

**The Qualitative Shift in European Integration:  
Towards Permanent Wage Pressures and  
a 'Latin-Americanization' of Europe?**

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## **Introduction: Types of Economic Integration and Definitions of Capitalism.**

US economist Hyman Minsky jokingly used to claim that there are as many varieties of capitalism as Heinz has pickles, that is 57 varieties (Minsky 1991). In this paper we argue that economic integration provides a similar analytical problem: economic integration can take many forms, and some are more conducive to wealth and freedom than others. Colonialism was probably the first form of international economic integration, and a very close form of integration at that. Intuitively we understand that what the European Union has attempted to achieve – ever since Winston Churchill called for ‘a kind of United States of Europe’ in a 1946 Zurich University speech – is something qualitatively very different from colonialism.

In this paper we argue that European economic integration has made a qualitative shift from one type of economic integration to another, from a *Listian symmetrical economic integration* to an *integrative and asymmetrical integration*. We argue that this change – originating in a new definition of the nature of capitalism – is measurably threatening European welfare, first in the economic periphery and secondly potentially also in the core countries. We argue that the new and enlarged Europe is undergoing structural change towards a *Latin-Americanization*, including a larger spread in wages (more inequality), wages falling as a percentage of GDP (in favour of the FIRE sector: Finance, Insurance & Real Estate), and the formation of pockets of urban wealth and an impoverishment of the countryside. These phenomena, which are clearer in the EU periphery than in the core, will increase the cost of economic cohesion and increase social tension. This development is aggravated by the timing of the enlargement in the present phase of the techno-economic paradigm, a period that already under normal circumstances is characterized by deflationary and downward pressures on wages, like in the 1930s.<sup>1</sup>

We argue that this analysis of qualitatively different types of economic integration escapes traditional economic analysis for three basic reasons: a) because of different definitions of capitalism, b) because of what Nobel Laureate James Buchanan refers to as the ‘equality assumption’ of standard economics (Buchanan 1979: 231ff): that economic activities are qualitatively alike as carriers of economic growth, c) because we assume that a nation or group of nations can be producing far from its production possibility curve; in other words we do not assume full employment.

Today capitalism tends to be defined by the private ownership of assets and market coordination of all activities not organized within firms (Williamson 1985). For Marxists, capitalism tends to be defined as a specific relationship between classes of owners and non-owners of the means of production. Our analysis is a third type, based on understanding of capitalism as *a system of production*, and follows Werner Sombart’s definition in his *opus magnum* on the subject (Sombart 1928). Sombart defines the foundations and preconditions upon which capitalism is built as follows:

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<sup>1</sup> On techno-economic paradigms, see Perez 2002 & 2004.

1. The business enterpriser (i.e. entrepreneur);
2. The modern state;
3. The machine process (i.e. industrialism), a term defining a dynamic system close to what we today would refer to as the 'national innovation systems'.

*With these elements at hand*, capitalism – according to Sombart – needs the following factors for full development:

1. Capital;
2. Labour;
3. Markets.

Since the main preconditions for capitalism – the entrepreneur, the modern state, industrial dynamics – did not lend itself particularly well to neo-classical quantitative analysis, this type of economic analysis had to focus on what to Sombart was only *auxiliary elements* in the process; i.e. capital, labour and markets. This removed the causes of capitalist dynamics from economic theory. The real causes of capitalist dynamics, what Nietzsche calls *Geist und Willens-Kapital* (Man's wit and will) – new knowledge, entrepreneurship, innovations and organizational ability – were left out of the analysis. Removing these elements automatically also removed the reasons why dynamic growth is so unevenly distributed between individuals, firms and nations. Neoclassical economic theory exogenised the dynamic driving forces of capitalism, and came to adopt what Schumpeter calls 'the pedestrian view that it is the accumulation of capital per se that propels the capitalist engine' (Schumpeter 1954: 468). In terms of understanding economic dynamics, neoclassical analysis developed into something akin to playing Hamlet without the participation of the Prince of Denmark.

An important result of this is that late 20<sup>th</sup> century economic theory came to conceive of economics as a *Harmonielehre* (Robbins 1952). By studying only capital, labour, and markets under 'the equality assumption' the world economy came to be seen as a machine producing automatic harmony. In this way, capitalism as defined by Williamson could not distinguish colonialism from the European Common market as being two qualitatively very different forms of economic integration. The equality assumption – that all economic activities are equally well suited as carriers of innovation and economic growth – leads into economics as a *Harmonielehre*. Not surprisingly, in a theory where all inputs are qualitatively alike – as in Paul Samuelson's trade theory – the outcome is also that all economic factors are alike: the outcome is *factor price equalization* (Samuelson 1948).

It is important to note that capitalism the way Sombart defines it – as a dynamic *industrial system* – never reached the colonies. The essence of colonialism was, from its very inception, precisely to prohibit industrial production there. Neither was agriculture a part of capitalism to Sombart. Successful economic integrations are win-win-situations that extend and develop industrialism and capitalism – as Sombart defines it – to new areas without destroying them in others. Unsuccessful economic integration is, from this point of view, forms of integration where one or both parties are prevented from, or lose,

the dynamic economic structures that used to go under the name of *industrialism* (Sombart's definition of capitalism), but today may contain just as much advanced services as physical production.

## 1. Causes of Uneven Growth as the Basis for a Theory of Types of Economic Integration.

A key part of the 18<sup>th</sup> century scientific revolutions was the development of taxonomies or classification systems as carriers of new and more detailed knowledge of the world that surrounds us. The archetypical case is that of Linnaeus (1707-1778) and his classification systems for living organisms. Distinguishing a good and useful plant from one deadly poisonous and useless was made into a science. As already alluded to when addressing the 'equality assumption', a remarkable feature of modern economics is the complete absence of any taxonomy: the 'equality assumption' is in a sense the mother of all assumptions of the economics profession.

We argue that a key feature of pre-Smithian economics was a taxonomic understanding of the economic world of production. This taxonomy of economic activities led, in turn, to a taxonomy of types of international trade that could, respectively, benefit only one of the trading partners or both. The seeds of this taxonomy can be found already in the 1550s (Ortiz 1558, quoted in Reinert 2003), it solidifies towards the end of the 1600s and is accepted across Europe as common sense in the early 1700s. This theory develops from a pre-scientific common sense to economic science. As English economist Edward Misselden describes this type of development: 'Before we knew it by sense; now we know it by science' (Misselden 1622)

The 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. Some, but not all, cities were wealthy, particularly those of Italy and those of the Dutch Republic. It was also a very common observation that the presence of manufacturing spilled over and increased the efficiency of agriculture. 'Promoting husbandry . . . is never more effectually encouraged than by the increase of manufactures' wrote David Hume, Adam Smith's close friend, in his *History of England* (Hume 1768, vol. 3: 65).

The experience-based economics of the early 1700-century had crystallized the following explanations for why some areas were much wealthier than others (Reinert 2004c):

- Economic development is *activity-specific*, available in some economic activities rather than in others. Development was seen as created by increasing returns and innovations in manufacturing (Botero 1590, Serra 1613, see Reinert and Reinert 2003) and not in agriculture, due to stagnant productivity, diminishing returns and monoculture, and absence of synergies.

- Economic development is a *synergic* process: the greater the division of labour and the number of professions, the greater the wealth (already very clear in Serra 1613, see Reinert & Reinert 2003).
- The targeting, support, and protection of *manufacturing* were argued in terms of
  - a) its ability to create wealth
  - b) its ability to create employment
  - c) its ability to solve balance of payment problems
  - d) its ability to increase the velocity of circulation of money
- Starting in the 1700s, great emphasis was put on the beneficial synergies between manufacturing and agriculture: only where there was manufacturing, was there successful agriculture. This crucial understanding – which today is lost – is found not only in Hume in England (see above), but also in the writings of the most influential economists on the continent at the time: Justi in Germany, Montesquieu in France, Galiani in Italy, Uztáriz in Spain and Berch in Sweden.<sup>2</sup> This understanding of synergies also calls for a great variety of manufactures in each country (as in Serra 1613)

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 normally seen as a protectionist, but 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 (1613), 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)

We shall argue that – regardless of what economic *theory* might have said – the *practice* and history of European economic integration has, until very recently, been based on the understanding expressed here by List: economic integration has essentially taken place between nations that already have achieved a comparative advantage in increasing returns activities (manufacturing) or, alternatively, as colonialism. In fact, economic development and integration of Central European states after the Westphalian Peace of 1648 followed precisely this path laying foundation for the economic success of Europe (see Backhaus 2001). We shall see below that the famous Harvard Commencement Speech by US Secretary of State George Marshall in 1947 – announcing the Marshall Plan – essentially

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<sup>2</sup> Modern economic historians agree with the mercantilist explanation of causality here: ‘The bulk of the evidence points to urbanization being the cause of agricultural productivity gain, not a result’. Philip Hoffman quoted in Prak (2001).

restates the Listian view about the importance of the synergies between city and countryside being the basis of Western civilization.

## **2. From an Understanding of Uneven Development to a Taxonomy of Economic Integration.**

Out of this understanding of economic development developed a theory of economic integration that, we claim, was in practice followed in Europe for centuries, including during the gradual buildup of what came to be the European Union over the decades following World War II. An essential feature of this type of economic theory is the understanding of the synergies between increasing return activities (urban/manufacturing activities) and the production of raw materials (rural activities).

The clearest early statement of this theory is found on the first pages of Charles King's three volume work (King 1721, vol. 1: 1-5), a compilation of works published in the previous decade, which was to enjoy unique authority for decades. It is important to note that this scheme 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. That a Trade may be of Benefit to the Merchant and Injurious to the Body of the Nation, is one of these Maxims' (King 1721: 1). This is, of course, very different from the later teachings of Adam Smith, who assumes an automatic harmony of interest 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 is essential to the success of modern nation-states in Europe and North-America (a point made already in Schmoller 1884).

In its simple form, the argument presented by King runs like this:

Good trade is importing raw materials and exporting finished goods. Exporting finished goods produced from native raw materials is the best kind of trade for a nation, but importing raw materials and exporting the finished goods is also good trade.

Importing manufactured goods in exchange for raw materials is bad trade.

But interestingly, exchanging manufactured goods for other manufactured goods is beneficial to both sides, i.e. mutually good trade.

If increasing returns are attributed to manufacturing industries and diminishing returns are attributed to the production of raw materials, King's taxonomy is perfectly

compatible with more recent trade theories (Graham 1923) and Krugman 'new trade theory' (Krugman 1980).

