Increasing Poverty in a Globalised World: *Marshall Plans* and *Morgenthau Plans* as Mechanisms of Polarisation of World Incomes.

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1. The Problem: Marshall Plans & Morgenthau Plans.

During the 1990's, a majority of the world's nations have experienced falling real wages – in many cases real wages have declined both rapidly and considerably. In some of the former communist countries a human crisis of large proportions is evolving. In most Latin American countries real wages peaked sometime in the late 1970's or early 1980's, and have fallen since then. In several African countries it is no longer possible to talk about a 'state' as such; the problem of 'failed states' is growing. Many institutions that used to be handled by the nation-state, like the educational systems, have broken down in these nations, and different areas of what used to be a nation are ruled over by different warlords. This is a type of political structure that a few years ago was thought of as belonging to a mediaeval past. If there is something called 'progress' and modernisation', globalisation has – particularly for many small and medium-size nations – brought with it the opposite: many are experiencing 'retrogression' and 'primitivisation'. Poverty and disease increase sharply in Sub-Saharan Africa, and we see a creeping 'Africanisation' in parts of Latin America.[1]

These events profoundly challenge the present world economic order and the standard textbook economics on which this order rests. This is because the increasingly globalised economy seems to produce opposite effects of what standard economic theory predicts. Instead of a convergence of world income (towards factor-price equalisation), we find that a group of rich nations show a tendency to converge, another convergence group of poor countries gathers at the bottom of the scale. Mainstream logic is that the more backward a nation, the easier it will be to catch up to some imaginary 'frontier'. In effect, what is actually happening is very different: Nations specialise. Some nations specialise in producing continuous flows of innovations that raise their real wages ('innovation rents'), whereas other nations specialise either in economic activities where there is very little or no technological change (*maquila* type activities), or where technological change takes the form of process innovations where technical change is taken out in the form of lower prices to the consumer rather than in higher wages to the workers, who are typically unskilled (typically for raw material production)[2]. We claim that economy-wide differences in wage levels originate in these specialisation patterns in the key areas of production, and that – as in standard trade theory – free trade reinforces the pattern of specialisation: Some nations specialise in being wealthy based on these innovation rents, others specialise in being poor. We shall return to this discussion in more detail later.

The World Bank estimates that a bus driver in Germany enjoys a standard of living 13 times higher than a bus driver in Kenya (Financial Times 2002). In other words, the world market rewards people with exactly the same productivity widely differently. The purpose of this paper is to explain the mechanisms and the economic policies that created this type of gap in the living standard of workers in the non-tradable service sector. This sector, which includes most of the government sector – jobs that are all subject to a natural and total protection from international competition – provides the majority of jobs in most developed nations. Whereas

[1] The bright spots in this development are that the two most populous nations on the planet – China and India – have not taken the same road towards increasing misery as have so many of the smaller Third World states. This is no doubt to a large extent a result of their reluctance to follow the recommendations of mainstream economics.
[2] See Reinert (1994) for a description of the two different ways technological change spreads in the economy; the classical mode – through lower prices to the consumers – and the collusive mode, through higher wages to the producers.

increasing population pressures in an agricultural sector subject to diminishing returns were the causes of historical mass migrations[3], a main factor behind modern mass migrations are these enormous differences in living standards between people who are essentially equally efficient.

In this paper we shall outline a theory that explains the economic forces that have produced the enormous wage differentials between people with the same level of productivity in different countries. This alternative theory of wealth and poverty – The Other Canon Theory – differs fundamentally from mainstream economic theory. The Other Canon constituted the toolkit of the pre-Smithian mainstream, around 1750, and has also been the basis of the economic strategies that have catapulted laggard countries from relative poverty to relative wealth, from 15th Century England to Korea in 1960-1980 and Ireland from 1980-2000 (Reinert & Daastøl 1997 & 2003).

For didactical purposes we have established two ideal types of economic policies. We have named economic policies that create the vortices of, respectively, wealth and poverty after two types of economic strategies that were developed and – like the atomic bomb – tried out in the field in the 1940's: Marshall Plans and Morgenthau Plans. We shall claim that virtual virtuous circles of development are the result of a set of policies that we refer to generically as Marshall Plans. The opposite effect, vicious circles, is the result of Morgenthau Plans.

The purpose of the Morgenthau Plan – named after Henry Morgenthau Jr., the US Secretary of the Treasury from 1934-1945 – was to prevent Germany, which had caused two wars in the 20th Century, ever from starting a war again (Morgenthau 1945). This was to be achieved by de-industrialising Germany and make it a pastoral state, taking all industrial machinery out of Germany and filling the mines with water. The plan was approved in an Allied meeting in 1943 and carried out after the German capitulation in May 1945.

The Morgenthau Plan was abruptly stopped in Germany in 1947 when ex-President Herbert Hoover of the United States reported back from Germany: 'There is the illusion that the New Germany left after the annexations can be reduced to a 'pastoral state'. It cannot be done unless we exterminate or move 25.000.000 out of it' (Hoover's Report No. 3, March 18, 1947, quoted in Baade 1955). Hoover had rediscovered the wisdom of the mercantilist population theorists: an industrialised nation has a much larger carrying capacity in terms of population than an agricultural state (Stangeland 1966). The de-industrialisation process had also led to a sharp fall also in agricultural yields and partly to an institutional collapse, giving evidence to the importance of the linkages between the industrial and agricultural sector that were also a hallmark of mercantilist economics (Reinert 2000). Less than four months after Hoover's alarming reports from Germany, the US government announced the Marshall Plan which aimed to achieve exactly the opposite of the Morgenthau Plan: Germany's industrial capacity was at all cost to be brought back to it's 1938 level. It cannot be emphasised enough that the Marshall Plan was not a financial plan, it was a *reindustrialisation plan*.

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We shall claim that Morgenthau Plans, after years of neglect, were resurrected by the Washington Consensus starting in the 1980's and, even more strongly, after the end of the Cold War in 1991. De-facto Morgenthau Plans came with the label of 'structural adjustment', which very often had the effect of de-industrialising Third World nations (Reinert 2000). These two ideal types of economic policy, the Marshall Plan and the Morgenthau Plan,

[3] Alfred Marshall quotes the Bible, Genesis xii &, to emphasize this point.

explain the 'virtuous' and 'vicious' circles that were fashionable, but not well explained, in the heyday of development economics during the 1950's and 60's. The crucial role of the nation-state in carrying out the right type of economic policy is discussed in Reinert (1999).

This paper can only outline what Schumpeter calls a Vision (Schumpeter 1954: 41-42). Schumpeter describes Vision as a 'preanalytic cognitive act' that supplies the raw material for the analytical effort, which in the case of this theory took place in the late 1970's and was expressed in my 1980 Ph.D. thesis (Reinert 1980). This particular vision developed from a profound conviction that the sources of uneven economic development fundamentally had to be found in the realm of production rather than in the neoclassical realm of barter, trade and finance. In several articles in the 1990's I have elaborated on the same basic understanding of the evolution of wealth and poverty.

