The Other Canon.

Reconstructing the Theory of Uneven Economic Development.

In most academic disciplines the canonical texts - those containing the 'truth' - are periodically revised. Economics, however, is almost totally unaffected by such revisionism. A fundamental problem of the ruling canon in economics has been that it essentially lacks a theory of economic development beyond seeing it as a process of adding capital to labour. The theory rests on what Schumpeter once called 'the pedestrian view that capital *per se* propels the capitalist engine'. There is an obvious connection between the lack of a theory of development as such and the lack of a theory of why the process of development is *uneven*. Recent economic models incorporating new factors and producing uneven growth have - mostly at the insistence of their authors - been barred from practical use in economic policy.

19th Century critics of the classical school of economics referred to it as *chrematistics*, a theory of exchange rather than a theory of production. Still the theoretical focus of the profession is on *Man the Consumer* rather than on *Man the Producer*. This project aims to resurrect the alternative and production-based canon of economics - The Other Canon - which dates back to the pre-mechanical *Weltanschauung* of the Renaissance. A key feature of this theory is that it explains why economic development is *uneven*. The practical uses of The Other Canon lies in the economic policy both in the First, Second and Third Worlds.

The challenge to theory and policy.

At the turn of the Millennium, the world faces social problems of increasing magnitude. During the 1990's, the majority of the world's nations have experienced falling real wages – in many cases real wages have declined both rapidly and considerably. In the former communist countries a human crisis of large proportions is emerging. These events profoundly challenge the present world economic order – the Washington Consensus – and the standard textbook economics on which this order rests.

The European welfare states are also facing new challenges. The main features of the economic policy of these nations have been an active Keynesian demand policy and a strong hands-on policy in the labour markets, combined with a laissez-faire policy as regards industrial structure. In a period of fundamental technological change, a new strategy is needed. By continuing their focus on demand management, labour markets and income distribution, these nations fail to confront the structural problems arising from the evolving new techno-economic paradigm.

The present change in the technological basis for growth creates mismatches between the traditional welfare state - its institutional structure, educational priorities, tax policy and industrial policy - and the conditions under which the new economic activities have shown to be thriving. At the same time traditional industry is experiencing the same type of development that characterised agriculture under Fordist mass production: New technology creates process innovations in mature markets, leading to a rapid fall in employment and fierce price competition. The welfare states must now focus on building economic activities in new industries facing product innovations in growing markets and Schumpeterian competition (on product differentiation and quality).

Presently the stakes are higher for all nations than they have been for a long time. 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 while the rich nations enjoy sustained growth, ninety of the world's nations were poorer in 1997 than in 1990. Thirty-seven of these nations were poorer in 1997 than they were in 1970. Poverty and disease increases sharply in Sub-Saharan Africa, and we see a creeping 'Africanisation' in parts of Latin America.

According to a 1999 Report from UN Development Programme - 'Transition 1999' - a 'human crisis of monumental proportions is emerging in the former Soviet Union'. The transition years 'have literally been lethal for a great many people'. In Russia both GDP per capita and industrial production have been reduced by about 50 per cent since the fall of the Berlin wall. The biggest single cost has been the loss of lives among young and middle-aged men. According to the report there are nearly 9,7 million "missing men" in the transition economies as a whole. We are witnessing an outcome no one would have predicted: Notoriously inefficient command economies were able to produce considerably higher standards of living than do free market policies constructed on the textbook economics of the 1990's.

Financial liberalisation is accompanied by severe crisis in financial markets. At the institutional level we are witnessing the collapse of civil society and of the state in many developing countries. Even in the wealthiest nations we observe a deterioration of basic services such as health and education. At the same time, governments are grappling with an inadequate theoretical framework, attempting to adjust economic policy and the institutional framework in order to cope with disruptive and discontinuous technical and social change.