We argue that there is a remarkable continuity in the practice – rather than in the theory – of King's principle of economic integration from the early observations in the 1500s (Ortiz 1558 in Reinert 2003, Botero 1590) through the policies of the 1600s and 1700s, to the policies advocated by Friedrich List, and to the European integration as it slowly took form after World War II, assuring the strength and survival of the manufacturing sector in each member country. There is indeed a remarkable similarity between the quote from Friedrich List above and US Secretary of State George Marshall's Harvard Commencement Speech on June 5, 1947, when Marshall says:

There is a phase of this matter which is both interesting and serious. The farmer has always produced the foodstuffs to exchange with the city dweller for the other necessities of life. ***This division of labour is the basis of modern civilization.*** At the present time it is threatened with breakdown. The town and city industries are not producing adequate goods to exchange with the food-producing farmer. Raw materials and fuel are in short supply. Machinery is lacking or worn out. The farmer or the peasant cannot find the goods for sale which he desires to purchase. So the sale of his farm produce for money which he cannot use seems to him an unprofitable transaction. He, therefore, has withdrawn many fields from crop cultivation and is using them for grazing. He feeds more grain to stock and finds for himself and his family an ample supply of food, however short he may be on clothing and the other ordinary gadgets of civilization. Meanwhile, people in the cities are short of food and fuel, and in some places approaching the starvation levels. So the governments are forced to use their foreign money and credits to procure these necessities abroad. This process exhausts funds which are urgently needed for reconstruction. Thus a very serious situation is rapidly developing which bodes no good for the world. The modern system of the division of labour upon which the exchange of products is based is in danger of breaking down. (Emphasis added).

Marshall's remarks were essentially comments on the result of the Morgenthau Plan in Germany (Morgenthau 1943, Reinert 2003). The purpose of this plan, named after Henry Morgenthau, the US Secretary of the Treasury from 1934-1945, was to prevent Germany from ever starting a war again. This was to be achieved by de-industrializing Germany and make it into a pastoral state; closing factories, taking the industrial machinery out of the country 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 1947 when ex-President Herbert Hoover of the United States, on a fact-finding mission, 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 had rediscovered the wisdom of the cameralist and mercantilist population theorists: an industrialized nation has a much larger carrying capacity in terms of population than an

agricultural state. The de-industrialization process had 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 cameralist economics. 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 its 1938 level. It cannot be emphasized enough that the Marshall Plan was not a financial plan, it was a *reindustrialization plan*. It can be argued that early development economics started with very similar ideas. (See, e.g., Rosenstein-Rodan 1943; Singer 1950; Nurkse 1953)

One of the authors has argued that the type of economic integration that resulted from 'structural adjustment' starting in the 1980s has been of the Morgenthau Plan type (Reinert 2003 & 2004a): a rapid de-industrialization that has threatened what both Friedrich List and US Secretary of State George Marshall saw as the basis of modern civilization. We maintain that a shock-wave of free trade between a relatively advanced nation and a relatively less advanced nation, or group of nations, will tend to kill the most advanced industries in the least advanced countries. We refer to this effect as the Vanek-Reinert Effect (Reinert 1980 & 2004a). This effect can be observed from the 19<sup>th</sup> century unification of Italy, when Southern Italian industry suffered, to the Czech computer industry as perhaps the earliest casualty of the fall of the COMECON block. As in Mongolia, the last economic activity to survive is subsistence agriculture – in Mongolia in the form of animal herding.

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 below. 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.

## I. SYMMETRICAL FREE TRADE AREAS.

### A. Listian Integration (From Friedrich List).

Examples of Listian economic integration is 19<sup>th</sup> century Germany and the 'old' European Union. Listian economic integration is between nations on roughly similar levels of GDP/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 labour intensive industries could be farmed out to Portugal increasing real wages both in Portugal and in the rest of the EU. 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. 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 Type IIC strategy.**

### **B. Peripheral Symmetrical Integration.**

Examples of this type 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 types are preferences for relative laggard countries, as for Ecuador and Bolivia the in Pacto Andino. The Latin American Free Trade Association (LAFTA/ALALC) is an example of such an integration that failed. A problem with this type of integration is often that such nations have similar economic structures and relatively little to sell to each other.

This type of regional integration is probably a necessary stepping stone before reaching global free trade.

COMECON seems to fall in this symmetrical category because of the emphasis on distribution of increasing return activities, but because of the starting asymmetry it is not clear if this is a third type under category 1.

**Peripheral symmetrical integration is also a *win-win* strategy if the right dynamics are achieved.**

## **II. ASYMMETRICAL FREE TRADE AREAS.**

### **A. ‘Colonial’ and Non-Integrative.**

In the classical colonial relationship a dynamic industrial nation integrates with a periphery that, whether explicitly stated or not, is not to specialize in innovation and increasing returns activities.

Traditionally ‘colonies’ specialized in supplying raw materials. Now a more sophisticated neo-colonial division of labour appears as both manufacturing and agriculture sectors split up in a high-tech/capital intensive/innovative/high wage segment on the one hand and a low-tech/low capital intensity/non-innovative/low wage segments on the other

hand. 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 labour. This development finds its parallel in the Mexican agricultural sector, where highly subsidized US imports of mechanizable grain production is replacing Mexican agriculture even in a traditional product like corn – produced with exceptionally advanced technology including unmanned tractors using global positioning equipment – while Mexico specializes in exporting the unmechanizable agricultural production, some of the fruits and vegetables (e.g. strawberries, cucumbers). The Mexican national innovation system is deteriorating accordingly, and returning to a centre-periphery relationship with the United States (Cimoli 2000)

In asymmetrical trading areas the Vanek-Reinert Effect starts operating, and the least advanced nation concentrates in the low-skilled areas both in manufacturing and also in agriculture. In the worst case this can lead to rampant de-industrialization (Reinert 2003 & 2004b). In Mexico a deteriorating sequence can be observed; first *de-industrialization*, subsequently *de-agriculturalisation* (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.

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 is high enough, and the supply of labour 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 labour-intensive crops with cheap labour, but not the disadvantages.

**Classically 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’ Ross Perot used to talk about hits US employment and real wages. If the world moves towards *factor-prize equalization*, this may very well be downwards.

## **B. 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. As he readily admits, Akamatsu’s theory rests on a Germanic conception of society and economy, references to Kant, List, Sombart and Schumpeter –as well as to Russian economist Nikolai Kondratieff – abound.

The essence of the flying geese 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), but is both more full-fledged and better integrated into the dynamics of Kondratieff and Schumpeter. Appendix 1 gives graphical representations of this strategy.

To illustrate the process, follow a product: a hairdryer is produced in Japan and exported to the rest of the world. When Japan upgrades her 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 increased their wealth and upgraded technologically, based on the same product.

There are several interesting aspects to this strategy:

1. An intra-industry aspect: product development within a particular developing country, within a single industry, from import to production and then to export (very much List 1841 & Vernon 1966).
2. An inter-industry aspect: sequential appearance and development of industries in a particular developing country, with industries being diversified and upgraded from consumer goods to capital goods and/or from simple to more sophisticated products.
3. An international aspect: subsequent relocation process of industries from advanced to developing countries during the latter's catching-up process. (GRIPS Development Forum, see bibliography)

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 (see also below). However, the strategy was only possible because it was in the interest of the United States to build a *cordon sanitaire* around the communist world, i.e. an interest in giving the world Marshall Plans rather than Morgenthau Plans. This strategy requires heavy-handed government intervention and is impossible to initiate today under the rule of the Washington Institutions.

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.

### **C. Welfare Colonialism.**

The term welfare colonialism was coined by anthropologist Robert Paine (Paine 1977:1-52) to describe the economic integration of the Arctic population into Canada, and may equally well be applied to the integration of the Saami people 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, 'non-demonstrative' (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 'centre' in a peripheral population, a centre 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 is an economic burden to the colonial power.

### **D. Integrative and Asymmetrical Integration.**

This type of economic integration 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 see the present European Union enlargement as largely falling under this heading in terms of economic integration. However, the future quality of integration in the new Europe is by no means clear, it may well turn out be a win-win integration or exactly the opposite, a lose-lose one. Europe does not start as *tabula rasa*. In particular, the new member states have, in recent years, experienced unprecedented changes in economic and social terms. The decade of deindustrialisation that preceded the last EU enlargement, in all new member states except Hungary, is an important factor that needs to be taken into account. In what follows, we try to measure the development potential of the new Europe and sketch out the dynamics determining this development.

### 3. The New Europe: Cost and Nature of the Integration.

#### 3.1 Characteristics of Transition

The economic integration of Central and Eastern European (CEE) and newly independent countries from the former Soviet Union (NIS) into world markets after the fall of Berlin Wall in 1989 was based on three basic assumptions shared by most of these countries:

- 1) economic liberalization through the abolition of controls over prices and production;
- 2) macro-economic stabilization through control of the money supply and balancing of the government budget;
- 3) the sale of state property to private individuals. (Kregel et al.1992:14; also King 2002)

The goal of this architecture of transition was rapid transition to free market economy and, obviously, higher standard of living.

However, the integration of the CEE countries into the EU took place during a particular and peculiar *Zeitgeist*, during the triumphalist euphoria following the fall of the Berlin Wall. With hindsight, this was a period when the West in a sense had come to believe in the propaganda version of their own economic theory, that markets were creators of automatic economic harmony, that immediate opening to international trade would create factor-price equalization (Samuelson 1948). However, in reality this fast integration led to what we have labelled a Vanek-Reinert Effect, a situation where the most advanced economic sectors in the least advanced countries are killed off. In the extreme periphery, Mongolia, most industrial sectors were virtually exterminated, and the only two growing industrial sectors are the collection of bird feathers to produce combed down and the production of alcohol (Reinert 2004b). We have argued that assymetrical shock integration has the same effects as the Morgenthau Plan that was forced on Germany between 1945 and 1947 (see above).

As indicated in Figure 1, the integration of the CEE countries into the world economy had – in varying degrees – all the characteristics of a Morgenthau Plan. In all countries except Hungary, industrial employment fell – in several cases dramatically – between 1990 and 2001. Both in post-World War II Germany and in Mongolia during the 1990s this pattern of deindustrialization was accompanied by a rapid growth in agricultural employment and a precipitous fall in agricultural productivity (Reinert 2004b). Figure 1 shows two strikingly different patterns. In the least developed countries (Armenia, Azerbaijan, Bulgaria, Kyrgyzstan, and Romania) the surplus labour from deindustrialisation moves back to agriculture – following the Mongolian pattern – lowering labour productivity there. In the slightly less underdeveloped periphery this

surplus labour moves into the service sector, including underemployment and informality.

It is important to note that this type of deindustrialization of *low-income countries* is qualitatively very different from the slow 'de-industrialization' of *high-income countries* as they upgrade into a knowledge-intensive service sector (UNCTAD Report reference to follow).