For nearly 500 years, from the late 1400's to the 1960's, it was common knowledge that a nation with an inefficient manufacturing sector would have a higher standard of living than a nation with no manufacturing sector at all. Such was the common sense behind the reconstruction of Europe after World War II. Everyone knew that world free trade in 1945, because of the superiority of the United States, would have meant a virtual de-industrialisation of Europe. Free trade was only a goal that was to be introduced after Europe had been solidly re-industrialised. The essence of the Marshall Plan was to bring back Europe's industrial production, even Germany's, to the pre-war level. Around 1750 it was generally understood that colonialism was in effect what we call a Morgenthau Plan; it was only with the appearance of barter-based economic theory – with Adam Smith and David Ricardo – that colonialism ceased to be understood as a system of poverty creation.

The contrast between the 1950's and the 1990's in terms of economic understanding is abysmal. Many Third World countries were subjected to a de facto Morgenthau Plan – a de-industrialisation – in the 1990's (Reinert 2000). This is because the economics profession by 1990 – in the meantime having lost all roots to history – had come to believe in the Cold War propaganda version of neoclassical economics; a theory where the market produces automatic harmony. We shall argue that understanding uneven development requires an understanding of imperfect competition, and that the mercantilist policies that laid the foundations for Europe's wealth did indeed have a developed understanding of the type of mechanisms which created wealth and fame for Boston Consulting Group starting in the 1970's. We shall return to this argument later.

2. The Two Conflicting Theories of Globalisation.

It is generally not remembered that two Nobel laureates in economics have provided two ***largely conflicting*** theories of what will happen to world income under globalisation.

1. Based on the standard assumptions of neo-classical economic theory, US economist **Paul Samuelson** 'proved' mathematically that unhindered international trade will produce 'factor-price equalisation', i.e. that the prices paid to the factors of production – capital and labour – will tend to be the same all over the world (Samuelson and Stolper 1949 & 1950).
2. Based in an alternative tradition – which we broadly have labelled The Other Canon – Swedish economist **Gunnar Myrdal** was of the opinion that world trade would tend

> to increase already existing differences in incomes between rich and poor nations (Myrdal 1956).

The economic policies of the Washington Consensus – the basis for the economic policies imposed by The World Bank and the International Monetary Fund – are exclusively built on the type of theory which is represented by Paul Samuelson. The developments of the 1990's are in sharp conflict with Samuelson's type of theory, but confirm Myrdal's assertion: the rich nations as a group seem to converge into a cluster of wealthy countries, while the poor seem to converge towards poverty, with the gap between them rising. Paul Samuelson's theory seems to be able to explain what goes on inside the group of rich nations, while Gunnar Myrdal's theory seems to be able to explain the development of relative wealth between the group of rich nations and the group of poor nations. Samuelson's theory is not harmful to nations which already have established a comparative advantage in increasing returns; in Schumpeterian activities. It is, however, extremely harmful to those nations that have not passed the mandatory passage point of a conscious industrialisation policy.

The kind of theory that Myrdal proposes – a type of institutional economic theory that we call The Other Canon – is today almost extinct, it either exists only in fragments or it exists as perverted form tied to neoclassical economics as 'New Institutional Economics' In its original form, it is rarely taught in the economics departments in today's leading universities. The economics profession as a group is therefore very reluctant to see that – when it comes to the relationship between rich and poor countries – Myrdal might be right instead of Samuelson.

Seeing only the broad outlines of world development, Samuelson's type of theory can claim a certain degree of success in predicting the developments *within* each group of nations. The rich nations seem to tend towards being more equally rich, while the poor seem to converge towards being equally poor. A result of this is that the 'medium-rich' – or middle income – nations are disappearing, and the two convergence groups, rich and poor, stand out as isolated clusters in a scatter diagram. Myrdal's prediction is definitely correct when it comes to the relationship between rich and poor countries since 1990. We shall argue that the poverty of the Second and Third Worlds was an outcome of a Morgenthau Plan rather than a Marshall Plan.

3. The Mechanisms at Work.

> '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.'
>
> Thomas Kuhn, *The Structure of Scientific Revolutions,* p. 37.

3.1. The Absence of Taxonomies and Categories Prevents us from Seeing the Causes of Wealth and Poverty.

We would assert that the type of theory represented by Paul Samuelson fails to account for the increasing miseries of the 1990's essentially because this standard economic theory does not involve any theory of economic development, other than that of adding capital to labour. In standard economic theory, all inputs – human beings & economic activities – are seen as being qualitatively identical and equally fit as carriers of economic growth. In this standard

theory Man's wit and will, Man as a spiritual being, is also largely absent. Not surprisingly, a theory in which all inputs are qualitatively alike, all outcomes are also qualitatively alike. In other words, this is a type of theory which can only produce theoretical outcomes where all factors are as they were when they entered into the model, i.e. perfectly identical. 'Factor-price equalisation' – the prediction that in a globalised economy all wage-earners will tend to have the same wages – is therefore the only possible outcome of standard economic theory: the conclusions about equality are already built into the assumptions where everything is equal.

On this basis Thomas Kuhn – in what is the most-quoted scientific book – is right when he explains how scientific paradigms may insulate the community from burning social problems like the increasing poverty of the poor during the 1990's. The problem at hand is – as Kuhn says – not reducible to the 'language' of standard economic theory. For this reason the standard reply of the economics profession to the dramatically diminishing standards of living in many countries is 'more of the same'. Their ***type of theory*** does not contain the elements that can explain why economic development is, by its very nature, an uneven process. In this paper we shall attempt to explain the developments of the 1990's in a 'common sense' language, in the language of the nearly defunct Other Canon theory of economics.

Picking up on Kuhn's point: Standard economics is not a taxonomic science; the theory of the Washington Consensus is void of any possibility to observe and classify the differences in conditions that ultimately cause the differences in wealth. 'One must first observe differences in order to observe attributes', says Rousseau[4]. Its inability to observe such differences makes standard economics a theory that can only explain even economic growth.

An important explanation as to why the mainstream paradigm insulates the community from the problems created by globalisation is loss of ***the role of production*** in economic development. The roots to inequality of wealth are to be found in the realm of production. This loss of production is certainly one of the unfortunate legacies of Adam Smith, who makes no distinction between *commerce* and *industry*. Smith assimilates the process of production to that of exchange, and labour time becomes the common measuring rod of both.[5] In this way economics becomes what Lionel Robins calls a *Harmonielehre*, a system that, if left to itself, creates a system of economic harmony.