In spite of the challenges to the present paradigm of economic policy, no coherent alternative theory seems to be at hand. This project claims that a full-fledged alternative theory did exist, but disappeared. We call this set of theories The Other Canon, because it runs like an alternative and parallel theory in opposition to the standard canonical writings from physiocracy, Smith, Ricardo, and the classical and neoclassical school. Two factors seem to have contributed to its disappearance since World War II: Firstly, the Keynesian focus on demand management moved attention permanently away from the real side of the economy to the monetary side. Secondly, The other Canon - largely independent of traditional left-to-right politics - was a cold war casualty, caught in the ideological crossfire between the utopia of communism and the neo-classical utopia of the market as a creator of automatic harmony and factor-price equalisation.

Historically the alternative theory has been carried out most consistently, and for the longest periods, as an economic policy in the United States and Germany. Although no longer taught, the genetic material of the holistic economic theories behind these policies is accessible in the form of literally thousands of books and journal articles. In this Century - reflecting a higher degree of division of labour in the profession - different aspects of the alternative canon have been put forward by authors as diverse as Keynes, Kaldor, Minsky, Myrdal, Penrose, Polanyi, Schumpeter, and Max Weber.

The crash of 1929 produced a crisis in the economics profession similar to the one we experience today, but with one important difference. The crisis of the 1930's was one, which was solved principally by intervention in the monetary sphere. The 21st Century also requires a new set of policies in the sphere of the real economy producing goods and service. To the former Second World and to the Third World this is a period not only of underconsumption, but also of a kind of underproduction, which cannot be solved through monetary means. Tibor Scitovsky, who later was to become a leading US economist, recollects the dissatisfaction, which was felt with the standard canon of economics also in the 1930's:

> 'Those were the depressed 1930's; and I found myself fascinated by the model of a self-equilibrated system of markets but greatly bothered by the gulf that separated that beautiful theory from the ugly reality of great misery and mass unemployment. We students were shocked by the faculty's helplessness in the face of pressing problems and suspicious of the bitter and cruel remedies some of them advocated.'[i]

The Other Canon.

The premise of this project is that the 1990's present a backlash of a world order economic based on a particular *type* of economic theory carried to its logical extreme. The world has experienced similar reversals in welfare before, also then as the result of exaggerated applications – of a *reductio ad absurdum* - of the same basic *type* of economic theory. The backlash of the 1990's is particularly comparable to that following the 1840's. After the 1840's a different type of economic theory re-emerged – a theory which is part of a tradition dating back to the Renaissance. This tradition is 'The Other Canon'; a tradition which (using a metaphor from Kenneth Arrow) 'acts like an underground river, springing to the surface every few decades.' [ii]

Consciously developed particularly from the early 1850's, this alternative canon successfully addressed both the social ills in the emerging industrialising nations *and* it enabled the latecomeing nations – like Germany, US and Japan – to catch up with England. During the 19th Century US politicians and economists frequently observed that England, as the leading or hegemonic nation, adhered to the activity-specific economic policies of The other Canon for centuries. Having caught up with Venice and Holland and established herself as the first industrial nation, England promoted Ricardian economics. This was seen, particularly in the US, as attempting to prevent other nations from repeating her own strategy. England was thus accused of trying to 'pull up the ladder', of preventing other nations from industrialising.

In the appendix to this document, *The other Canon* is contrasted to standard economic theory as it is presently carried out in *economic policy*, particularly to the Second and Third World. We are aware that such dichotomies carry a danger of caricature, yet we claim that these two set of theories represent fundamentally different *Weltanschauungen*, each with their own philosophical base and their own genealogy. The two canons rest on fundamentally different philosophical foundations. When Nietzsche claims that English philosophy is 'an attack on the philosophical *Geist'* and accuses Hobbes, Hume and Lock of debasing the meaning of the term 'philosopher'[iii], we are witnessing the same canonical *Methodenstreit* on the philosophical level.

One important feature of *The Other Canon* is that economic growth is seen as *activity-specific* – that welfare results from being engaged in some economic activities rather than in others. Today we intuitively understand that Bill Gates and Microsoft could not have achieved the same profits and the same wage levels if they had been raising sheep instead of producing software. A theory and policy distinguishing various types of activities were fundamental to centuries of economic policy.

