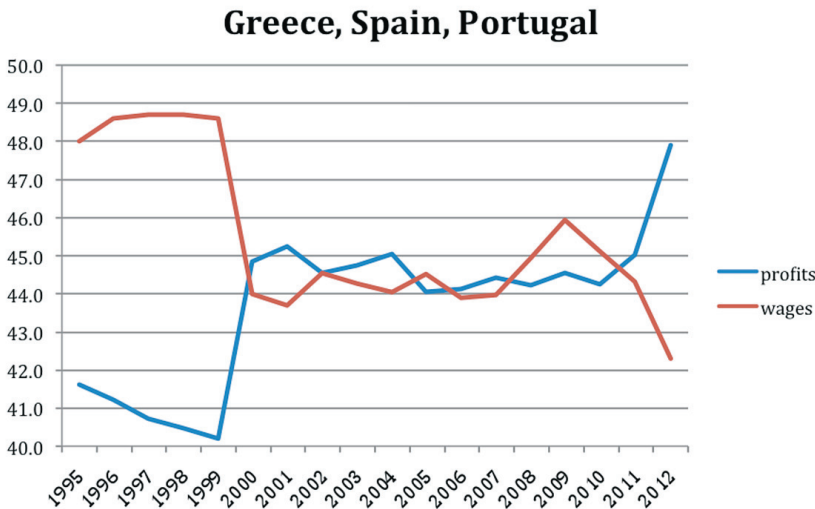
Source: Eurostat; calculations by the authors.

¹⁵ Here and below we use Eurostat's categories "Gross operating surplus and gross mixed income" for profits and "compensation of employees" for wages.

In this graph we can observe the sacrifice – so to say – of German labor when wages were kept fairly constant in the 2000s. Wages as a percentage of GDP fell by more than 5 percentage point from 1995 to 2007, while the share of profits rose accordingly. However, when the crisis started in 2007, labor share of GDP again rose markedly at the expense of profits.

This may be read as showing the success of the German wage restraint strategy – one that appears to have been successful for German labor as well when they now recuperate a share of the pie. This, however, leaves out the problem of worsening income distribution inside Germany (which we shall not discuss) and also the beggar-thy-neighbour aspect of this strategy. Germany’s strategy towards the EU periphery was not a win-win proposition.

Figure 13. Greece, Spain, Portugal: Share of Profits and Wages in GDP. 1995-2012.



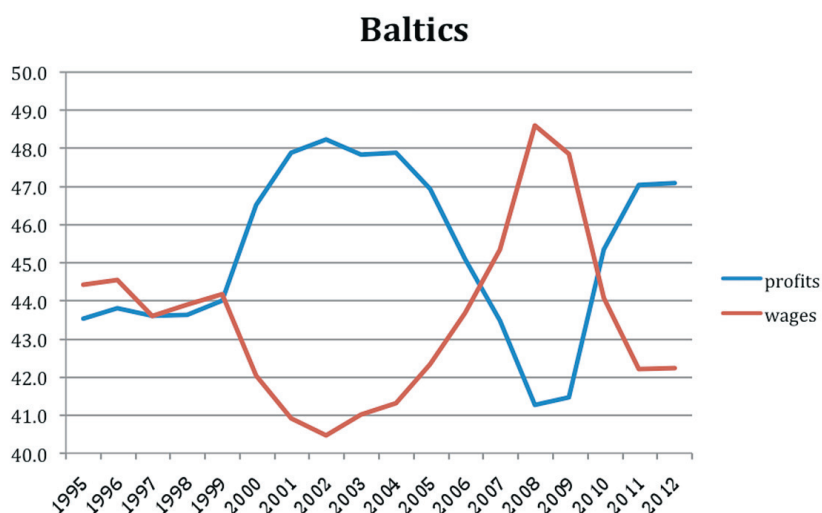
Source: Eurostat; calculations by the authors.

Greece entered the European Union in 1981, and Spain and Portugal in 1986. This graph shows the remarkable redistribution of income which took place after the accession: In these three countries as a group wages as a percentage of GDP fell by 5 percentage points in the 1998 and 2001, while the share of profits rose accordingly. On a comparative note we should remember that in the US it took 40 years – from 1970 to 2010 – for the share of labor to fall by 10 percentage points (from 54% to 44% of GDP). 5 per cent in three years is a very fast deterioration. In the case of Spain the initial overvaluation of the *peseta* – and a corresponding high rate of unemployment – is an important part of the explanation.