During the 20th Century this weakness was exasperated, and economic theory came to lose the very cause of 20th Century wealth; ***industrialism.*** Swedish institutional economist Johan Åkerman explains these mechanisms well: 'Capitalism, property rights, income distribution came to be considered the essential features, whereas the core contents of industrialism – technological change, mechanisation, mass production and its economic and social consequences – partly were pushed aside. The reasons for this development are probably found in the following three elements: *Firstly,* Ricardian economic theory….became a theory of 'natural' relations, established once and for all, between economic concepts (price, interest, capital, etc). *Secondly*, the periodic economic crises are important in this respect because the immediate causes of the crises could be found in the monetary sphere. Technological change, the primary source creating growth and transforming society, disappeared behind the theoretical connections which were made between monetary policy and economic fluctuation. *Thirdly*, and most importantly, Marx and his doctrine could capitalise on the discontent of the industrial proletariat. His teachings gave hope of a natural law which led towards the 'final

[4] Quoted in Lévi-Strauss (1996: 247)
[5] For an excellent discussion of this, se Biernacki (1995), page 253.

struggle', when the pyramid of income distribution would be turned on its head, the lower classes should be the powerful and mighty. In this ongoing process the technological change came to be considered only as one of the preconditions for class struggle' (Åkerman 1954: 26-27).

3.1. Which Factors Cause Economic Development?

Austrian Harvard economist Joseph Alois Schumpeter once criticised 'the pedestrian view that it is capital per se that propels the capitalist engine' (Schumpeter 1954: 468). This is indeed the basic mechanism by which standard economic theory sees economic development happening: by the addition of more capital to each worker.

We would claim that this perception is fundamentally wrong. What cause economic development are **new ideas, new knowledge** which produce investment opportunities and therefore create a demand for capital to invest. In this view what the Third World lacks is not capital, but ***investment opportunities*** that lead to innovations, projects in which capital may be profitably invested. For this reason, among others, we observe capital flight from the poor countries to the rich. By attempting to provide capital to the Third World without creating profitable investment opportunities, we are treating the symptoms of economic development – the lack of capital – instead of its real cause: the lack of certain types of economic activities from which growth and structural change emanate.

Two important 15th Century inventions made it possible to *increase the supply of investment opportunities*: Patents and Protection. These two features – one so much loved and the other so much hated by present United States trade policy – were brainchildren of the same qualitative understanding of human progress. The first patents were created in Venice in the late 1400's and enabled people to make a living by generating new ideas. When ideas no longer could be immediately copied, investment in new ideas became profitable, and a continuous supply of new and steep learning curves became what we call economic development. In order for these new activities – these productivity explosions and learning curves (see points 3.2 & 3.3) – to spread to other nations and other labour markets, protective tariffs were created in order to make it profitable also to introduce the new activities in more backward nations. The protective system prevented economic development from becoming a game where the winner – the first inventing country – could take it all[6]. Patents vastly increased what Carlota Perez calls the *windows of opportunity* for profitable investments, and protection made it possible for laggard nations to catch on to the steep learning curves in the industries where technological change was focused. The origins of path-dependent trajectories of economic development are to be found in these early policies. These policies were all products of an administrative tradition based on *civic humanism*.

3.2. The Productivity Explosions.

To use Nathan Rosenberg's term, technical change and human learning is – at any point in time – 'focused' in certain business areas (Rosenberg 1975). A nation with a strong concentration in the economic activities that experience high growth, will experience a 'catapult effect' in real wages.

[6] England did indeed attempt this winner-takes-it-all strategy – being the only industrial nation - well into the 19th Century by attempting to 'kill American industry in its cradle' as a Parliamentarian expressed it.

Figure 1.

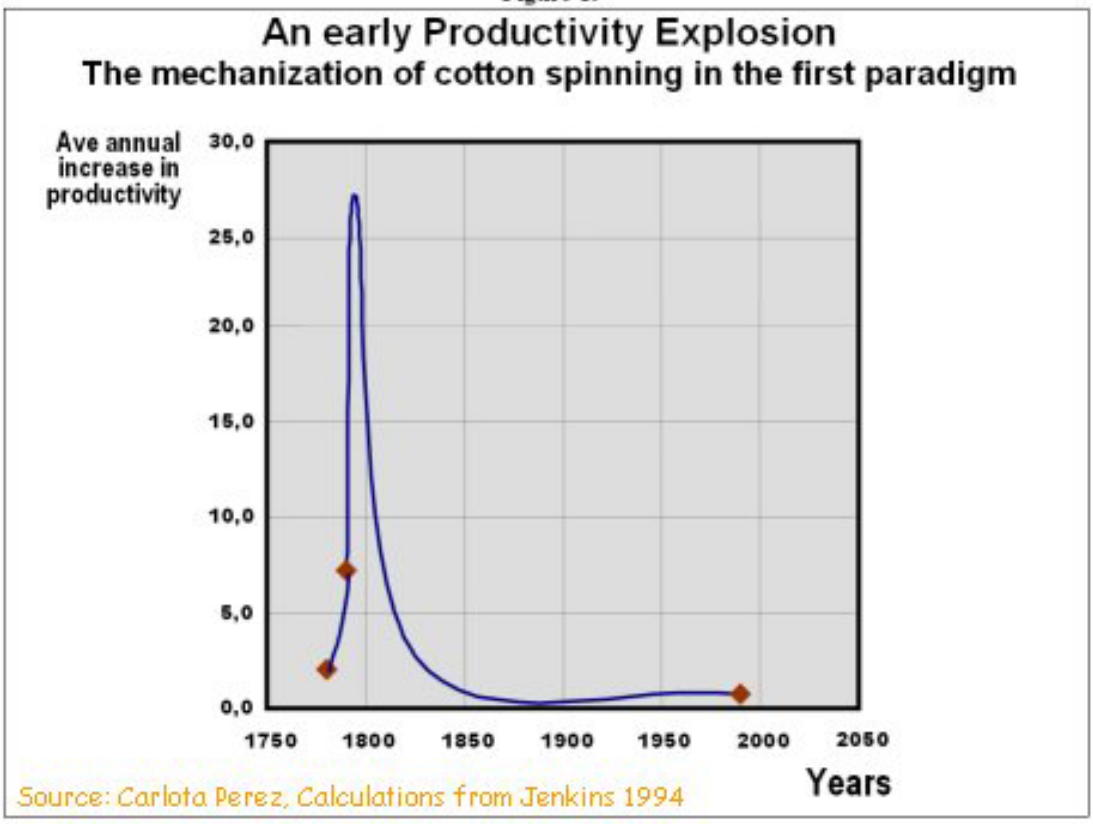


Figure 1 shows the first 'productivity explosion' of the first industrial revolution. In the late 18th Century, about the time when Adam Smith was writing his *Wealth of Nations,* the productivity of cotton spinning was increasing at an incredible speed in English manufacturing industry, reaching levels of increase up to more than 25 per cent per year.

At that time – in fact since the late 15th Century – all European nations based their economic policy on the fact that the production from such 'leading sectors' had to take place inside the borders of every nation. Since the time when Henry VII came to the throne of England, in 1485, the synergies observed between these 'leading sectors' and the rest of the economy (see section 3.3) were accepted wisdom in all nations. In fact, the essential difference between a colony and the Mother Country was that the colony was not allowed to produce any goods from the leading sector – from the manufacturing sector – at all. The English prohibition of most manufactures in the North American colonies was in fact a major factor behind the American Revolution in 1776. The accepted knowledge of the time – and indeed in practice until after World War II and into the 1950's – was that the export of manufactured goods and the import of raw materials was 'good trade' for a nation. Contrary, the export of raw materials and the import of manufactured good was considered 'bad trade' for any nation. This latter was the trading pattern imposed on overseas colonies.