**Figure 1. Integration and Deindustrialization 1990-2001: Employment Structure by Sector, Selected Transition Economies, 1990 and 2001 (per cent).<sup>3</sup>**

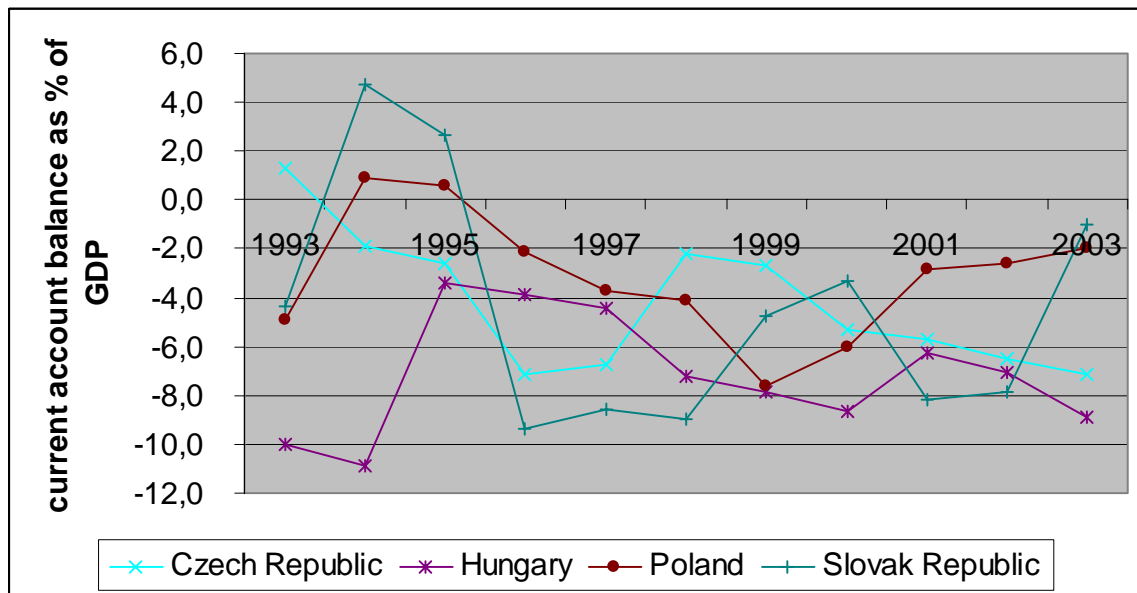
Country	1990			2001		
	Agriculture	Industry	Services	Agriculture	Industry	Services
Armenia <sup>1</sup>	17.7	30.4	38.3	44.4	14.1	37.2
Azerbaijan	30.9	22.9	31.1	40.0	10.8	49.3
Bulgaria	18.5	44.2	37.3	26.3	27.6	46.0
Czech Republic	12.3	45.5	42.2	4.8	40.4	54.8
Estonia	21.0	36.8	41.8	6.9	33.0	60.1
Hungary <sup>2</sup>	8.7	33.0	58.1	6.2	34.7	58.9
Kazakhstan <sup>3</sup>	22.3	31.5	40.7	22.0	18.3	59.8
Kyrgyzstan <sup>3</sup>	32.7	27.9	39.4	52.4	11.6	36.1
Latvia	17.4	37.4	45.2	15.0	25.6	59.4
Poland	25.2	37.0	35.8	19.1	30.5	50.4
Romania	29.1	43.5	27.4	42.3	26.2	31.5
Russian Federation <sup>3</sup>	13.9	40.2	45.6	11.8	29.4	58.8
Slovakia <sup>2</sup>	10.1	39.6	50.0	6.1	37.6	56.2
Slovenia <sup>4</sup>	10.7	44.1	45.1	9.8	38.1	50.8

Source: International Labour Office 2004.

These problems in the sphere of production rapidly translate into balance of payment problems, and just as there was no Marshall Plan to restore the productive sector of Eastern Europe as there had been in the West after 1947, there were no counterparts in the monetary sphere, nothing similar to the European Payments Union for settling trade balances as in 1950-1958. The emerging divergent developments in CEE and NIS countries were inevitable given the policy framework: increased social stress and constraints in form of a negative current account balance. Indeed, the former was the case in all countries and as Figure 2 illustrates, in some CEE countries the current account balance deteriorates starting in 1993. The CEE countries were on their way to what Celso Furtado has called 'the break-down of the capacity to import'.

<sup>3</sup> <sup>1</sup> 2000; <sup>2</sup> 1994; <sup>3</sup> 1999; <sup>4</sup> 1994. Numbers do not add up to 100% because some industries are 'not adequately defined'.

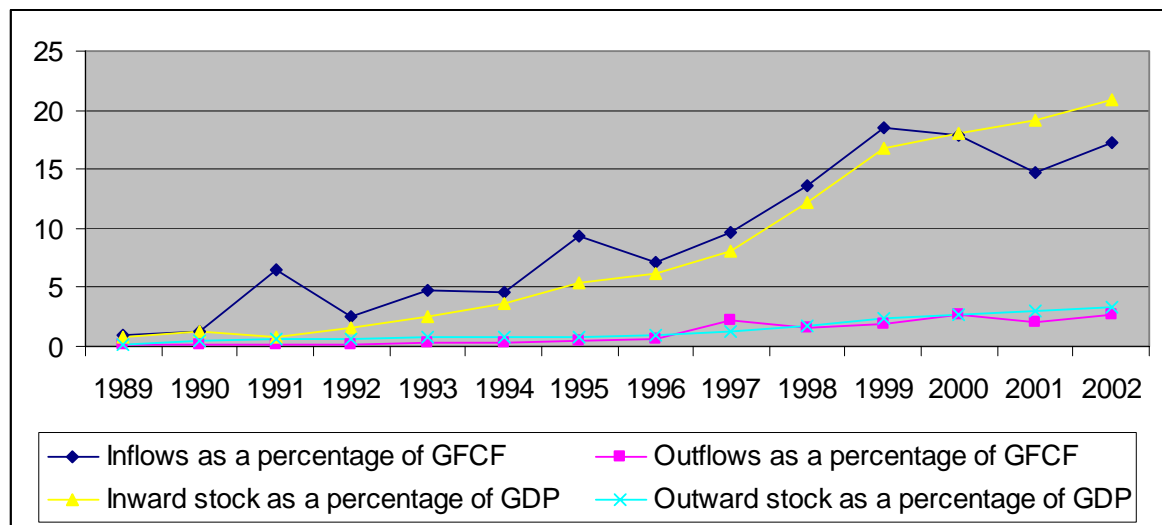
**Figure 2. Current Account Balance as a Percentage of GDP, Selected CEE Countries, 1993-2003.**



Source: OECD 2004.

In 2001, all CEE countries had a negative balance in trade of goods. (Sneijers 2004:2) Yet, inflow of foreign direct investments (FDI), gradually picking up after the mid 1990s enabled rapid change and covered some of the negative trade balance consequences (See Figure 3). FDI also fuelled rapid privatization of industries: there was a strong correlation between FDI inflow and privatization revenues in CEE and NIS in the 1990s. (EBRD 2000:84). These cannot, of course, be permanent flows.

The financial architecture created for the transition turned both FDI and privatization, especially in the beginning, into means of 'destructive destruction' and Myrdalian vicious circles. The most recent financial transfers by the state to industrial companies of the Soviet period were transferred into loans of newly founded banks to the same companies. Most of the latter were to be privatized. This automatically created liabilities on the balance sheets of companies, in turn making the industrial restructuring of companies very difficult and creating high risks in the banking sector. The system set up was weak and prone to crisis from the very beginning.

**Figure 3. Foreign Direct Investments in CEE, 1989-2002.**

Source: UNCTAD FDI database.

Thus, there was strong ‘liability destruction’ but hardly any ‘asset creation’. (See further Kregel et al. 1992:44-54; King 2002) This prepared the ground for the Vanek-Reinert Effect, as described above, to rapidly take root in CEE and NIS industries. This, in turn, translated into a sudden and unprecedented onset of social problems: between 1989 and 1996 “the number of poor and unemployed in the region [CEE and NIS] rose respectively by 100 and 10 million while the crime rate tripled”. (Cornia 2004) Almost all CEE countries have experienced severe deterioration in life expectancy up to mid 1990s, and the non-EU member countries in CEE and NIS are still seeing lowering life expectancy. (Cornia 2004) In addition, all CEE countries experienced growth in regional and income inequality during the 1990s. (See below)

The positive effects of FDI and privatization were offset by the dramatic rise in social problems as so-called transition costs. Arguably there had to be some rather painful costs as well as uneven development. (Hirschmann 1958). Yet, by any standard or understanding of capitalism, the rapid liberalization and onslaught of social problems should have been counterbalanced by creation of new value by upgrading – rather than permanently destroying – large parts of the previous industrial structure. Too little was done to create value by developing the industrial structure of the respective economies towards higher skill and technology intensity. Only if this had been done –as an assisted Listian form of economic integration – the high human costs of transition would have been justified. This would have produced a Schumpeterian creative destruction rather than varying degrees of destructive destruction (Reinert 2004a). The change towards higher skill and technology would have enabled competitive production for export as well as for local markets, thus raising wages, in turn raising government revenues which would, in principle and practice, have allowed for higher investments in education, health and other social services in a virtuous circle of development.