A careful study of the history of economic policy reveals that *The Other Canon* has been employed as the basis for economic policy in all nations that have ever made the transition from poor to wealthy countries. In England, the policies of *The Other Canon* were adhered to for more than 350 years, 1485 being a clear starting point. In Korea these set of policies were in force only for about 40 years, starting after World War II, but with remarkable results.

Economics and 'social questions' – a 19th Century parallel.

During the late 19th Century – with the rise of industrialism – 'the social question' rose rapidly on the agenda both for politicians and for economists. The large number of economics books on 'die soziale Frage', published in all European languages, testify both to the intensity and to the geographical diffusion of the debate. In a narrow sense, the debate addressed the problems of poverty and income distribution within each nation state, but in a wider sense also the very causes of economic growth were addressed. Over the next decades 'the social question' slowly improved – no doubt also driven by a wish to dispel the socialist menace. By creating social insurance systems, and through heavy-handed interventions both in national industrial structures and in labour markets, all industrialised nations came to create some form a welfare state.

The economics profession was a crucial player in this transformation. In Germany the association of economists – the *Verein für Sozialpolitik* – was created explicitly with the purpose of addressing the social question. Even in the United States, 'This was a time when a very wide range of economists, from marginalist to historical, shared a commitment to economic justice.'[iv] Richard Ely – 'the most widely known economist…in the United States around the turn of the Century' according to the New Palgrave – could be called a 'Christian socialist.'[v]

Although inequalities are rising also within industrial nations, the main 'social question' today is *between* nations. In our view these same principles which then solved the problems of *national* income distribution must be invoked in order to address today's problems of the *global* economy.

The 1840's were a period where extreme liberalism created a backlash similar to what we are experiencing in the late 1990's. In 1899 H. S. Foxwell - the Cambridge economist - described the 1840's as a period where laissez-faire policies reached a *reductio ad absurdum.* This - says Foxwell - cleared the way for 'a more realistic school'. This realistic school not only laid the foundations for the economic latecomer, Germany, to catch up with England, it also renewed the foundations for US economic policy. Today we are, in a sense, facing a global version of the distributive crisis that in 1848 ended up causing revolutions in all major European countries except Russia and England.

In 1886 Edwin Seligman - a Columbia University economist - outlined the programme of the new economic movement started by German economists in the 1850's. This tradition – The Other Canon - also formed the basis both for the US institutional school of economics and for US economic policy up to World War II. This alternative theory to English classical theory:

1. 'Discards the exclusive use of the deductive method, and stresses the necessity of historical and statistical treatment.

2. Denies the existence of immutable natural laws in economics, calling attention to the interdependence of theories and institutions, and showing that different epochs or countries require different systems.
3. Disclaims belief in the beneficence of the absolute laissez-faire system; it maintains the close interrelations of law, ethics and economics; and refuses to acknowledge the adequacy of the assumption of self-interest as the sole regulator of economic action.'[vi]

Today's alternative theory will have to be based on these same principles. In fact, even many of the early but neglected English critics of Ricardo's economic theory today have a familiar and 'modern' ring to them.

Edwin Seligman describes the impetus that The Other Canon gave to economics from the 1850's:

> 'An entirely new impulse was thus given to scientific research. Freed from the yoke of a method which had now become obsolete, the new school, devoid of all prepossessions, devoted itself to the task of grappling with the problems which the age had brought with it.'[vii]

The Other Canon is <u>not</u> the Third Way.

There is little intellectual counterweight to The Washington Consensus and to neoliberalism. The search in Europe and the U.S. for a 'Third Way' has been an attempt to create such an alternative. In England after Thatcherism there is clearly a need for such a Third Way – a capitalism providing better income distribution and social security than neoliberalism.