Interestingly the export and import of manufactured goods was considered 'good trade' for both trading nations. The kind of economic theory which gives support to this long-practiced tradition disappeared in the 1930'**s** because increasing returns to scale – the key factor explaining the difference between manufactured goods and the production of raw materials – was not compatible with the equilibrium models that had been voted in as the core assumption

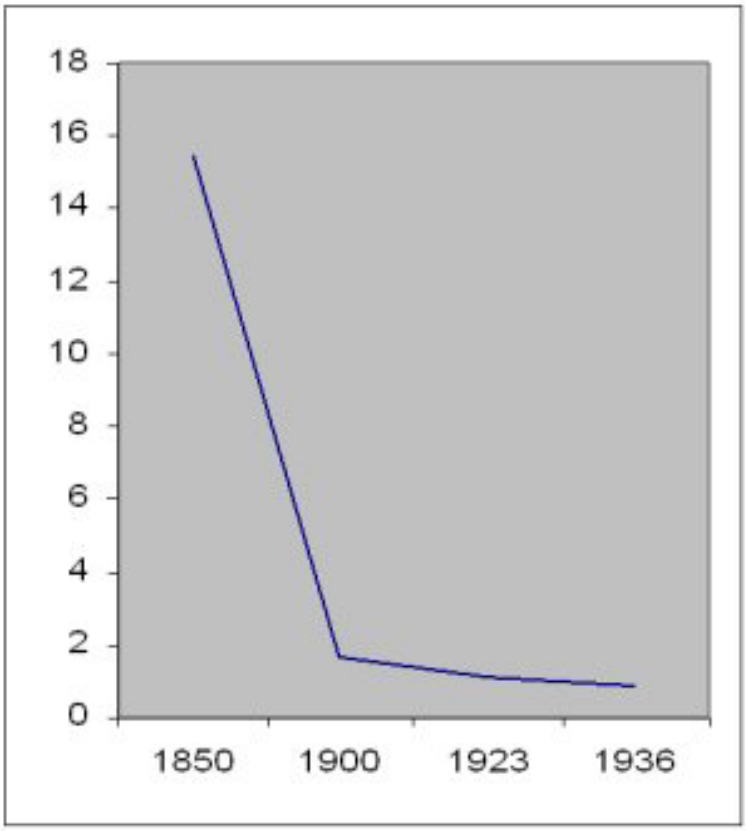
of standard economic theory. It is deeply ironical that the practical implementation of the standard theory – leading to the de-industrialisation of the Third World – only started in the early 1980's, at the time when the old models depicting increasing returns had been resurrected under the label of 'New Trade Theory', again 'proving' that the pre-Smithian theories were correct (Paul Krugman, etc.) The essential problem with the new models which 'proved' that the old theories were correct, was that they were only seen as 'toy models' by the economics profession. The equilibrium models of the early 20th Century – where all economic activities are qualitatively alike as carriers of economic growth – became the sole foundations of The Washington Consensus and the policies which de-industrialised so many Third World Countries during the 1990's.

Since the 1770's the world has experienced many 'productivity explosions'. These are described in the works of Christopher Freeman and Carlota Perez. Recently the so-called IT revolution has given birth to 'Moore's Law', which essentially explains the same phenomenon that is recorded in Figure 1. According to Moore's Law the productivity of the silicone chip doubles every 18 months. Obviously this is not a development that can go on forever, but in the decades when this 'law' has been observed to be correct, the nations engaged in the economic activities subject to this 'productivity explosion' have moved ahead of the poor nations in fast growth without inflation. 'Productivity explosions' are deflationary: the price decreases recorded in these industries tend to reduce the general price level.

3.3. Learning and The Pattern of International Trade.

Seen from a different angle, the productivity explosions – when plotted in terms of labour productivity per unit of product – produce 'learning curves'. These are curves that show the speed of human learning in economic activities. As a general rule, the faster the speed of learning, the faster is the rate of economic growth. This is because the benefits from productivity improvements not only spread to the consumers of the world as lower prices (a 'classical' spread of the benefits from economic change), they also spread in terms of higher wages to the workers (a 'collusive' spread of the benefits from technical change). Se also section 3.4 for the 'collusive' effects.

FIGURE 2. Learning as the Essence of Economic Growth. USA: Learning Curve of Best-Practice Productivity in Medium Grade Men's Shoes.



Man-Hours Required by Best-Practice Methods of Producing A Pair of Medium-grade Men's Shoes at Selected Dates in the U.S.

Year	Man-Hours per Pair
1850	15.5
1900	1.7
1923	1.1
1936	0.9

Source: Reinert 1980, p. 259.

Figure 2 shows the progress of human productivity, drawn as learning curves, in the production of a standard pair of shoes from 1850 to 1936. While the learning was particularly intense, from 1850 to 1900, the United States was a big producer and exporter of shoes. The United States experienced a 'productivity explosion' in the shoe industry from 1850 to 1900. As the possibilities for productivity improvements fell, the US slowly became a net importer of shoes. This is effect, the 'product life cycle theory of international trade' associated with Ray Vernon and Lou Wells in the 1970's (Reinert 1980).

A wealthy nation produces where the learning curve is steep – as it was in the IT industry in the 1990's – and imports products where the possibilities for learning are small and the learning curve correspondingly flat. This is the natural working of the world market: industries with fast learning use knowledge and skilled and expensive labour intensively. This is the comparative advantage of wealthy nations. Poor nations automatically specialise in economic activities where the potential for learning is low. These economic activities use inexpensive labour intensely. In this way the poor nations automatically develop a comparative advantage in providing cheap and uneducated labour. In other words, within the international division of labour they specialise in being poor. This kind of perspective is lost in standard economic theory, where all economic activities are seen as being qualitatively equal.

The mercantilist economic policy that was carried out in Europe and in the United States for so many centuries found its scientific explanation in the world of business in the 1970's through the work of Boston Consulting Group (BCG). This world-wide consulting firm became famous in the world of business for the creation of two tools which helped companies survive in a world dominated by dynamic Schumpeterian competition. The first tool was 'The Experience Curve', essentially a learning curve plotting total cost rather than labour hours on the vertical axis (Figure 2) (Boston Consulting Group 1972, Reinert 1980). The second tool was the product portfolio, a matrix where mature cash cows continuously finances innovations that in their turn become the cash-cows of the future (Stern & Stalk 1998: 35-37). In our view this theory emulates the strategy of the best mercantilists; making sure all European nations got into the cash-cows requiring new skills, creating national productivity explosions and steep learning curves. The policy towards the colonies, however, caused these nations to be stuck in what BCG calls 'dog industries', activities bereft of increasing returns, with no growth and with the low profitability of commodity competition.