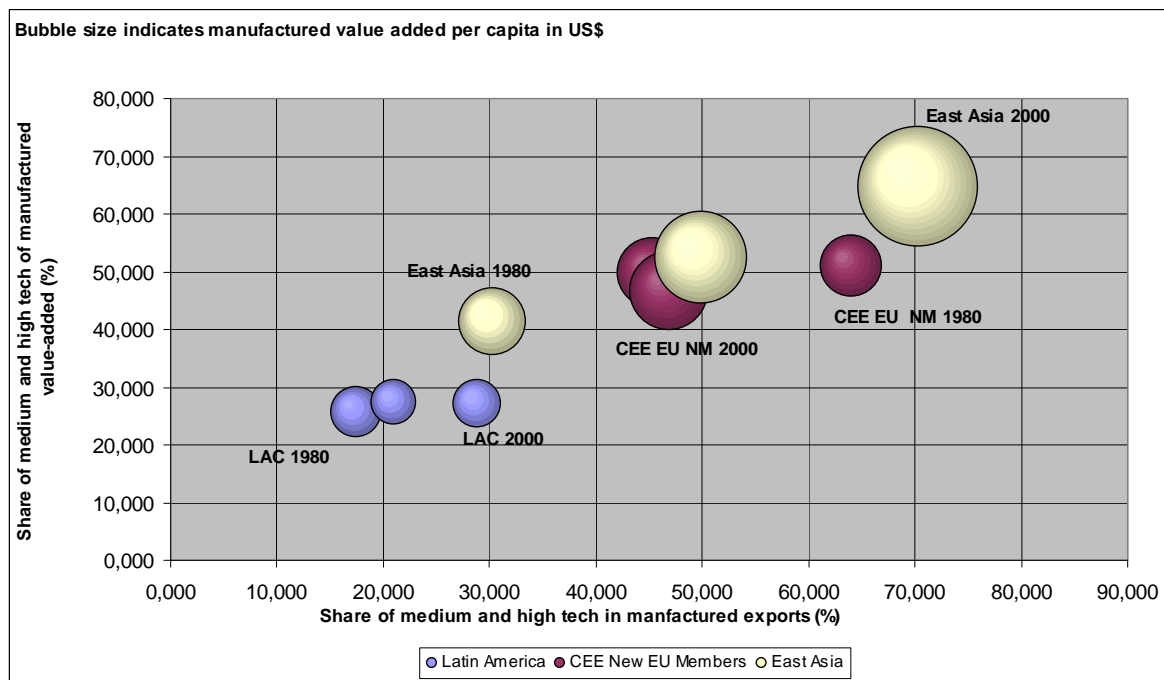
### 3.2 Quality of Industrial Change

If we look at the development of share of medium and high technology in manufactured exports (international competitiveness) and in manufactured value added (quality of the industrial structure), the new EU member states from CEE were more competitive in 1980 than in 2000.<sup>4</sup> (Figure 4) In 1990 CEE countries had qualitatively better industrial structures and were more similar to the East Asian economies than they are today. However, by 2001 the difference between these two groups of countries is truly astonishing. Latin America, by comparison, has fared even worse: if CEE countries have managed to raise the manufactured value added per capita from 1980 to 2000, then Latin America, though more competitive internationally in 2000 than in 1980, has clearly not been able to break out of the vicious circle of uneven development.<sup>5</sup> (See also Cimoli and Correa 2002).

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<sup>4</sup> For specific case studies, see Tiits et al. 2002; King 2002.

<sup>5</sup> The development of NIS will not be followed below. It can be argued that most countries in the region are experiencing a rather severe but also novel form of vicious circle of development. The main characteristics of this development, emerging at first almost overnight and then re-enforcing itself through 1990s, are: high inflation; strong fall in real wages and productivity; collapse of the productive sector, particularly industry and its capability to export, resulting in severe external constraints in the form of current account deficits and large illegal economic activity; overregulation of the private sector and largely over-bureaucratized state structures disabling cooperative policy actions rendering in turn governance structures disabled to deal with existing and emerging problems. These mechanisms are described in detail in Reinert (2004b).

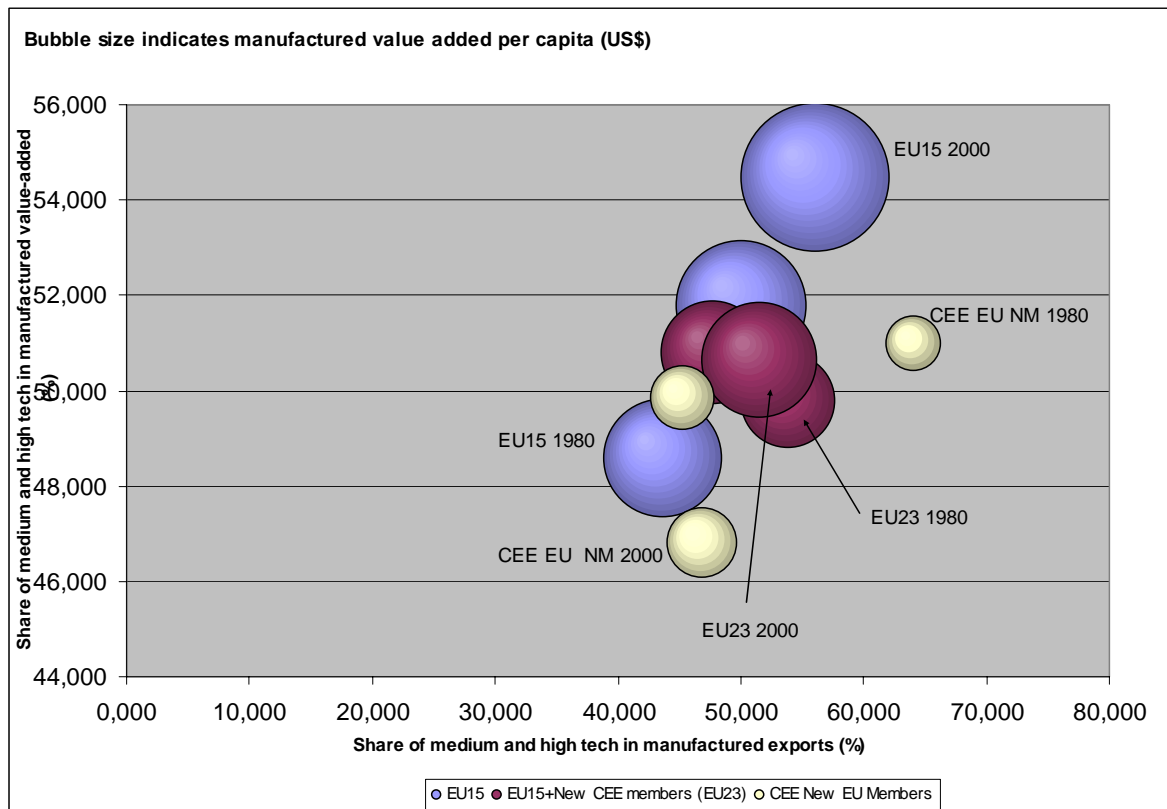
**Figure 4. Quality of Industrial Change in Selected World Regions, 1980-2000.<sup>6</sup>**

Source: UNIDO 2004; calculations by the authors.

In comparison to the EU15, however, the CEE new member states still score lower in terms of the quality of the industrial structure in 2000 than EU15 did in 1980. (Figure 5) CEE new member states are slightly more competitive in 2000 than EU15 was in 1980, yet the per capita value added is significantly lower, indicating huge wealth and productivity gaps. Adding up the EU15 with the new member states, the quality of the industrial structure of this new EU23 is catapulted back to a level below the one in 1990. In terms of manufactured value added per capita, the EU23 is catapulted back to the 1980 level. The wealth produced in industry in EU23 in 2000 per capita is similar to that of EU15 in 1980. The fact that the 1990s brought rapid de-industrialisation to the CEE instead of industrial upgrading – the lack of a Listian strategy as in Europe in the 1950s and 1960s – is the explanation for this development

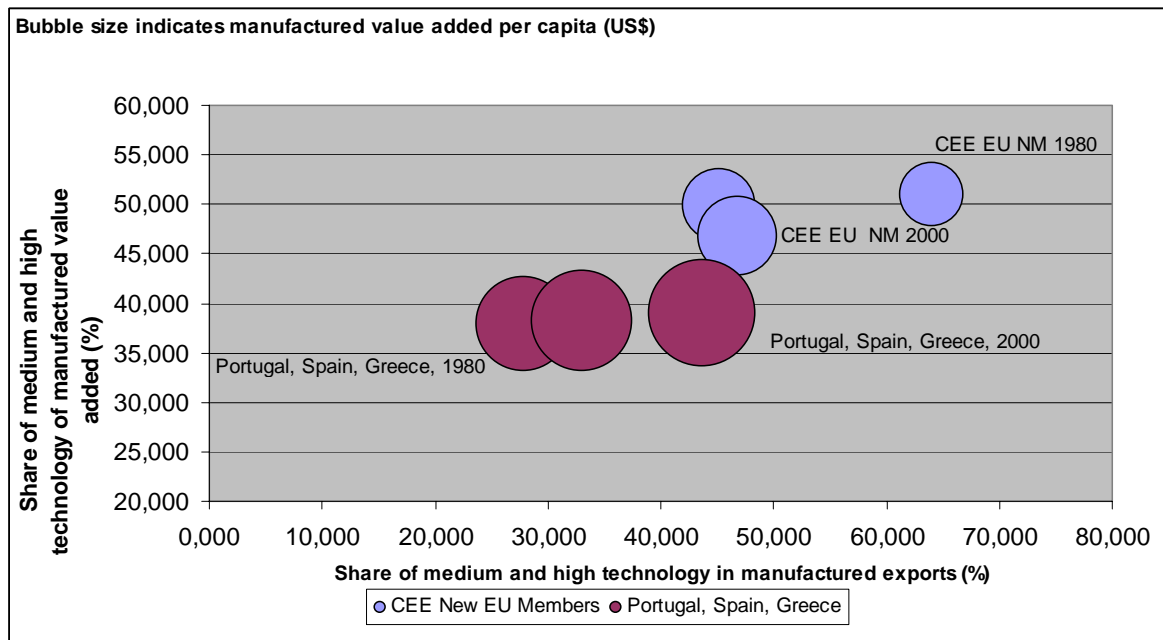
<sup>6</sup> Data from the following countries were used in the figures. **Latin America:** Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Haiti, Honduras, Mexico, Paraguay, Peru, Uruguay, Venezuela. **EU15:** Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom. **CEE New Members EU:** Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia. **Earlier EU enlargement:** Portugal, Spain, Greece. **Other/Rest CEE:** Belarus, Bulgaria, Moldova, Romania, Ukraine. **Central Asia:** Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Mongolia, Tajikistan, Turkmenistan. **East Asia:** Korea, Malaysia, Singapore, Thailand. In all cases averages are calculated.

Figure 5. The EU Enlargement and Quality of Industrial Change, 1980-2000.



Source: UNIDO 2004; calculations by the authors.

Comparing the integration of the CEE countries with the earlier enlargement of EU – Portugal, Spain and Greece – countries with significantly lower income, skill, and technology levels than the rest, interesting patterns emerge. By 2001 all of these countries are closing in on each other in terms of competitiveness and quality of industrial structure, but significantly differing in wealth and productivity. (Figure 6) In terms of industrial development the new member states are competing with older enlargement countries.