Overvaluing the currency value of new EU members in order not to threaten the profitability of the old core is indeed a long-standing EU policy dating back to the 1980s. It is just that with Greece and Spain this strategy was pushed way too far in recent years, also because its effects combined with those of the financial crisis. We should note that the major concern here is really to maintain total demand: the collapse of demand is at the core of most of the vicious circles in the EU at the moment.

After having temporarily recuperated somewhat, the share of wages in GDP in this group of countries (GSP) again fell by 4 percentage points during the financial crisis from 2009 to 2012.

Figure 14. Baltics: Share of Profits and Wages in GDP 1995-2012.



Source: Eurostat; calculations by the authors.

In the Baltics the development of the share of wages in GDP shows a slightly different picture. The GSP countries joined in the 1980s after a smooth and long transition aimed at consolidating the benefits of the import substitution strategies of the preceding decades. In contrast the Baltic countries all joined the EU in 2004 after a massive shock therapy following the 1989 fall of the Berlin Wall. Therefore at the 1995 starting points of the graphs 13 and 14, the share of wages in GDP lies almost 5 percentage points higher in the GSP countries than in the Baltics (close to 49 per cent vs. around 44 per cent). So, following the logic of Henry Carey, GSP appear as being considerably more advanced than the Baltics.

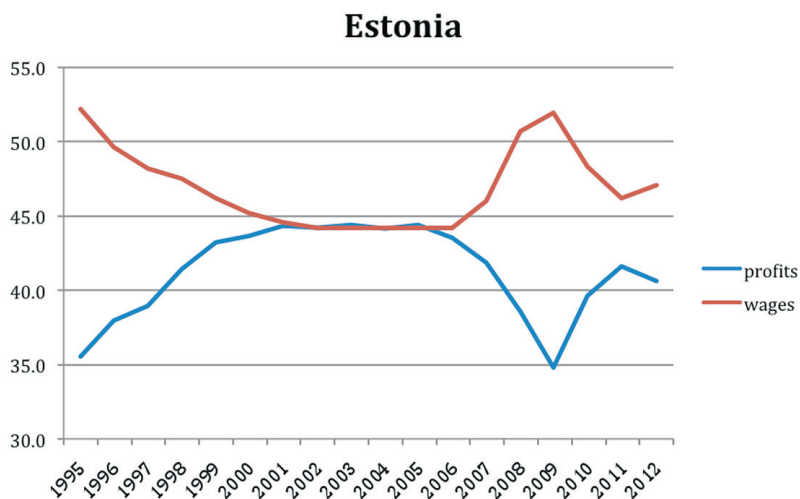
In the Baltics as a region (figure 14) we also observe a fall of the wage share of 3.5 percentage points starting in 1999 as in the GSP countries (4 %). But then, particularly from the accession year 2004, the Baltic

share of labor rises by a remarkable 8 percentage points in just six years (2002-2008). The reason for this – as already mentioned – is a combined effect of outward labor migration (“exporting your own people”) and a resulting relative labor scarcity (particularly in the building trade) plus the inflow of EU structural funds, rather than from any successful national policies.

However the wage boom proved to be short-lived. When the financial crisis hit, the wage share dropped by almost 7 percentage points in three years (2008-2011). In terms of economic sophistication, the present Baltic wage share of just over 42 per cent of GDP is at the level of a developing country. Although there has been a falling tendency worldwide, as a comparison wages as a percentage of GDP in Norway has been over 60 per cent and even a country like Chile traditionally has wage share of GDP above 50 per cent.

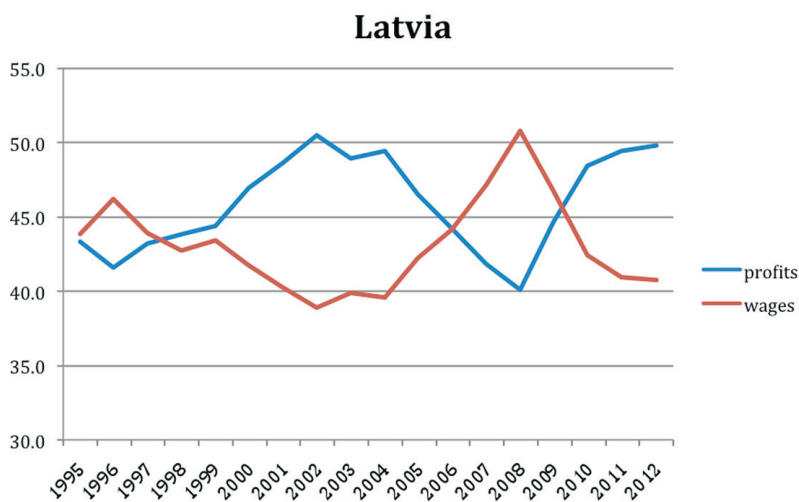
In the case of the Baltic countries we can take a country-by-country look that also shows the differences between the three small economies (Figures 15-17).