3.4. The Synergies Emanating from the Productivity Explosions.

> ''Promoting husbandry..is never more effectually encouraged than by the increase of manufactures'
>
> David Hume, *History of England,* 1767.

The extremely important synergies between the leading sectors with 'productivity explosions' and the rest of the economy have been noted at least since the late 1400's in England. The quote above, from Adam Smith's best friend, is typical: Efficient agriculture is normally only seen in industrialised nations.

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An illustration of the importance of synergies from the manufacturing sector can be observed by studying the wages of barbers or bus drivers around the world. How can we explain why

the German bus driver has a standard of living 16 times higher than his counterpart in Kenya or in La Paz, Bolivia? This is essentially because as the industrialised countries experienced wave after wave of productivity explosions in a sequence of new industries, the wages – not only of the industrial workers – but of the whole industrial nation were raised with the rising productivity. The workers received their part of the productivity improvements not only as lower prices (in the 'classical' way) but to a large extent also as higher wages (the 'collusive' way) (Reinert 1994). In this way, each productivity explosion in the First World jacked up the real wages also of barbers and bus drivers, and in this way they gained, step by step, in real wages compared to their equally productive counterparts in the Third World.

In our opinion, the only way to raise the living standards of the Third World is to repeat this procedure, the only one that has ever worked from 15th Century England to 20th Century Korea. Today the application of the rules of the Washington Consensus – essentially that the historically proven procedure of artificially creating a comparative advantage in manufacturing is no longer allowed – means that the road to development that has been followed by ***absolutely all*** industrialised countries up until now, is completely blocked for the Third World of today. To use a 19th Century expression, we have pulled up the ladder preventing new nations from following us on the path to development. In the meantime we address the mere symptoms of development, not the causes, through our development aid.

4. Enters Taxonomy: How Economic Activities Differ.

We will never be able to understand why economic growth is so uneven unless we understand how economic activities differ. We all intuitively understand that a group of investment brokers make more money than a group of people washing dishes in a restaurant. Once this kind of pre-Ricardian common sense was part of economics. Particularly 19th Century United States emphasised the need for a 'high wage strategy': the logic was that providing the nation with jobs that paid well would make the nation rich. To the United States this meant getting out of cotton growing, which required slavery and could not support wage labour.

4.1 Two Basically Different Kinds of Economic Activities.

We argue that there are essentially two kinds of economic activities, having very different characteristics. A nation specialising in Schumpeterian activities, will find that both increasing returns and technological change will cause production cost to fall, and thus open up for technology-based rents which can be divided between capitalists, workers and the government. A nation specialising in Malthusian activities will find that, after a certain point, specialisation will cause unit production costs to rise. This is the core of Antonio Serra's argument from 1613, where he explains the wealth of Venice and the poverty of his native Naples. Reinert (1980) showed that the main export activities of Peru, Ecuador and Bolivia were actually producing well into diminishing returns: when production was reduced, production costs were also reduced. This is a main mechanism explaining why nations exporting raw material – in the absence of a national manufacturing sector – have never managed to get out of their poverty trap.

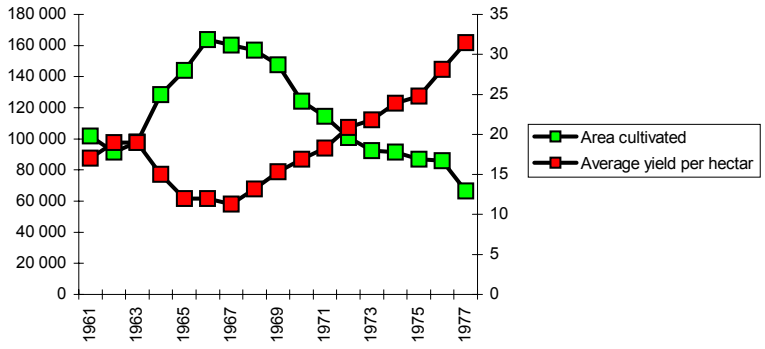
Figure 3. How economic activities differ: Only the presence of Schumpeterian Activities has ever managed to raise a nation out of poverty

Marshall Plans: Produced by focus on **Schumpeterian Activities** **(= 'good' export activities)**	Morgenthau Plans: Produced by focus on **Malthusian Activities.** **(= 'bad' export activities if no Schumpeterian sector present)**
Increasing Returns	Diminishing Returns
Dynamic imperfect Competition	'Perfect competition' (commodity competition)
High growth activities	Low growth activities
Stable prices	Extreme price fluctuations
Generally skilled labour	Generally unskilled labour
Creates a middle class	Creates 'feudalist' class structure
Irreversible wages ('Stickiness' of wages)	Reversible wages
Technical change leads too higher wages to the producer ('Fordist wage regime')	Technical change tends to lower price to consumer
Creates large synergies (linkages, clusters)	Creates few synergies

A nation specialising in Malthusian type activities will stay poor, while nations that specialise in Schumpeterian type activities will raise their wage level and standard of living. The growth of Malthusian Activities at the expense of Schumpeterian Activities is at the core of any Morgenthau Plan, also those unleashed under the label of 'structural adjustment' in the 1990's. (see Reinert 2000 for a detailed description of these mechanisms).

In our opinion Malthus was right when he predicted that human wages would always be around subsistence level. The historical record on this is unanimous: only Schumpeterian type activities are able to lift nations out of poverty. This type of theory has dominated the history of economic policy, and was first advanced on a theoretical level by Antonio Serra in 1613.

FIGURE 4.
Ecuador: Diminishing Returns in Banana Production
1961-1977



Source: Reinert 1980, page 175. Programa Nacional del Banano y Frutas Tropicales, Guayaquil. Unpublished data.