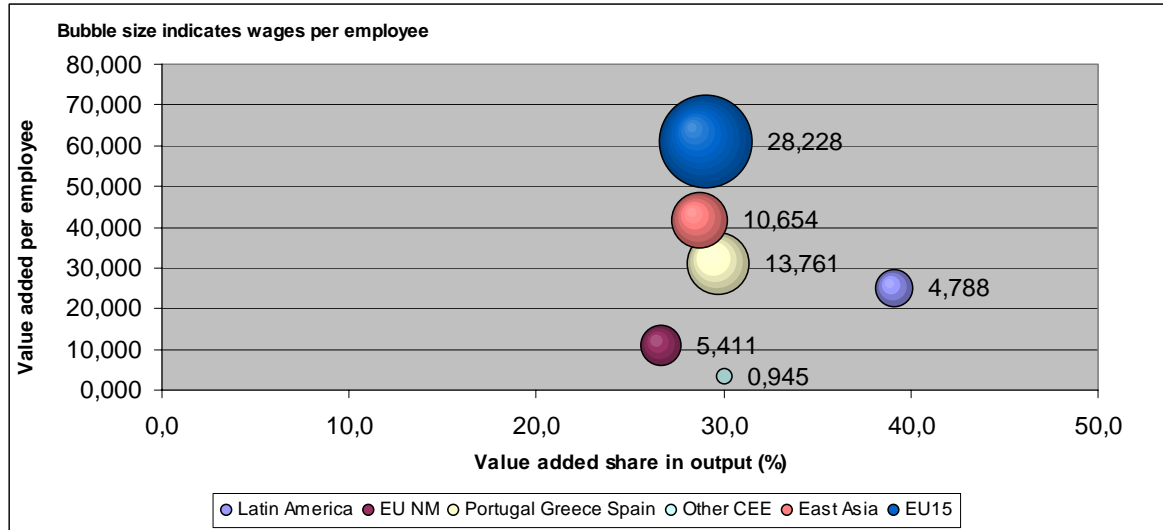
**Figure 6. Earlier EU Enlargement and Quality of Industrial Change, 1980-2000.**

Source: UNIDO 2004; calculations by the authors.

The quality of industrial change in the CEE countries indicates that the incentives created by the transition architecture for the private sector have not changed significantly over time, nor have these incentives increased productivity of labour and consequently more income has not been generated. In other words, the high human costs of transition have hardly been justified, and the policies initiated and the socio-economic frameworks created in the 1990s have failed to deliver. These developments deteriorate the EU23 competitiveness and quality of industrial structure as compared to the East Asian economies and the rest of the world. Portuguese integration into the CEE served as a pool of relatively cheap labour creating a flying geese win-win integration. Spain's integration was qualitatively different, but in both these cases the slow reduction of tariffs made it possible for Spanish and Portuguese industries to upgrade. This potential has been wasted in the case of the CEE countries. A logical consequence of this is a growing competition of wages and productivity between the EU and other world regions. (Figure 7).

In terms of value added share in output most world regions depicted in Figure 8 are relatively close. It does not make a huge difference where a company is set up. However, in terms of labour productivity and wages this choice makes a huge difference. As in terms of quality of industrial change, we can also observe here that East Asian economies outperform Portugal, Spain and Greece. Latin America is in turn outperforming CEE new member states.

**Figure 7. Wage and Productivity Competition in Selected World Regions, 2001 (or latest), in US\$.**<sup>7</sup>

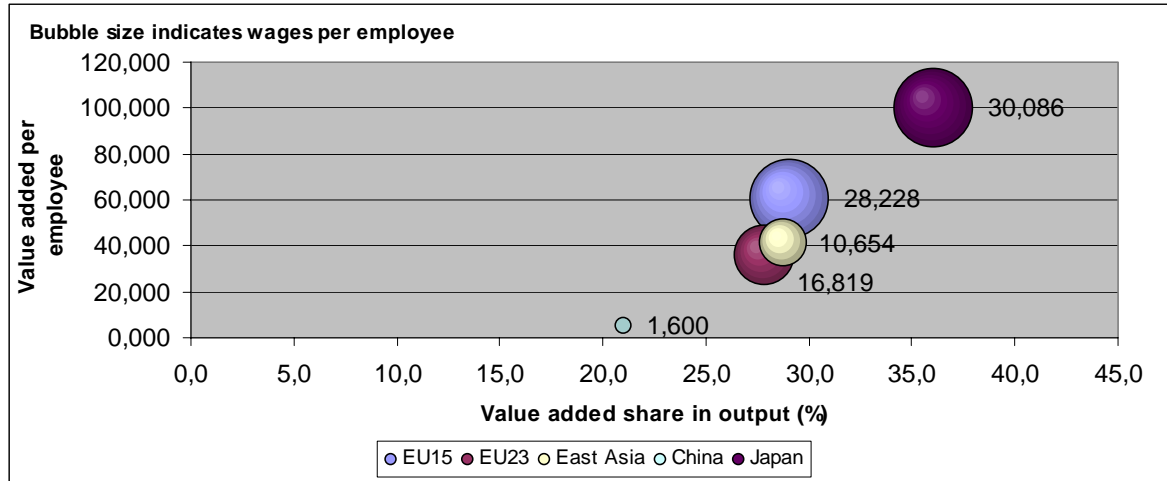


Source: UNIDO Country Statistics database; Götzfried 2001; Eurostat 2004; Mittag 2001; calculations by the authors.

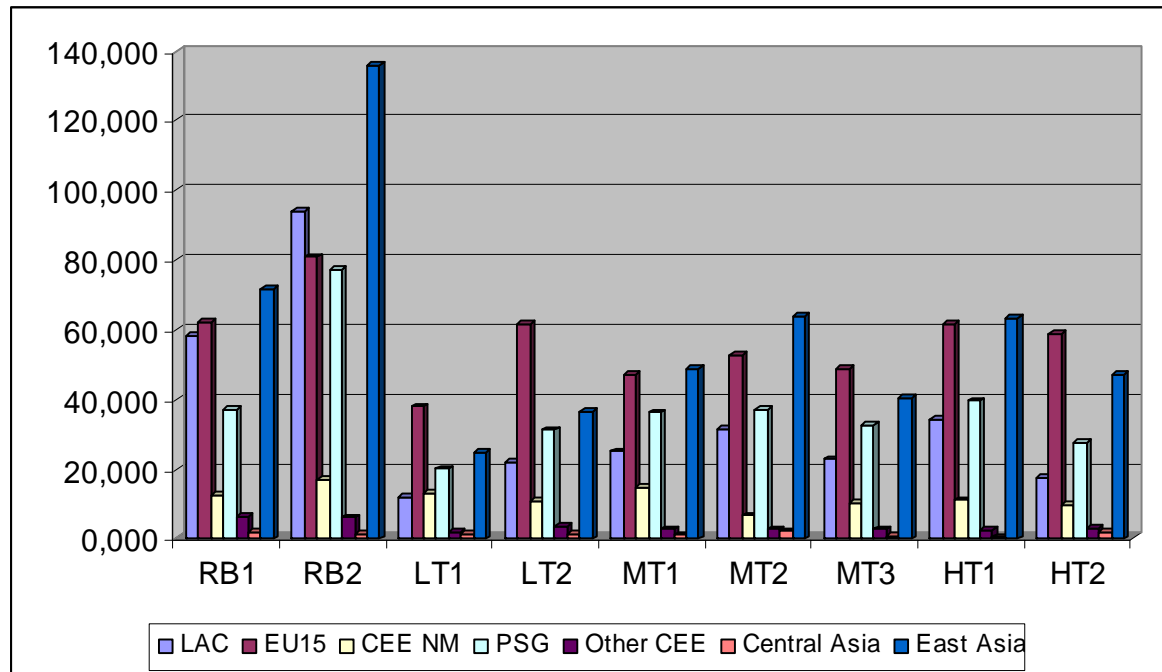
If we calculate again the figures for EU23, the East Asian economies outperform EU23 in terms of productivity, yet offer lower wages. (Figure 8) Thus, as a region EU23 is relatively similar to East Asian economies in terms of international competitiveness and quality of industrial structure, yet worse in terms of productivity, accompanied by higher wages in EU23. In other words, it would seem that, as an economic region, EU23 faces fierce competition from East Asia and strong pressures to lower salaries and or to raise productivity, or alternatively to raise unemployment.

<sup>7</sup> In Figures 7,8 and 10 data is calculated from the same countries as in Figures 4-6. In all cases averages are calculated.

**Figure 8. Wage and Productivity Competition Between the EU and Asia, 2001 (or latest), in US\$.**



Source: UNIDO Country Statistics database; Götzfried 2001; Eurostat 2004; Mittag 2001; *China Statistical Yearbook 1999*; calculations by the authors.

**Figure 9. Average Value Added per Employee 1997-2001, in US\$.**<sup>8</sup>

Source: UNIDO Country Statistics Databases, Lall (2000).

In terms of labour productivity, the East Asian economies are performing at the level of EU15 in all industrial sectors, and in cases of RB2, MT2 and HT1 actually better than EU15. (Figure 9) New CEE member states are in most cases competing with Latin American economies in terms of labour productivity. Portugal, Spain and Greece are outperforming CEE countries in all sectors, and Latin America in most sectors. Other CEE and NIS countries have extremely low productivity in all sectors. Portugal, Spain and Greece show strong performance in resource-based production as well as in LT1 and MT1. These countries show significant differences to EU15 and East Asia only in high technology sectors. Yet, the fact that Portugal, Spain and Greece show relatively strong productivity in lower technology sectors shows that their integration into EU has been rather successful and that without current enlargement the convergence between older EU and Portugal, Spain and Greece in terms of productivity and living standards would have certainly been rather swift and successful.

The quest for higher productivity is, however, complicated by inner EU wage and productivity competition. (Figure 10) If output in most European countries is similar in terms of proportion of value added, then the differences in terms of wages and productivity appear huge. With the common market, an entrepreneur or a company in the

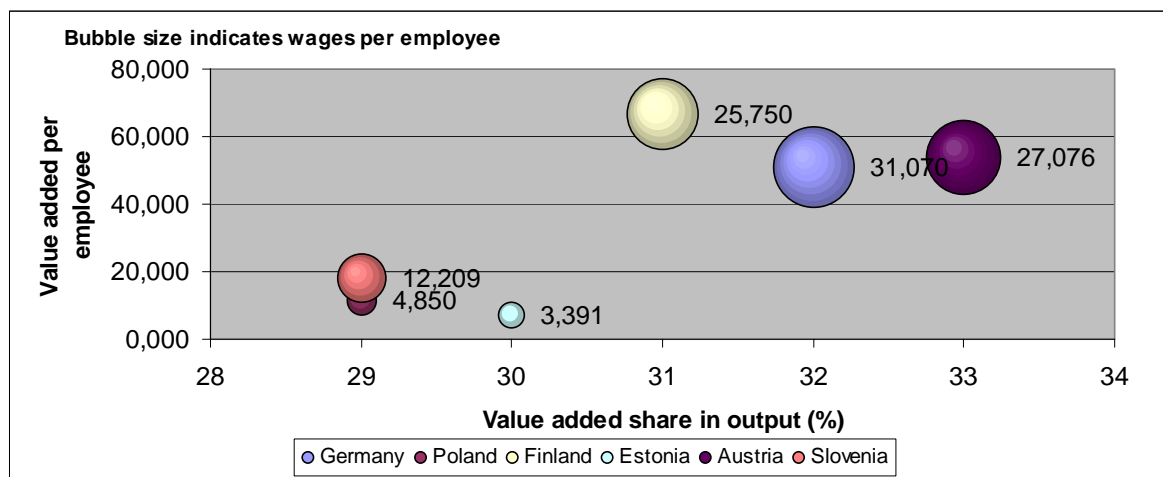
<sup>8</sup> The taxonomy follows Lall 2000. RB1 means agro based production, RB 2 other resource based production; LT1 (low-tech 1) indicates textile, garment and footwear production, LT2 is other low-tech; MT1 is automotive production, MT2 process technology and MT3 engineering; HT1 means electrical and electronics production and HT2 other technology. LAC signifies Latin America; CEE NM new members of the EU from CEE.

old EU member states seems to face two choices in the face of Asian competition: to lower wages in the home country or move production into CEE or other parts of the world. (See further UNCTAD 2003). The third possibility, radical product or process innovations, is in many cases just not there. From the CEE perspective, however, this needs to be supplemented by development in the quality and competitiveness of the industrial structure if the newly 'imported' industries are here to stay. Yet, as we have seen above, the lack of industrial upgrading under the transition did not create conditions favourable to this development.