Figure 15. Estonia: Share of Profits and Wages in GDP 1995-2012



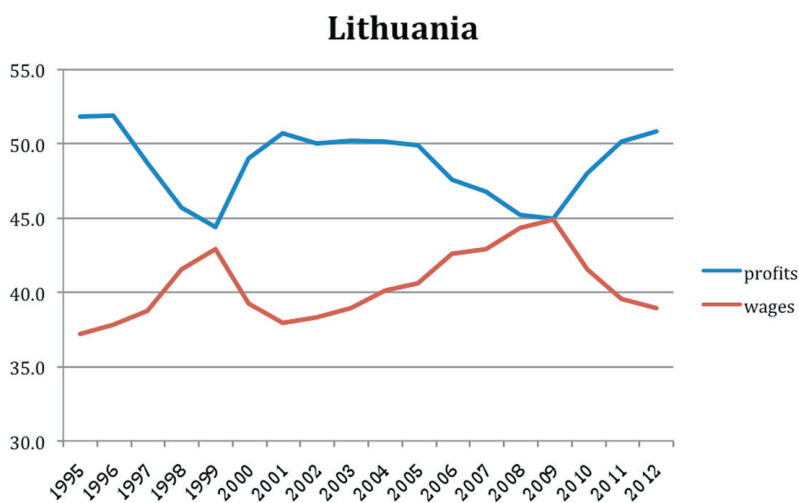
Source: Eurostat; calculations by the authors.

Figure 16. Latvia: Share of Profits and Wages in GDP 1995-2012



Source: Eurostat; calculations by the authors.

Figure 17. Lithuania: Share of Profits and Wages in GDP 1995-2012

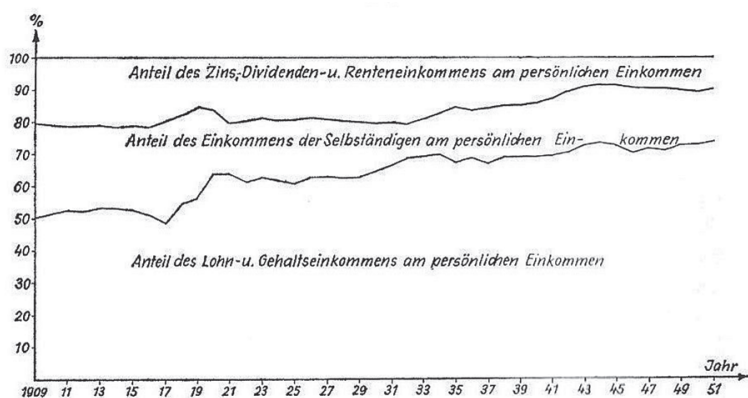


Source: Eurostat; calculations by the authors.

Latvia and Lithuania seem to differ quite strongly from Estonia in that the share of profit as a percentage of GDP in the former two countries was significantly higher than in Estonia throughout the decade leading up to the crisis in 2008. Conforming to Henry Carey's original vision, this is the result of Estonia's economy operating on a more technologically advanced level than its two Southern neighbors. This also probably explains why both Lithuania and Latvia experienced significant migration already prior to the crisis.

We finally ask how the patterns of income distribution are likely to develop over the next years. If the future follows the US pattern from the 1930s (Figure 18 below), the income share of capital (the 1 per cent) will shrink, while the income share paid out as wages and salaries (the 99 per cent) is likely to increase considerably. It is important to keep in mind that figure 18 is based on taxable personal income, so retained profits have not been taken into the picture.

Figure 18. United States: Percentage Share of Pre-Tax Income by Sector 1909-1951.