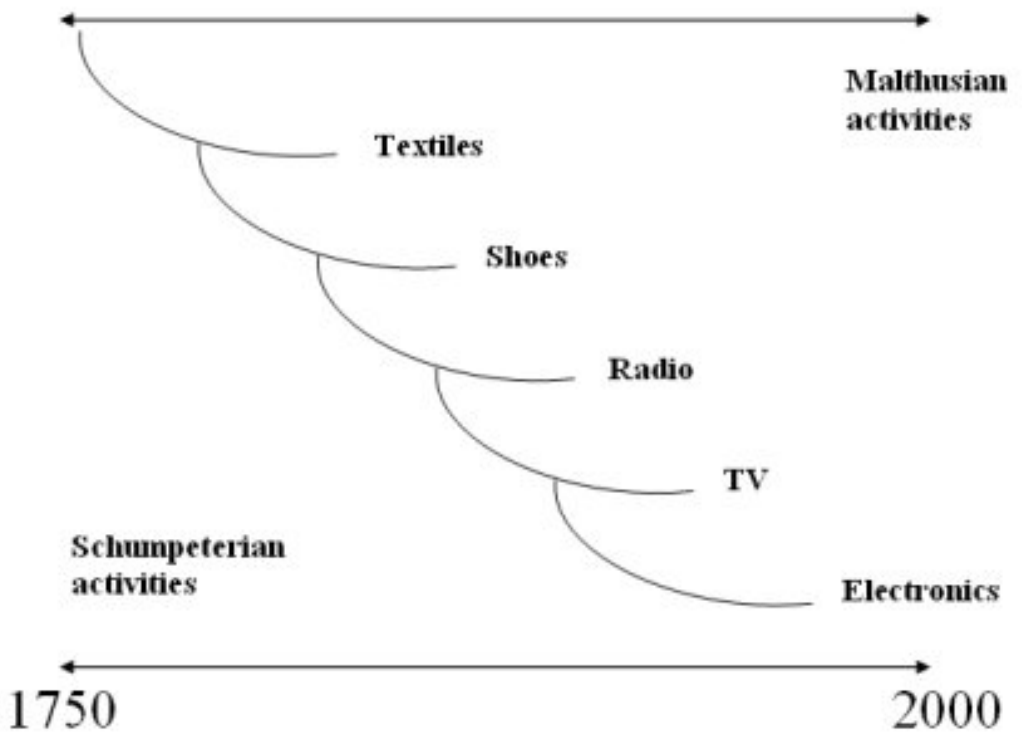
Figure 4 shows how productivity will fall when a nation specialises in a diminishing returns activity. These activities are also subject to technical change, but this example shows how the effects of diminishing returns dwarf the effects of technical change.

Studying four waves of industrialisation and de-industrialisation in Peru between 1950 and 2000, Roca and Simabuco (2003) showed the same mechanism at work: An extra percentage point in the share of manufacturing activities in the Peruvian economy increased white-collar real wages by 10.6 per cent and blue-collar real salaries by 15.5 per cent. This means that a growing manufacturing sector not only provides a 'catapult' for standards of living, but it also has a proportionally larger impact on blue-collar salaries, thus leading to a positive effect on income distribution.

4.3. Creating the Wage Gap: The Cumulative Effect over Time.

A central point in the alternative vision of economic growth is how the gap between the rich and poor nations developed over time: the mechanisms which created today's situation where the Frankfurt bus driver has a standard of living which the World Bank has calculated to be 16 times higher than the equally efficient bus driver in Nairobi. The developed nations have captured large rents from a sequence of productivity explosions (Figure 1) that have occurred since before the first industrial revolution. In addition to the obvious effect that these productivity explosions have made goods cheaper (what we call the ***classical mode*** of distributing productivity gains), it has also had the effect of 'catapulting' the general wage level of the industrial nation to a new and higher level (what we call the ***collusive mode*** of distributing productivity gains) (Reinert 1996)

Figure 5: How the wage differentials between rich and poor nations were created through sequences of ' productivity explosions' translated into wage rents



In Malthusian Economic Activities, for reasons given in Figure 3, technological change is essentially distributed in the classical mode, i.e. in the form of lower prices to the consumer rather than higher wages to the workers. Their flat wages are represented by the top flat line. The Schumpeterian Activities, on the other hand, create a sequence of steep learning curves which – every time – jacks up the wage rent in the whole labour market in the respective First World markets (Reinert 1980: 265).

Man plays two roles in the economy, as a producer and as a consumer. In order to understand the economic policies that previously made it possible for laggard countries – including, in sequence, England, United States, Germany and Korea – to catch up, it is necessary to understand the conflicts between the economic interests of Man-the-Producer vs. Man-the-Consumer. A key feature of today's standard economics is an exclusive focus on Man-the-Consumer. 19th Century US economic policy, based on the path-breaking works of Daniel Raymond (1820) and Mathew Carey (1821), explained the trade-off between the two roles. If the industrial nations have managed to jack up their wage levels in the way described in Figure 5, the poor nation will – after a certain point – achieve a higher national wage level by being ***a relatively inefficient industrial producer***, rather than to continue as a supplier of raw materials. Mathew Carey succeeded in convincing the farmers of the United States that even though in the short term they would have to pay more for US-produced industrial goods than for the goods they imported from England, in the longer run they would be more than

compensated for this: the rise in the general wage level in the United States would more than compensate for the higher prices which had to be paid for industrial goods. In other words, the benefits accruing to a person as a producer (in the form of higher wages) would more than outweigh the costs accruing to the same person as a consumer.

The 19th Century economic debate between the United States and England, the English consistently refused to see the logic of this until John Stuart Mill admitted the logic of 'infant industry protection'. Later Alfred Marshall recommended an economic policy subsidising increasing return activities by taxing diminishing return activities (Marshall 1890: 492). This is just the kind of policy that is at the core of creating Marshall Plans out of previous Morgenthau Plans. US economic policy was based on this principle all through the 19th Century. Today, the vast majority of US economists will be as blind to this argument as their English colleagues were for most of the 19th Century.

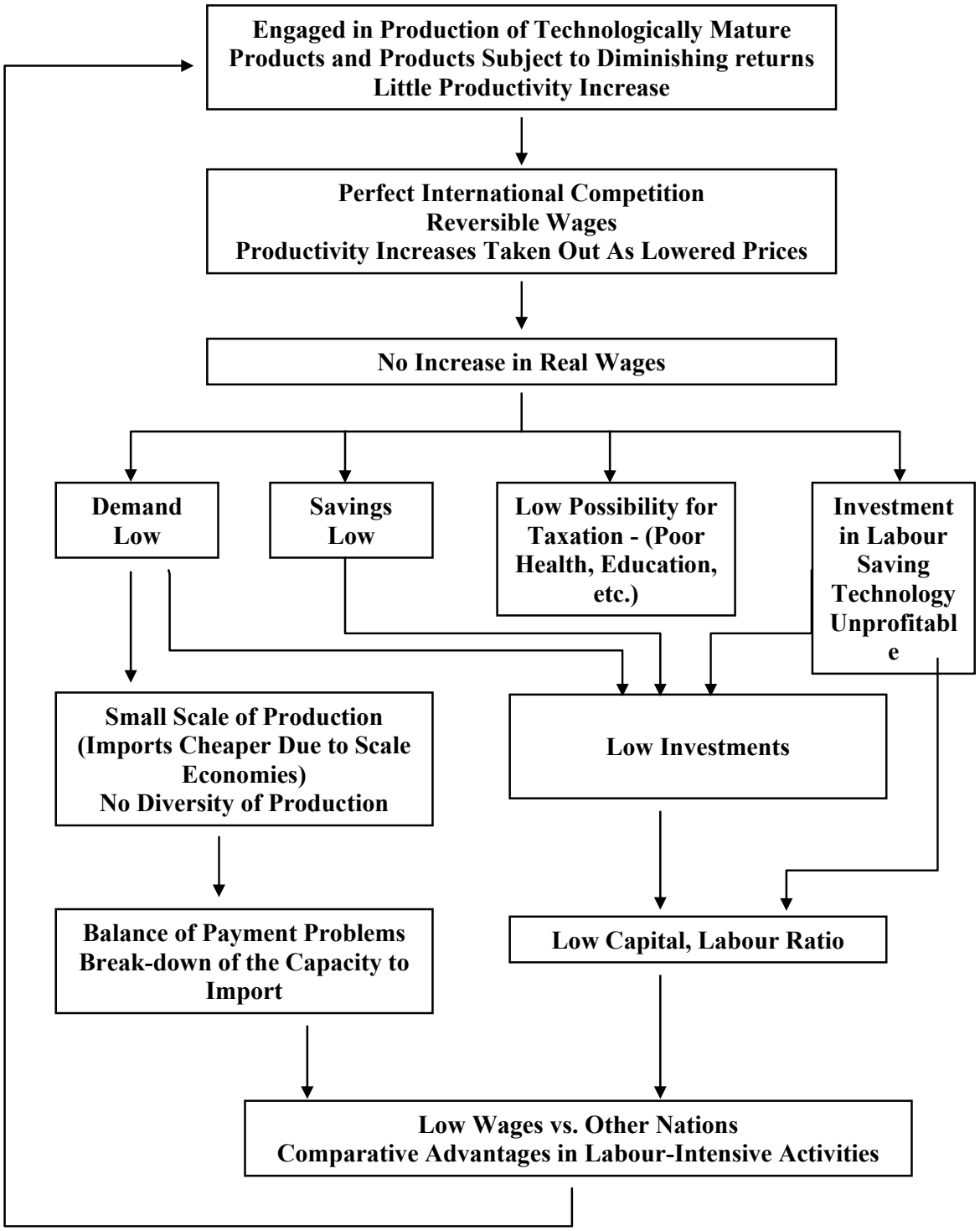
6. Systemic Effects: Globalisation as a Morgenthau Plan for the Third World.