The size of this problem becomes apparent when we look at the share of CEE countries in world manufacturing: This share plummeted from 19,3% in 1980 to 2,7% in 2001 (including the non-EU members from CEE and NIS (UNCTAD 2004:89)) Thus, in the CEE we can see a rapid increase in foreign direct investments in the automotive industry (UNCTAD 2003: 60-61) and simultaneously a *relocation in electronics* out of the CEE (particularly from Hungary, UNCTAD 2003: 62; on China in this context, see Boston Consulting Group 2003). Both IBM and Philips decided to move their production from Hungary to China in 2002. (Horvath 2002 and Horvath 2003). This indicates a loss of high-tech industry (electronics) and a specialization in a mature industry (automotive).

Thus, there are hardly any pressures in CEE countries that would significantly push the wages higher, but there also appear to be hardly any pressures for EU15 wages to stay high in the new EU.

**Figure 10. Wage and Productivity Competition in Europe, 2001 (or latest), in US\$.**



Source: UNIDO Country Statistics database; Götzfried 2001; Eurostat 2004; Mittag 2001, calculations by the authors.

### 3.3 International Trends and Regional Diversity add to the Problems.

The present globalization is taking place against a fairly dramatic backdrop that is rarely discussed. Wages as a percentage of Gross National Product have been falling in the Western World (see Figure 11 below). This is all the more surprising because the share of



wages in GDP – roughly the division of the fruits of productivity increases between capital and labour – had so far been surprisingly stable through the turbulent 20<sup>th</sup> century (Krelle 1962). During the 1930s in the United States, the percentage of GDP going to labour even increased, meaning that capital income decreased more than labour income during the crisis. The dramatic losers in the 1930s, however, were the farmers who had no market power or union to protect them.

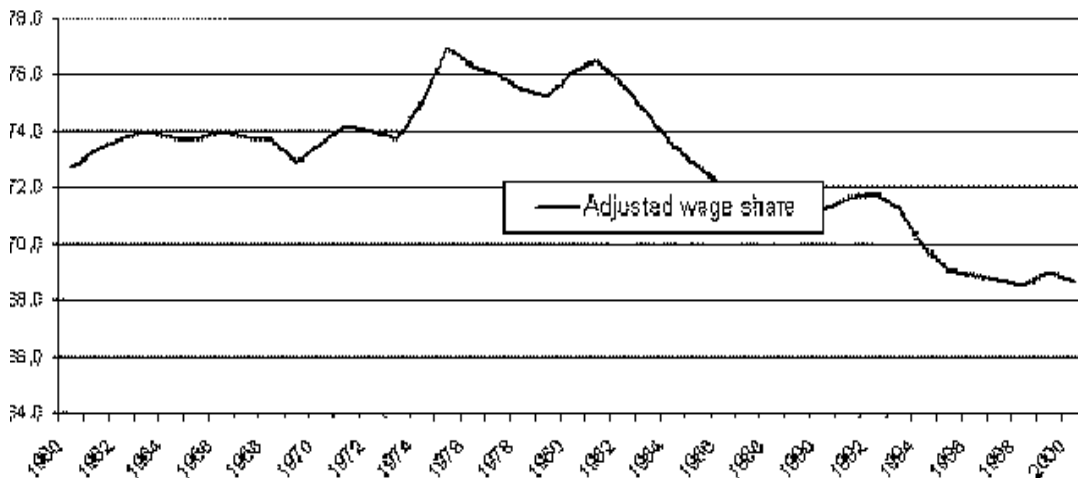
**Table 1. Adjusted Wage Shares of GDP in the European Union, 1961-2000.**<sup>9</sup>

	1960	1961-70	1971-80	1981-90	1991-2000
Austria	76.4	76.7	78.8	80.0	76.4
Belgium	69.9	70.4	75.8	74.3	72.2
Denmark	71.3	75.2	77.7	70.3	68.3
Finland	73.7	73.1	72.5	71.9	66.5
France	75.2	75.3	76.6	75.4	69.3
Germany*	70.6	71.6	73.7	70.9	67.9
Greece	-	86.1	70.7	74.0	67.2
Ireland	79.4	79.3	77.3	72.5	63.7
Italy	77.2	75.5	76.7	74.3	70.5
Luxembourg	56.3	57.7	65.5	66.5	64.5
Netherlands	63.4	69.4	74.8	68.1	65.9
Portugal	68.5	67.8	81.2	74.0	73.1
Spain	74.4	77.3	79.1	73.0	68.8
Sweden	69.4	72.3	74.1	70.5	68.9
UK	71.3	72.6	73.2	72.7	73.6
European Union	72.7	73.6	75.3	73.0	69.7

Source: European Industrial Relations Observatory On-line, <http://www.eiro.eurofound.eu.int/2000/07/study/tn0007402s.html>, based on European Commission 1999.

Table 1 and Figure 11 show how wages as a percentage of GDP have been declining in Europe since the very early 1980s. The trend is the same in the United States, but starting from a lower level. This is another aspect of *latinamericanization*. In 1990, the year the Peruvian Statistics office stopped collecting this data, the share of wages + income of independent workers reached 23 % of Peruvian GDP.

<sup>9</sup> Adjusted wage share = percentage of GDP at factor costs; \* 1961-91 West Germany.

**Figure 11. Adjusted Wage Share in the European Union 1960-2000.**

Source: European Industrial Relations Observatory On-line, <http://www.eiro.eurofound.eu.int/2000/07/study/tn0007402s.html>, based on European Commission 1999.

Clearly globalization as a form of asymmetrical economic integration is playing a crucial role here, and not only for the developing countries. On November 15, 2003, *New York Times*' editorial warned of the Wall-Martization of the US, a continuing drop in real wages that has already been going on for a long time.<sup>10</sup> Two weeks later, *Business Week* followed with the article "Waking up from the American Dream".<sup>11</sup> The essential message of these high profile warning signals is that the challenge of mobility of industries and services posed by economic globalization is threatening to create low-wage peripheries in the US. It took a few months for Europe to follow: on March 25, 2004, Germany's most influential weekly *Der Spiegel* ran a story predicting the loss of 250,000 jobs in German electronics industry in the near future.<sup>12</sup> This was the first public expression of what is still an ongoing debate in Germany about the lowering of wages.

Simultaneously with globalization we observe the decomposition of what used to be nation-based 'industrial sectors' into globally dispersed value-chains in a manner where geographic location and proximity are losing their importance. (See also Boston Consulting Group 2004; Ernst 1997) This means that high technology sectors of developing countries might become part of larger international value-chains, leaving little reasons for increasing division of labour or clustering in the home (developing) country. (Castaldi et al. 2004. For an Estonian case study, see Kalvet 2004) It also means that economic sectors are becoming increasingly different in nature, which makes the traditional liberal policy of treating all sectors the same way impossible. This

<sup>10</sup> [http://www.labourrights.org/press/walmart\\_editorial\\_112503.htm](http://www.labourrights.org/press/walmart_editorial_112503.htm).

<sup>11</sup> [http://www.businessweek.com/@A50u5oUQ9Q4xyREA/magazine/content/03\\_48/b3860067\\_mz021.htm](http://www.businessweek.com/@A50u5oUQ9Q4xyREA/magazine/content/03_48/b3860067_mz021.htm).

<sup>12</sup> <http://www.spiegel.de/wirtschaft/0,1518,292371,00.html>.

development opens up for some nations specializing in unskilled and routine (maquila) activities, while others specialize in the innovation-intensive and high-wage areas (the main theme in Reinert 2004a). Such a development will inevitably continue to increase international wage gaps, as some nations specialize in uneducated low-skill labour performing routine operations, while other nations continuously innovate and enjoy innovation rents. This represents a huge challenge for public sector policies: 'the performing state must serve the people, even if doing so requires that it serve them differently'. (Schick 2003:72).

The problem of extending the European welfare state to new member states in this situation is best shown by the East German developments. In an ideal world, East Germany could very well serve as the best of all possible forms of globalizations: trade liberalization with social welfare programs at the Western-European level. However, German reunification is turning into an economic nightmare creating such claims as 'economically West Germany has become a colony of the East' (Steingart 2004: 8) because the net flow of funds is going that way. Real wages in Germany peaked as a percentage of GDP already in the 1980s and in real terms in 1990 (Steingart 2004: 48). Also here, the integration did not follow the path of gradual upgrading of East German industry but rather that of swift exchange of production facilities by West German companies in order to capture the market as well as relatively cheaper yet skilled labour.

It is calculated that the costs of the reunification add up to 1, 25 trillion Euro. One should have thought that the high cost of the German unification, with minimal industrial upgrading of the East, would have prevented copying this experiment on an even larger scale with the EU23. If the EU enlargement were to follow the pattern of integration set by German reunification, the costs would be prohibitive. Like most CEE countries, East Germany has experienced highly uneven development with large cities, particularly capitals, growing rapidly, with rural areas constantly falling further behind (See Table 2 below). The risk Europe faces is that there will not be enough new activities to absorb the huge level of rural unemployment in the CEE countries. The modernization of the agricultural sector makes it unlikely that this sector will be able to produce more employment.

**Table 2. Regional Development in Selected CEE Countries, 2001.**<sup>13</sup>

	GDP pc 2001, EU 25 = 100	Youth unemploy. 2001	Long-term unemploy., 2001
Czech R.	66,5	16,3	51,5
<i>Prag</i>	148,6	9,2	34,6
Hungary	56,4	10,5	44,8
<i>Budapest</i>	89,2	8,6	50,3
Poland	45,3	41,5	50,1
<i>Warsaw</i>	70,6	32,4	53,1
Slovak R.	49	38,9	58,3
<i>Bratislava</i>	111,7	19,9	39,9

Source: Eurostat 2003; Krueger 2004.