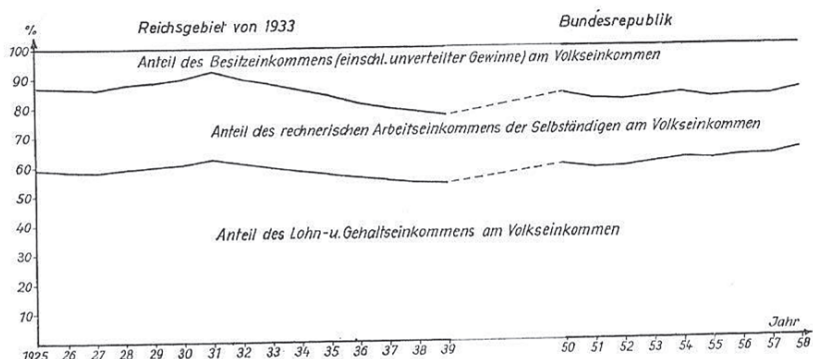
The categories are: Top: Share of total US income from interest, dividends and rent, Middle: Share of total US income from the self-employed, Bottom: Share of total US income from salaries and wages. Total 100 %. All incomes pre-tax. Social transfers have been added to salaries and wages. Profits retained in companies are not included.

Source: Krelle (1962), page 12.

From 1909 through 1943 salaries and wages increased their share of total taxable income from 50 per cent to more than 70 per cent, and much of that increased after 1929. Note also the huge shrinkage in the middle sector, the self-employed, many of whom will be farmers, whose share of income in 1933 is extremely small.

The effect in figure 18 is easily explained: irreversible wages during the Great Depression, labor which was still employed kept their wages. These were “sticky” while profits were the “fudge factor”. Based on previous data and looking around us this pattern is not likely to be repeated. With labor union power greatly reduced and the large companies possessing huge market powers the scenario is more likely to be more similar to figure 19.

Figure 19. Germany: Percentage Share of Pre-Tax Income by Sector 1925-1958.



Description as Figure 18, with the important difference that the German figure includes undistributed income (i.e. retained earnings) while the US figures do not.

Source: Krelle (1962), page 10.

Comparing the crisis years in the US and Germany, some important differences appear. In Germany the self-employed, mainly farmers, do not see their share of income decline nearly as much as in the United States. Compared to the US, the share of salaries and wages stays fairly constant, but the most surprising difference is that profits in the US appear to have suffered much more during the depression than in Germany. This could be due to the fact that the German data include retained earnings, while the US data do not. But do we have indications that US companies accumulated huge undistributed earnings during the 1930s?

Due to the differences in the two sets of data we are not able come up with a definitive answer. But if we employ the business school concept of “barriers to entry” as determinant of profits, which would correspond to the degree-of-monopoly theory of national income distribution (e.g. Kalecki 1939), it does appear that German farmers faced much better conditions than US farmers. We also know that as a result of the Great Depression 400.000 Mexican farmhands were repatriated. It is not immediately clear why the farming sector was so much worse hit in the United States, it may have to do with a concomitant fast degree of mechanization (e.g. tractors) which had not yet reached Europe.

The order of magnitude of difference between capitalist income and labor income in Germany vs. the US suggests that while US labor was well organised and competition continued to be relatively fierce in a shrinking market, we know that German businesses were well – and completely legally – protected from “ruinous competition” though cartel agreements

(promoted by the German government, while totally illegal in the US). So in the US business and farm profits were the fudge factor which had to yield in a shrinking market, in Germany the share of labor in the suffering appears to have been much higher than in the US.

Looking at figures 18 and 19, which of the two scenarios – the US or the German – do we think will best fit the future of the European periphery? There is little doubt in our minds that the forces at work are not at all those which prevailed in the United States in the 1930s. Profits now appear to play the “sticky” part, while labor costs become the fudge factor. The present situation is much more similar to that of Germany in the 1930s than to that of the US, which bodes ill for social and political peace.

7. Conclusions

It can be argued that the European Union enlargement project started out being laudably idealistic. The US does not absorb any of the social costs of the Mexican deindustrialization of high-wage traditional industry and the rise of a low-wage *maquila* sector and allows little legal immigration. The European integrative model, on the other hand, employs subsidies – e.g. in the form of structural funds – which accrue high costs on several counts. The large internal wage differentials – combined with imports from Asia – create strong downward pressures on the wage level in the core EU countries. The conflicts during 2004 and 2005 may in fact have been just preliminary skirmishes for much larger battles to follow.