As Morgenthau Plans under different headings, de-industrialisation has always had the same effect. From the same problems of desperate poverty, the same remedy – industrialisation – appears again and again in history. Antonio Serra (1613) saw the wealth of Venice and the abject poverty of Naples being the result of the lack of manufacturing in Naples. 150 years later economist in Northern Italy under French rule made the same observation there. Observers in France after the Napoleonic Wars reported the same kind of misery that Hoover saw in Germany in the spring of 1947 and that we see today in Ulaanbaatar; Mongolia or Lima, Peru: where industry is closed down, poverty enters. The 'American System' of protecting manufacturing was born in the early 1820's in a similar difficult situation. It is about time we again make the same rediscovery.

Figures 6 and 7 show – in a circular flow-chart form – the cumulative effects of the vicious circles of de-industrialisation and poverty contrasted with the virtuous circles of economic development (after Reinert 1980). The main point here is that economic development is ***activity specific***, it can only occur in certain economic activities (Schumpeterian type activities), and not in others (Malthusian type activities). This is why, for a very long time, the term 'industrialised country' was considered synonymous with 'rich country'. The policies of the Washington Institutions have, since the late 1980's, left this traditional understanding behind.

FIGURE 6

The Mechanisms of a Morgenthau Plan: The "Vicious" Circle of Economic Underdevelopment



Note: It is futile to attack the system at any one point, e.g., increasing investment when wages are still low and demand is absent. An instance of this is poor capital utilisation and excess capacity in Latin American LDCs.

Source: Reinert (1980), *op.cit*, p.41.

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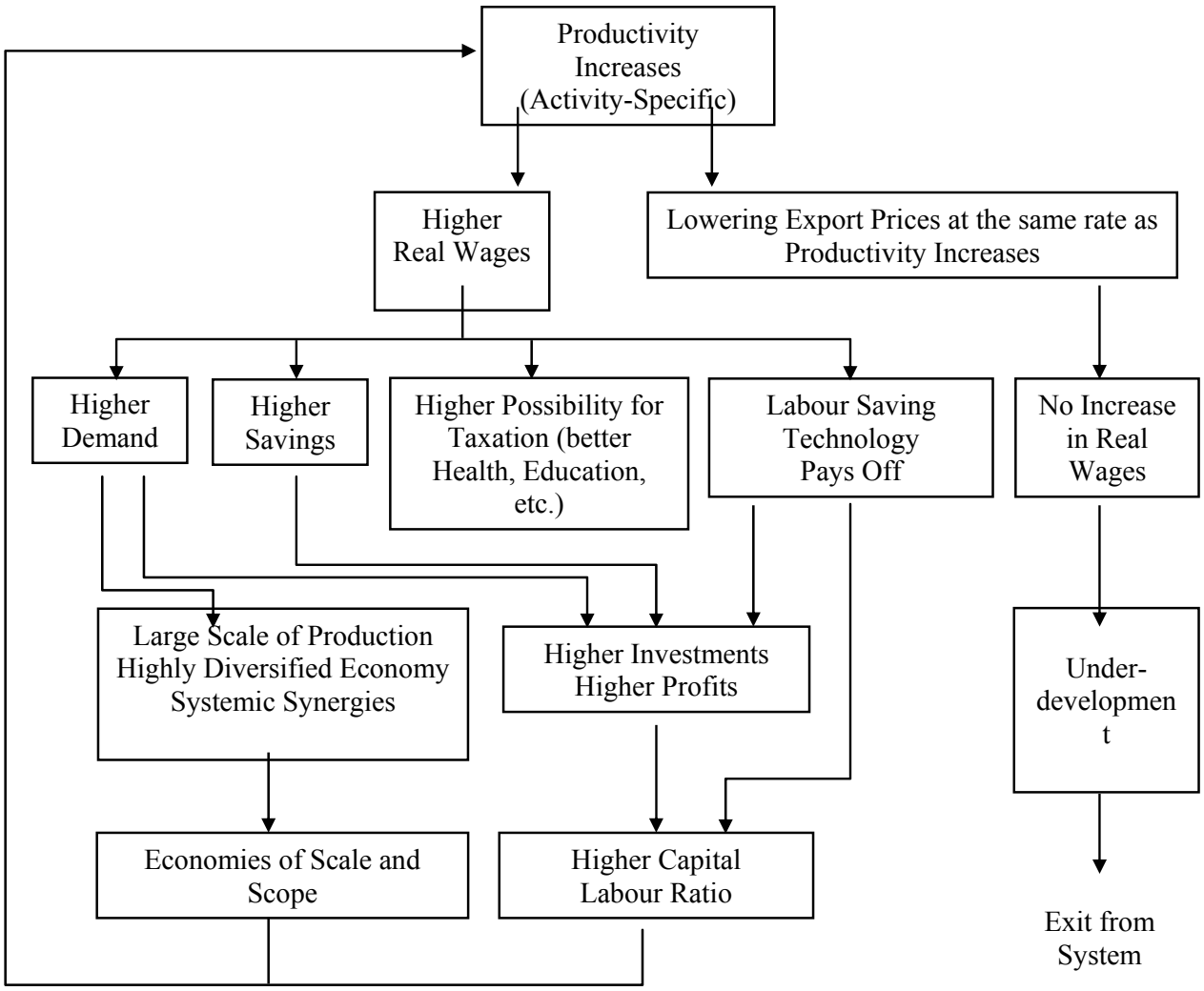
FIGURE 7.