The direction of FDI between urban and rural areas shows a very similar pattern. (European Commission 2004). Regional differences in economic performance in the EU are not present only in the new member states (European Commission 2004). This is a historical pattern everywhere, and recent research in the United States shows the income gaps between urban and rural areas increasing also there (Porter 2004). Successful studies of the moving forces behind the urban/rural income gap go all the way back to Serra (1613), and is the main reason behind agriculture support and protection as practiced in all wealthy nations. Yet, in the new member states these developments have surfaced only recently, as opposed to the older member states where these problems last time were acute in the 1930s.

One of the outstanding characteristics of Soviet-style industrialization was the creation of so-called monostructural cities or entire regions that depended on one industry or sometimes even on one single factory. What in the West would be an industrial cluster was in the East often one single firm in one single location. As there was no market for suppliers, these monostructural regions did not develop any high degrees of specialization. The organization of supplies was left to the planning agencies. With the opening of markets most of these companies faced fierce competition, and at the same time they lacked the means and experience to launch efficient restructuring. Most of them probably went bankrupt before they even had a chance to put a costing system into place. In a matter of few years many of these monostructural regions or cities saw massive unemployment and migration, with whole cities developing into ghost towns with depopulated buildings and blocks. Similar developments took place in almost all agricultural centers that used multi-storey buildings to house many people in a relatively small area. These used to have a living standard comparable to that in the cities. With the collapse of large-scale agriculture, these centres have been depopulated, and the rural standard of living has deteriorated dramatically.

<sup>13</sup> Data for Budapest is for the region of Közép-Magyarország; Warsaw for the region of Mazowieckie. Youth unemployment is unemployment in age group 15-24; Long term unemployment is defined as lasting more than one year.

A brief picture of regional disparities: Today, in Siimusti in central Estonia one can buy a fully functional 60 m<sup>2</sup> apartment, for ca 250 US dollars. For the same sum one can *rent* a similar apartment for a month in a modest district of Tallinn, the capital of Estonia. In the same modest district of Tallinn, this apartment would cost about 50 000 US dollars. In the downtown area the price would be doubled. The average wage in Estonia was around 600 US dollars per month in the second quarter of 2004. However, in Chisinau, the capital of Moldova, 250 US dollar would pay the rent of a very nice apartment for an entire year. In 1989, Moldova and Estonia had relatively similar standards of living. The periphery of the periphery is the economically hardest hit.

Also European R&D efforts are highly concentrated. Of the top 15 R&D intensity regions, nine are in Germany, two each in Sweden and Finland. (Frank 2004a; on patenting, see Frank 2004b) The EU enlargement compounds the already existing inequality in knowledge production. The difference between old and new member states is almost absolute. For example: per million inhabitants the Czech Republic and Estonia claimed only one patent application for high technology at the European Patent Office in the period 1996-2001; Poland none. On the other hand, Germany has 49 such patent applications per million inhabitants, UK 36 and Sweden 101. (Götzfried 2004:6)

In addition, the change of techno-economic paradigms in the 1980s and 1990s – from Fordist mass-production into one based on ICT – has certainly played a crucial role in the development dynamics of CEE as well as in European integration. The Soviet style economy could cope relatively well with the mass-production paradigm, yet almost by definition networking via backward and forward feedbacks could not develop. This was done centrally. However, networks are perhaps one of the key characteristics of the ICT-led paradigm. (Perez 2002 & 2004) Thus, the entire economic culture and structure of the CEE countries was alien to the new paradigm.<sup>14</sup> (Freeman 1998; on European welfare state in this context, see Esping-Andersen 2002)

In addition, the EU enlargement falls into the middle period of the techno-economic paradigm, typically characterized by financial crisis and socio-economic and institutional adaptation to the new paradigm. (Perez 2002, 2004) We are at a stage of the techno-economic paradigm where the harvest of the new technologies ‘is gathered under recessive symptoms and with more anxiety than rejoicing’ (Schumpeter 1939, Vol. 1: 139). Similar wage pressures could be observed in the 1930s where only strong unions kept the industrial sector from the total collapse in real income which happened in the agricultural sector (US rural wages fell 70 per cent in purchasing power during the early 1930s). Such processes feed back into the economy as falling demand, and possibly into a new depression, which – just as the Asian Crisis – cannot happen in neo-classical theory, but may well happen in practice. Thus the EU needs to go through a double institutional change: adapting to an enlarged Europe as well as to a new techno-economic paradigm, both under increased wage-pressure from other continents.

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<sup>14</sup> Also, it could be argued that military industry played a crucial part in CEE industrial development prior to 1989.

Capitalism's most tumultuous periods are characterised by widening gaps between rich and poor. Historically any improvement of this trend – a change in the Kuznets Curve towards a better income distribution – is invariably a result of political decisions, not of market forces (Freeman 2004, Perez 2004). The long way towards the European welfare state started with a description of a situation similar to that of Europe today, by Gustav Schmoller during the very first meeting of the Verein für Sozialpolitik, an organisation that during next sixty years was to build the institutional design of generalised European welfare:

We believe the healthiest and most normal society can be expressed by a ladder containing rungs between different existences, depicting easy access from one step to another. Today's society threatens more and more to look like a ladder which grows fast at the top and at the bottom, but where the middle steps increasingly fall out, and where there is solid hold only at the very top and at the very bottom' (Verein für Sozialpolitik 1873:5).

#### 4. Conclusion

It can be argued that the European Union enlargement project is laudably idealistic. Whereas the US does not absorb any of the social costs in the Mexican deindustrialization of traditional industry and allows little (legal) immigration, the European integrative model has the disadvantage of possibly accruing very high costs on several counts. The large internal wage differentials are likely to create strong downward pressures on the wage level in the core countries, where the conflicts during the summer of 2004 may have been just preliminary skirmishes for a much larger battle to follow. Just as the free float of alcohol from new member countries has caused a collapse of alcohol prices in a country like Sweden, a large scale free float of labour may very well have a similar effect on labour prices (but some measures have been taken). At the same time the rapid integration into the world economy during the 1990s had already devastated the industrial structures in the new member states, so there is little to build on except moving already existing jobs and purchasing power eastwards in a lose-win, rather than a win-win flying geese type of integration.

An example of the slow advancement of free trade in the post World War II is that for a very long time outright import prohibitions existed. All import of garments into Norway was totally prohibited until 1956, and a shortage of foreign exchange made import licenses for cars last until 1960. Safeguards for the balance of payment also included frequent use of clearing arrangements: i.e. barter agreements that secured a balance on the external account.

The EU enlargement has brought the new EU into a situation where it is difficult to see reasons that would stop pressures towards lower wages, cuts in social benefits etc. An idealistic integration – which at a lower pace of integration could have had 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 in labour intensive products and

crops as the US does from Mexico, but on the cost side it may accrue heavy social expenses associated with integrating with the poor periphery. As with the integration of DDR, a first beneficial ‘pipe line effect’ will boost sales from the ‘old’ core, but this benefit is truly transitory.

Turning to the 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 growth 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 accessed, this country 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 deindustrialised. All in all, the integration of the large Spanish economy carries all the elements of a carefully planned Listian integration. There is, we argue, **a qualitative quantum leap towards the worse** in the philosophy behind European integration between the careful economic integration of Spain, Portugal and Greece on the one hand, and the May 1, 2004 integration on the other. The first was Listian, the second was much more ideological, a product of economists and politicians who had come to believe in the crude propaganda version of economics, and therefore now threaten European wealth and welfare.

The destructive destruction of the East European industrial structure that took place during the ten years leading up to May 1, 2004, now prevents the very important **flying geese** and technology upgrading aspects of integration to take place as they did on the Iberian Peninsula and even in Greece. In most CEE countries there is too little industry left to upgrade. There are even clear elements of **welfare colonialism** in today’s European integration, particularly in the former DDR. The classical colonial drain has been reversed, and now flows from the core country to the colony, while the productive structure of the colony has been greatly reduced and replaced by welfare payments. This is essentially the argument made by Gabor Steingart in his recent book: ‘economically West Germany has become a colony of the East’ (Steingart 2004: 8). This form of integration carries costs that in the long run are prohibitive.

We would argue that the present problem is that the ruling economic ideology has unlearned the logic and wisdom of Listian integration. Economic activities moving because wages are too high is a completely normal, and even necessary, process in the history of capitalism, and is an integral part of capitalist dynamics. Too high wages in London was the reason why English textile industry moved out of that city many



centuries ago. The variables that cause these moves to be problematic and damaging or not to the creation and even maintenance of real wealth are the following:

1. **The degree of dynamics** in the wealthy core, relative to the other world players (US, China, East Asia). Here Europe scores relatively low, in spite of considerable efforts,
2. **The timing of this event in the techno-economic paradigm.** With the Fordist mass production wave near its crest during the 1950s and 1960s, a radical integration would have been easier almost anywhere than now, in the post-financial crisis, deflationary period of the paradigm, resembling in so many ways the 1930s, including politically (Perez 2002, 2004). That financial capitalism, rather than production capitalism, is in charge during such periods further aggravates the problem (Veblen 1899, Hilferding 1912) carrying the focus of the economics profession away from studying production to studying finance.
3. **The size of the poor/unemployed/underemployed population** to be integrated compared to the population of the core countries. Here integrating Portugal and Spain was relatively easy, but again Europe now faces a problem (see table 2).
4. **The ability of the industrial structure in the poor countries to upgrade.** Compared both to the post-WW II situation and to the integration of Spain, Portugal and Greece, the situation in the CEE is very problematic. Instead of the slow reduction of tariffs that made the upgrading of Spanish, Portuguese and even Greek industries survive and upgrade, the CEE countries – with the exception of Hungary – had to varying degrees been subject to de-industrializing Morgenthau Plans that had also created havoc in the agricultural sector.
5. **The wage dynamics of the rest of the world.** Here the dynamics are generally strongly in disfavour of European wages. The United States is an innovation powerhouse with creeping Wall-Martization of the labour market, increasing illegal immigration, and falling real wages for last two decades. China is rapidly catching up technologically with minimal increases in real wages, and a virtually unlimited supply of labour from the interior at very low prices. The weakness of labour unions in both these countries will – combined with the other factors on this list – automatically lead to wage pressures in Europe. The efforts needed, and the bottlenecks that will appear, in order to upgrade the Chinese workforce fast enough will be a factor working in the other direction, in favour of a better European wage level.

As Paul Krugman says, there are periods when old economic wisdom is unlearned and has to be rediscovered (Krugman 1996). Or as John Stuart Mill says it, much stronger, ‘It often happens that the universal beliefs of one age of mankind – **a belief from which no one was, nor without an extraordinary effort of genius and courage could at the time be free** – becomes to a subsequent age so palpable an absurdity, that the only difficulty then is to imagine how such a thing can ever have appeared credible...It looks like one of the crude fancies of childhood, instantly corrected by a word from any grown person.’ (Mill 1848/1929: 3, emphasis added).