However, in our view The Third Way – as a middle way between neoliberalism and classical social democracy – fails as a solution to today's global challenges. The reason for this failure is that, just like Scandinavian social democracy from the 1960's onwards, 'The Third Way' is essentially a theory of *distribution* of income and wealth in nations where there is something to distribute in the first place. Modern social democracy possesses no underlying theory of what produces inequalities in the first place. The utter failure of social democratic policies – like those of Nyerere in Tanzania and Alan Garcia in Peru - to bring about development in the Third World seems to prove this point. Just like Marx, 'The Third Way' still seems to take for granted the productivity of capitalism and the eventual spread of industrialism to all corners of the world.

At one point in his book on *The Third Way* Anthony Giddens hints at the existence of The Other Canon. He correctly traces the origin of the welfare state to the German economic tradition, to Bismarck in the modern version which was copied by many countries. 'The ruling groups who set up the social insurance system in imperial Germany in the late nineteenth century despised laissez-faire economics as they did socialism', says Giddens.[viii]

The welfare state was clearly no middle way between two systems which its inventors equally detested, it was a system based on a completely different *Weltanschauung* than the mechanical world view which underlies *both* communism and neoliberalism. The communist planned economy and neoliberalism have important common roots in Ricardian economics. It was this *type* of economics – along with its policy implication – which the majority of economists and policy makers in Germany and the United States so much despised. This common dislike both of neoliberalism and communism is a central feature of The Other

Canon. In order to understand this feature, it is necessary to address the important common elements of the extreme left and the extreme right in the economics of David Ricardo. The cold war was in many ways fought between two versions of the standard canon of economics.

There are two main aspects here: In Ricardo's theory of value – the labour theory of value – originates the communist claim that the workers have the right to the whole produce of their labour. Ricardo's mechanical analysis is also the origin of the trade theory of the Washington Consensus, of Samuelson's factor-price equalisation in a world of perfect information. The Ricardian theory as it was formulated into a tool of economic policy disregards the 'true' factors of production like ideas, initiative, entrepreneurship, leadership and innovations. It reduces work to a wholly mechanical task void both of the dynamic *werden* (becoming) and of the human *Geist* which is the basic moving force in the German economic tradition. Marx analysis is very much in line with the German philosophical and economic tradition, but the labour theory of value is a mismatch - totally un-German and alien – to his system.

Only with a static and mechanical world view – void of human *Geist*, of new ideas and leadership – would it be logical that the person who executes the *mechanical* labour should have the right to the whole produce. Only in such a static world with perfect information – i.e. with cloned human beings – would Samuelson's factor price equalisation be thinkable.

Socialist planning was clearly in the standard canon of economics. Walras' model of a market economy uses the fiction of a single auctioneer to formalise the process by which prices are formed. Notice that the focus is on Man the Consumer - on how prices are set - not on Man the Producer. The auctioneer would adjust prices up and down in order to reach equilibrium. The socialist planners 'simply substituted the central planning authority for the auctioneer, and without any violation of the core precepts of the Walrasian model.'[ix] Typically to the standard canon, entrepreneurship and knowledge was kept outside the model.

The most vociferous critics of the centrally planned economy were Austrian economists with the same philosophical background as The Other Canon. But the Austrians (with the exception of Schumpeter) came to worship the market *per se*, in a sense excluding both producers and consumers. The Hayekian entrepreneur is a trader who creates perfect markets because he adds or creates nothing new. In contrast, the Schumpeterian entrepreneur is the driving force in history, a producer who relentlessly pushes forward the never-ending frontier of knowledge.

The *Ricardian Vice* + the *Krugmanian Vice*: Economic Policy in the Worst of all Worlds.

Pre-Columbian American cultures did not use the wheel. However, several pre-Columbian wheeled toys have been found in Mexico. One obvious question is why, while the principle of the wheel was known, was this knowledge not used in practice? Similarly, standard economic theory produces a plethora of 'toy models', which - often at the insistence of their inventors - are not used in real life economic policy. In The Other Canon these models are checked against the only laboratory of social sciences, history, and in particular the history of economic and social policy. The limiting of useful inventions to the world of toys and play we could label *the Krugmanian Vice*.