The Virtuous Systemic Effects of a Marshall Plan "Virtuous" Circles Circle of Economic Development



Note: In a closed system, with constant employment rate, the only way GNP per capita can grow is through the "Virtuous Circle." However, the system can be cut-off at any one point, e.g., if higher demand goes to foreign goods alone, the circle will break.

Source:
Reinert (1980) *op.cit*, p. 39.

The current fashion is to blame the poverty caused by globalisation on the lack of openness of the industrialised countries towards agricultural imports from the Third World. In other words, the problems are seen as being created by ***a lack of openness*** to free trade. In our opinion, the historical record proves these assertions to be wrong. No nation has ever taken the step from being poor to being wealthy exporting raw material ***in the absence of a domestic manufacturing sector.*** Malthusian activities alone have never and never will in the future be able to lift a nation out of poverty without the presence of a domestic manufacturing sector. The only results of any importance that will be achieved by freeing the imports of foodstuffs from the Third World to the First World are:

a) A destruction of First World farming and of the rural areas of the First World
b) A change to industrialised farming in the Third World, where the income will fall to an extent that the local workers will not be able to afford to purchase the food they produce for the rich. This is in essence the mechanism foreseen already by Malthus.

The only way to achieve a global trading system without hunger is to strike the following deal between the rich and the poor countries: **The rich nations selectively to nourish, target and protect some of their Malthusian Activities (agriculture)** whereas the Third World is **allowed selectively to nourish, target and protect some of their Schumpeterian Activities (industries and advanced services subject to increasing returns)** and also to protect their own food production; all under a system of internal competition. This must be done under a system of regional integration of the Third World countries.

The present policy of blind globalisation coupled with increasing 'development aid' is essentially a policy of applying palliative economics; economics that addresses the symptoms of poverty without at all attacking its causes. The essence of economic development is a violent structural change leading down steep learning curves towards increased productivity. Providing a better well to subsistence agriculture is purely a palliative medicine, unrelated to the process of economic development in the real sense.

7. Conclusion.

> 'From the raw materials from Spain and the West Indies – particularly silk, iron and *cochinilla* (a red dye) – which cost them only 1 florin, the foreigners produce finished goods which they sell back to Spain for between 10 and 100 florins. Spain is in this way subject to greater humiliations from the rest of Europe than those they themselves impose on the Indians. In exchange for gold and silver the Spaniards offer trinkets of greater or lesser value; but by buying back their own raw materials at an exorbitant price, the Spaniards are made the laughing stock of all Europe'.
>
> Luis Ortiz, Spanish Minister of Finance, to Felipe II: 'Memorandum to the King to prevent money from leaving the Kingdom', Madrid, 1558.

The nations that, in sequence, have taken the step from being poor to being rich have all been through a stage of what we could call 'the cult of manufacturing'. As it often happens, economic policy came before economic theory, but an early statement of this Other Canon policy is found in the above quote from Spain's Minister of Finance in 1558. The funnel of wealth coming from the New World had not been invested in the productive sector, and the

gold and silver had de-industrialised Spain as if it had been subject to a Morgenthau Plan. The present problems of Venezuela, and the growing problems in the productive economy of Norway, are examples of the same effect when monetary wealth crowds out the productive powers of an economy.

For most nations today, however, the problems are of a very different nature. As it gradually became clear during the 1990's that the basic Washington Consensus model failed to deliver its promised results, mainstream economics evolved by adding new prescriptions for the poor nations. 'Get the prices right' was initially the whole message, but it was later widened, in sequence, with 'get the property rights right', 'get the institutions right', 'get the governance right', 'get your competetiveness right' and 'get your national innovation systems right'. In our view, these prescriptions – these buzz-words of development – all fail, however, on their own to get to the core of the matter. We would claim that the key to understanding unequal development is to be found in the realm of production.

From an Other Canon point of view, one formula we have been waiting for is 'get your economic activities right', i.e. some kind of policy reflecting the fact that economic development historically fundamentally is a process of profound structural change where the presence of activities able to absorb new knowledge, and producing under conditions of increasing returns and high barriers to entry, is a necessary condition for achieving economic growth. For centuries this type of economic activity was called 'manufacturing' or 'industrialisation', but they are not necessarily limited to these activities. Today we have got the causalities wrong, we confuse the symptoms of development with their causes. 'It is known that a primitive people does not improve their customs and institutions later to find useful industries, but the other way around' (Meyen 1770: 11) was almost common sense at the time, an understanding that was not far from that of the 1960's.

Today, there are, broadly seen, only two possible solutions to solving the increasing poverty problems caused by globalisation:

1. We can **globalise the labour market,** the only main institution that is not yet globalised, by allowing all the poor to move where the 'Schumpeterian' economic activities are located. This will lead to an unprecedented exodus, to enormous social problems, and to a neo-classical type 'factor-price equalisation' where world wages will tend to be equalized *downwards*. All will tend to get equally poor.

2. We can **follow the 19th and early 20th Century path taken by all the presently rich countries** – Australia is an interesting prototype for a non-export led model – by creating national Schumpeterian sectors which initially are ***not*** competitive in the world markets, and slowly over time let the economy 'graduate' to compete on the world market. This is the only way to create dynamic 'factor-price equalisation' *upwards*. Only in this way can we make the poor countries into middle-income countries.

In our opinion option two is the only viable solution. By a mass migration of a large number of the world's poor to the rich countries, there is an overwhelming likelihood of a factor-price equalisation downwards: that the wages in the First World will fall towards the wage level of the majority of the world's population, i.e. very close to subsistence level. In this way the world will risk being caught in an underconsumption equilibrium from which the market alone will never unleash the economy.

The crucial transition from being a poor to being a wealthy country has, in all historical cases, been a situation where the market has been used creatively as a tool whereby the nations have created a comparative advantage for themselves in a type of economic activities which we have called 'Schumpeterian' (Figure 3) and 'High Quality Activities' (Figure 6). In this sense, the transition from a poor to a rich nation has always been a totally artificial construct; a managed economy in the sense of using private interest to artificially create a comparative advantage outside the raw materials sector. Once this threshold is overcome, the market can be left pretty much alone again. It us this transition – fist made by England after 1485 and last by Korea in the 1960's – that is no longer possible under the Washington Consensus.

Only when the Third World also has created a comparative advantage in Schumpeterian activities, will free trade be beneficial to all nations involved. This was the essential credo of United States and Continental European economic theory during the 19th Century. This was the theory behind which Europe and the US industrialised, and this is the only theory which will bring the Third World out of poverty. This is the type of production-based economic theory which we have labelled The Other Canon (www.othercanon.org) which all presently wealthy nations have used during their transition from poor to rich nations.

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