Going back to Hyman Minsky, with whom we started the paper, we just **may** be in a similar situation as regards European wages as Minsky argued regarding financial crises: things happen that theoretically cannot happen, just like a financial crisis. If the world

should move towards factor prize equalization under global free trade and relative upskilling of huge numbers of poor (China, India), the huge majority of unemployed, underemployed and poor in the world make it much more likely that equalization will be downwards rather than upwards. For slightly different reasons there was a tremendous pressure in this direction during the 1930s, and the industrial sector wages were only saved by having very strong labour unions as a defense line. If this argument has just a slight validity, we had better turn to a better understanding of Friedrich List.

Now this labour union defence line is seriously weakened, and Europe may be closer than is comfortable to where the agricultural sector was in the 1930s, when the US agricultural sector experienced a 70 per cent fall in income compared to the industrial sector. This catastrophe led to the agricultural policy we still have remnants of today: monopolies to the farmers (US almonds and raisins are still today legal monopolies) and price controls. Farm subsidies have now turned agriculture into an increasing returns activity both in Europe and the US<sup>15</sup>, but we otherwise seem, to a large extent, to have forgotten why we have the agricultural policy we have. The Common Agricultural Policy seems to hang in there by inertia and lobby pressures rather than based on any theoretical or historical understanding.

Friedrich List had a very good reason for arguing for economic integration only when an industrial and increasing return sector had been established in each country. The alternatives are either extremely expensive or cause poverty, or both. Industrialization, particularly after the 1848 revolutions, combined enormous productivity increases combined with extremely strong political pressure for increasing wages. This led to what French Regulation School economists refer to as a Fordist wage regime: industrial workers increased their wages roughly at the pace of the productivity improvements in all industrialized countries. For this reason, the huge productivity improvements after World War II did not lead to deflation, and for this same reason the industrialized countries' Terms of Trade with the non-industrialized world did not move in the favour of those nations with fewer productivity improvements. The wealthy nations took their productivity improvements out in the forms of higher wages, not lower prices (Singer 1950). The countervailing forces of capital and labour were in balance, resulting in a situation where their respective shares in GDP were surprisingly stable through business cycles and the depression (Krelle 1962).

Figure 11 and Table 1 show how the economic power game gradually was lost by the unions. First this only meant that labour was losing its share in GDP without a loss in real income. The further effect is a fall in real wages. This process, which was slow and not clearly noticeable, now is potentially accelerating. Through feed-back through diminishing demand (and a lower and qualitatively different consumption pattern of the rich, whose incomes increase), the falling real wages are likely to start a downward spiral in spending/demand, which again – given Europe's external challenges which we have described – may be difficult to stop even by cutting wages. As England did after the first wave of globalization, the former world leader Europe may have to resort to protectionism again in order to save its welfare. *The Rise and Decline of the Free Trade*

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<sup>15</sup> We are indebted to Jan Kregel for this point.

*Movement* was the title of a 1905 book by famous Cambridge economist, William Cunningham. We may get back to a similar situation.

Competition between nations is at times similar to competition between airlines, it becomes a winner-takes it all market (Frank & Cook 1996), but with a difference. Instead of airlines going bankrupt we may have wages falling rapidly. European nations have spent a lot of money propping up their own 'inefficient' national airlines. They may face a similar choice as regards the wage level of their 'inefficient' European workers, compared to extremely efficient and very poor Chinese. The retreat from the first round of globalization, as described in Cunningham's 1905 book was a decision of this type. However, if our possible scenario as described here comes true, it will be a very hard fight, both due to an entrenched ideology and to a relatively recent power imbalance between capital and labour.

Economists have not properly understood that, due to the Fordist wage regime, what we used to call 'Economic Development' was, in effect, a high-tech and dynamic Schumpeterian oligopoly where the fruits of industrialism were shared by capital and labour. The developing countries, lacking this industrialist engine, were not able to catch up. As long as new nations were added to this oligopoly slowly, in a Listian fashion, and with controlled tariff reductions, this shared oligopoly worked very well. This system was not the result of market forces, but of wise political control, and the system functioned well until and including the enlargement of the EU with Spain and Portugal. If the shocks are too big, and the balance of power becomes imbalanced, it is our conviction that the system potentially may deteriorate into a 'race to the bottom' in terms of wages.

Krugman (1996) and Mill (1848), quoted above, argued that economics goes through periods of relative ignorance when previously accumulated knowledge is lost. In our opinion, following the market euphoria and triumphalism of the early 1990s, the West started believing in its own propaganda version of economics, that markets by themselves were creators of automatic harmony. This has previously proved extremely damaging in the periphery, where countries like Peru and Mongolia have experienced a 50 per cent fall in real wages (Reinert 2004a). Now this development is approaching Europe, strongly reinforced by some very unfortunate political decisions in the past. First de-industrializing a group of nations, later to fully integrate them economically, may with hindsight prove to be one of the situations of collective blindness that John Stuart Mill refers to. Such a strategy puts extremely high pressure both on the social fabric and on the resources of the system. Historically this is probably a unique event in this magnitude.

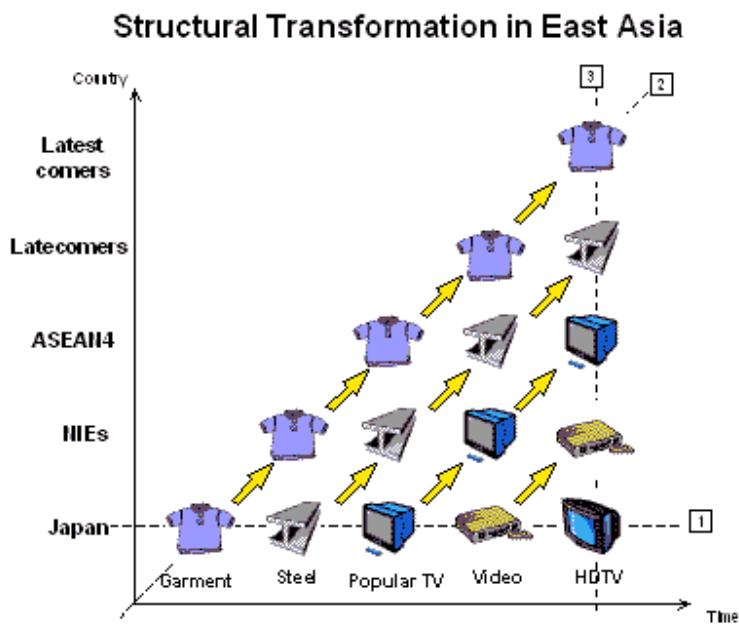
As already mentioned, the free flow of alcohol forces the wealthy European countries to cut their alcohol prices, and in terms of price pressure there is no difference between the effects on a free flow of alcohol and a free flow of labour. Unless something unlikely happens to improve the labour situation in many CEE countries, the West will have to limit labour migration and thus cause political turmoil in CEE countries. Given the international setting, it is simply very difficult to see Europe creating enough industrial dynamics to solve all these challenges without falling wages, spreading from one sector to the other, or without protection of some kind, as happened in the wake of the first

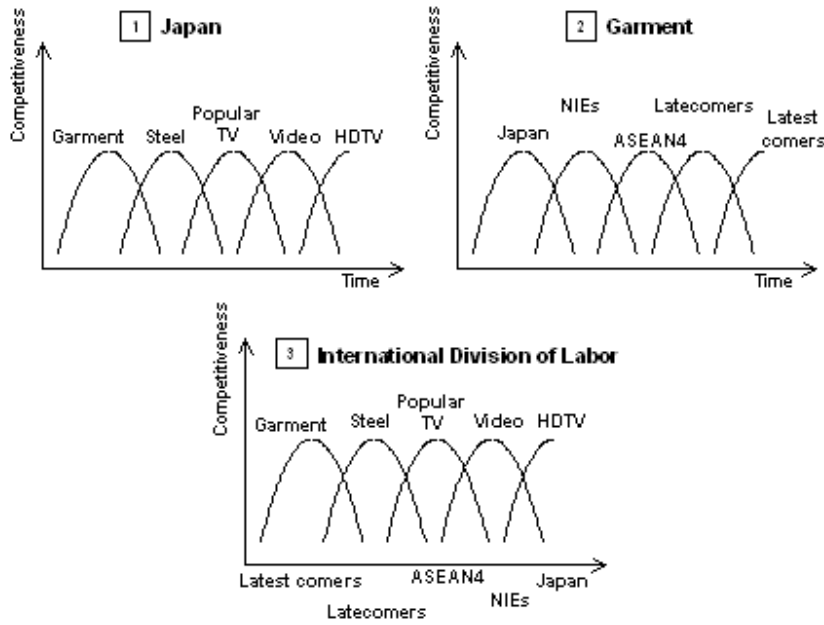
wave of globalization. There may be reasons why one need not be alarmist, but the arguments heard in favour of this tend, on both sides of the Atlantic, to be purely ideological, not to discuss the facts, and therefore not to be convincing on a logical level.

In our opinion these issues and mechanisms ought to be put higher up on the agenda. Are the huge pressures for lowering the real wages in Europe this summer a first skirmish in a long and inevitable battle or are they not? The timing in the technology cycles points to a 1930-scenario, where protection is not a beggar-thy-neighbour policy but simply a way to prevent a winner-takes-it all situation. To pick up the airlines industry metaphor again, this means making more than one airline survive, i.e. leaving more than the winner country or area with a decent wage level.

Cambridge economist H. S. Foxwell argued: 'Just as we may avoid widespread physical desolation by rightly turning a stream near its source, so a timely dialectic in the fundamental ideas of social philosophy may spare us untold social wreckage and suffering' (Foxwell 1899: xxi). Clearly the transition and later integration of the CEE countries were not done with these words in mind. We can still limit the damage in Europe by admitting that something went wrong. Hyman Minsky suggests that if something goes wrong and we have not sufficiently understood what is happening, we are just likely to find a scapegoat. Perhaps we can call it 'the Bin Laden Depression' in Europe. Says Minsky: 'A theory that denies that what is happening can happen, that sees unfavourable events as the work of outside forces (such as the oil crisis) rather than as the result of characteristics of the economic mechanism, may satisfy the politicians' need for a villain or scapegoat, but such a theory offers no useful guide to a solution of a problem.' (Minsky 1986).

## Appendix 1: The Flying Geese Pattern of Sequential Economic Development.





Source: GRIPS Development Forum, <http://www.grips.ac.jp/module/prsp/FGeese.htm>

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<sup>16</sup> Free trade at the time signified the absence of monopolies, not the absence of tariffs.

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