To this vice is added what Schumpeter calls *the Ricardian Vice*. This vice was well described already one hundred years ago by Foxwell:

> 'Ricardo, and still more those who popularised him, may stand as an example for all time of the extreme danger which may arise from the unscientific use of hypothesis in social speculations, from the failure to appreciate the limited applications to actual affairs of a highly artificial and arbitrary analysis. His ingenious, though perhaps over-elaborated reasonings became positively mischievous and misleading when they were unhesitatingly applied to determine grave practical issues without the smallest sense of the thoroughly abstract and unreal character of the assumptions on which they were founded.'[x]

This criticism could indeed have been tailor-made to criticise the devastating effects on welfare in the Second and Third World produced by neo-classical economics. It is this kind of theoretical 'mischief' – among other things a fairly conscious de-industrialisation of the Second and Third World - which has caused the loss of welfare in the 1990's.

The present world economic order suffers from a combination of the Ricardian vice and the Krugmanian vice. The actual policy carried out against the Second and Third World is based on the unscientific use of Ricardo's arbitrary analysis. At the same time the more relevant models which are developed are not used outside the economists' playrooms.

The aim of this project is to focus attention on already existing alternative economic theories and historical experiences: The Other Canon attempts to re-establish a holistic and dynamic *Weltanschauung* rather than the present static one. In this theory Man the Creator and his productive activities are at the core of the theory rather than Man the Trader in a dead equilibrium which is void of any empirical foundations. A major goal of this 'Reality Economics' is to broaden the spectrum of available policy options to incorporate policies that have been highly successful in the past, but which have now been unlearned. While standard textbook economics is a system which creates natural harmony, in The Other Canon harmonious evolution is man-made, the result of Man's institutions and Man's will.

The Other Canon - the Four Papers.

The project the 'The Other Canon' initially consists of four position papers. These papers are discussed in three workshops (Venice January 2000, Oslo August 2000, Venice January 2001). They will later be published in a book form and will be available on this home page.

1. **The widened Schumpeterian vision.** Erik Reinert.

   At the core of The Other Canon is *Change*. Creativity and new knowledge, producing dynamic imperfect competition in a process of *creative destruction*, increase welfare. The search for profit through dynamic imperfect competition is the very engine that propels the market economy in producing increasing wealth. The role of entrepreneurship is crucial in this system.

   At any point in time different technologies and products provide widely different potentials (windows of opportunity) for wealth-creation. Economic growth and welfare is therefore **activity-specific**, it is created in some activities rather than in others. Economic activities differ in their ability to absorb new knowledge in a profitable way. In this aspect, the factors and mechanisms explaining income differentials between individuals **inside** nations also explain differences in income level **between** nations. From the point of view of The

Other Canon, this is perhaps the most important blind spot of standard textbook economics predicting an equalisation of wages world-wide.

In the present wave of globalisation, labour markets are not globalised. In this situation, the activity-specific nature of economic growth increases economic divergence between groups of nations.

2. **The Financial Dimension.** Leonardo Burlamaqui & Jan Kregel.

Economic change takes place under conditions of uncertainty. The Schumpeterian system produces constant desequilibria, and credit is thus an essential part of the mechanism that makes it possible for the system to grow. Nations need national systems of credit in the same way that they need national systems of innovations.

In the best of times, the *real* and the *financial* sides of the economy are synchronised in a symbiotic relationship reinforcing each other. The financial sector, however, periodically 'takes off' from the real economy and takes on a life of its own, no longer anchored to the real economy. This process normally ends in a financial crack, which drags the real economy (and real wages) down with it.

The mechanisms causing the periodic mismatches are created by what the late Hyman Minsky called 'destabilising stability'. In periods of growth, the banks compete in order to achieve market share. When, through this competitive process, the financial markets have overextended themselves, the same financial markets start competing for liquidity, thereby increasing the risk exposure of all existing projects, starting the *spiral of collapse* of the real economy. The structural conflicts between the financial sector and the productive sector seem to occur at certain periods in the trajectory of a technological system. These structural conflicts can and should be controlled by technocratic policy means.

3. **The Role of Institutions.** Ha-Joon Chang & Peter Evans.