Just as the free float of alcohol from new member countries has induced a collapse in alcohol prices in a country like Sweden, a large scale free float of labor may very well have a similar effect on labor prices (some, but few, measures have been taken). At the same time the rapid integration into the world economy after the fall of the Berlin Wall had already devastated the industrial structures in the new member states, so there was little to build on except moving already existing jobs and purchasing power eastwards from Scandinavia. This made European integration into a lose-win / zero-sum game type of integration, rather than a win-win flying geese type. The high cost of these policies put the EU at the risk of creating a version of *welfare colonialism*.

The EU enlargement has brought the new EU into a situation where it is difficult to envision any forces that would stop pressure towards lower wages, cuts in social benefits etc. The situation in the EU is increasingly similar to the one in Argentina before the great crash (1999-2002). Here

a financial crisis combined with a refusal to devalue (which of course in the end had to happen anyway) caused real wages to drop by 40 per cent from peak to bottom. A striking similarity also lies in the official optimism – also from the IMF – while close observers of the economy could see absolutely no reasons for the downward trend to do anything but deteriorate. While Mario Draghi keeps markets up invoking ideology-based optimism and the magic of the *confidence fairy*, Argentina then and the EU now – paraphrasing Gabriel García Márquez – both represent chronicles of crises foretold.

An idealistic integration – which at a lower pace of integration could have produced more flying geese qualities – may end up as a lose-lose strategy. The present European strategy does not capture the benefits from really cheap imports of labor intensive products and crops as does the US in its NAFTA integration with Mexico. On the cost side the EU accrues heavy social expenses associated with integrating the poor periphery. As with the integration of DDR into a united Germany, a first beneficial ‘pipe line effect’ boosted sales from the ‘old’ EU core, but this was bound to be a transitory phenomenon.

Turning to our earlier theoretical discussion of types of economic integration, Europe is weak in the win-win categories. The present integration of the European Union is clearly a departure from the slow and careful Listian form of symmetrical integration that characterized the early extensions of the European Common Market starting in the immediate post-war period. In the old mercantilist tradition, in the first decades of European integration it was made sure that the important paradigm carrier industries – at that time above all the automotive industry – were present in all large countries. When Spain later acceded to the Union, it already had a basic industrial structure which – through gradual rather than abrupt tariff reductions – was able to upgrade and successfully integrate symmetrically with the rest of Europe. The automotive industry with its layers of suppliers is one example of this successful transition. An artificially high exchange rate of the peseta prevented social dumping and wage pressures on the rest of Europe, at the cost of relatively high unemployment in Spain. However, with the former DDR, the exchange rate was so high and the economic structures so rigid that the new *Länder* lost all competitiveness and were largely reindustrialized. All in all, the integration of the large Spanish economy carries all the elements of a carefully planned Listian integration.

It is remarkable how the EU seems consciously to copy all the mistakes of the German reunification, the *Wiedervereinigung*. At the time of the 1990 monetary unification of the East and West *Deutschmark* the market

exchange rate was as low as 4,3 *Ostmark* to one *Westmark*. In spite of this, running wages were converted at an exchange rate of 1 to 1. This of course gave an initial burst of increased purchasing power in the East, but – in spite of probably being the most high-tech of the Soviet Block – and in spite of some large relocations eastward, the technologically inferior East German industry could not survive the cost shock. In spite of Germany doing all the right things in terms of building infrastructure, production – and with it people – moved to the West. The destructive long-term effects of over-valued currencies were obvious, but still the same mistakes were repeated again and again in the EU. The alternative to correcting exchange rates is to move people. It may be argued – as it has – that this way was the only politically feasible. Maybe so, but this is absolutely no excuse for repeating the same mistake again in the EU periphery.

There is – we argue – a qualitative quantum leap towards the worse in the philosophy of European integration between the careful and gradual economic integration of Spain, Portugal and Greece, on the one hand, and the 1 May 2004 integration eastwards on the other. The first integration was pragmatic, gradual, and Listian; the second was much more ideological, based on free trade shocks, a product of economists and politicians who had come to believe in the crude propaganda version of economics where markets create automatic economic harmony. The errors created by the ideology of the 1990s now threaten wealth and welfare all across Europe. Failing to take into account the forces that by their very nature make economic development into an uneven process, the Lisbon Strategy becomes merely a list of good intentions which –faced with the totally unsurprising effects of normal economic gravity – appear more and more utopian. But the state of denial continues: largely to the short-term benefits of the financial sector and at considerable long-term expense to the real economy and to human welfare in Europe.

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