Institutions provide the necessary scaffolding for building stability and supporting wealth creation. Institutions are also the main buffers providing income distribution and protecting against instability in a system which is driven by *creative destruction*. Institutions co-evolve with the economic activities, which need their support. Therefore institutions, as well as economic activities are *activity specific*. Some institutions that are taken for granted in an industrialised nation, can only be created with great difficulty - if at all - in an agrarian nation. The importance of the State as an institution has been neglected by the economic theories which have dominated in the 1990's.

The discontinuous technical change we are experiencing in the 1990's creates mismatches between old institutions and new technologies, and requires the building of new institutions and of new tools for political economy. The global economy needs to build and develop new institutions in a similar way to the conscious building of institutions that accompanied the slow rise nation states.

4. **Economic Policy and Economic Transformation: The Historical Record**. Erik Reinert.

The history of economic policy is virtually non-existent as a field of inquiry. Historical processes have both unique and recurrent aspects, and examples on how and why nations have caught up, forged ahead, and fallen behind in the past produce the laboratory against which The Other Canon operates. Most textbooks in the history of economic thought ignore important policy aspects, and tend to narrate the history of neo-classical economic theory and its predecessors. The Other Canon is based on an even longer tradition - an alternative canon of economic theory which has been virtually neglected during the last decades.

The Other Canon - or 'Reality Economics' - would argue that all presently industrialised countries have passed through a period of *active* and *activity-specific* economic policy - that such a period represents a *mandatory passage point* for any nation. The policies, incentives and methods employed are also surprisingly similar over time from the rule of Henry VII in England starting in 1485 through Korea's growth spurt starting in the 1950's. By praising the English Navigation Acts - actively fostering certain economic activities - as the wisest laws ever passed in England, Adam Smith also supported this activity-specific element at the early stage of economic development. In this section of the Wealth of Nations 'the invisible hand' can be understood as a snowballing effect which has been set in motion by *activity-specific* economic policies of the past.

The historical part of the paper traces the economic policies of presently wealthy nations during the early periods of catching up - the period when they start their growth spurt. The policies recommended by The Other Canon were actively being pursued in Europe after WW II, but had been unlearned during and were not applied in Eastern Europe after the fall of the Berlin Wall. It is argued that the fact that a majority of the nations of the world are poorer in 1997 than they were in 1990 - the opposite of what is predicted by mainstream theory - can be explained in the light of The Other Canon.

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[i] Scitovsky, Tibor, 'My Search for Welfare', in Szenberg, Michael (editor), *Eminent Economists. Their Life Philosophies*, Cambridge, Cambridge University Press, 1992, page 250.
[ii] Arrow in his foreword to Arthur, W. Brian, *Increasing Returns and Path Dependency in the Economy*, Ann Arbor, University of Michigan Press, 1994.
[iii] In *Jenseits von Gut und Böse.*
[iv] Morgan, Mary S. And Malcolm Rutherford, 'American Economics: The Character of the Transformation', in Morgan and Rutherford *From Interwar Pluralism to Postwar Neoclassicism*, Annual Supplement to History of Political Economy, Volume 30, Durham, Duke University Press, 1998, p. 4.
[v] See Everett, John Rutherford, *Religion in Economics. A Study of John Bates Clark, Richard T. Ely, Simon N. Patten*, Morningside Heights, New York, King's Crown Press, 1946.
[vi] Seligman, Edwin, 'Continuity of Economic Thought', originally published in 1886, reproduced in Seligman's *Essays in Economics*, New York, Macmillan, 1925, page 15.
[vii] Seligman, *op.cit*.
[viii] Giddens, Anthony, *The Third Way. The Renewal of Social Democracy*, Cambridge, Polity Press, 1998.
[ix] Hodgson, Geoffrey M, *Economics and Utopia*, London, Routledge, 1999.
[x] Foxwell, H. S., Foreword to Menger, Anton, *The Right of the whole Produce of Labour,* London. Macmillan, 1899, p. xli. Our emphasis.