

# Mercantilism and Economic Development: Schumpeterian Dynamics, Institution Building, and International Benchmarking<sup>1</sup>

Mercantilismo e Desenvolvimento Econômico:  
Dinâmica Schumpeteriana, Construção Institucional  
e Benchmarking Internacional

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**Abstract** In most arts and sciences – from astronomy to zoology – the Renaissance represents a qualitative watershed in human history, and historians are generally united in considering it a period of unprecedented intellectual ferment. Echoes of da Vinci, Galileo, and Machiavelli still resound in the way we approach art, science, and human coexistence, and it is noticeable how these developments came ‘out of Italy’ (Braudel, 1991). As a precondition for this, the Renaissance was also a period when the productive powers of small European city states allowed a large part of the population to live free from poverty. Where feudalism had provided wealth for the very few and misery for most, the city states of the Renaissance for the first time witnessed a situation where artisans, merchants and public employees filled the ranks of a new middle class. **Keywords** Mercantilism, Economic Development, Renaissance, Schumpeterian Dynamics.

**Resumo** Na maioria das artes e ciências – da astronomia à zoologia – Renascimento representa um divisor de águas qualitativo na história humana, e historiadores estão geralmente coesos em

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considera-lo um período de fermento intelectual sem precedentes. Ecos de da Vinci, Galileu, e Maquiavel ainda ressoam na forma como abordamos arte, ciência, e coexistência humana, e é notável como estes desenvolvimentos alcançaram 'fora da Itália' (Braudel, 1991). Como uma pré-condição para isso, o Renascimento foi também um período no qual os poderes produtivos das pequenas cidades-estado européias permitiram uma grande parte da população viver livre de pobreza. Onde o feudalismo tinha fornecido riqueza para muito poucos e miséria para a maioria, cidades-estado da Renascença pela primeira vez assistiram uma situação onde artesãos, comerciantes e funcionários públicos encheram as fileiras de uma nova classe média. **Palavras-chave** Mercantilismo, Desenvolvimento Econômico, Renascimento, Dinâmica Schumpeteriana.

## The Debate on Mercantilism: A Brief Overview

In this picture, the economics profession stands out with a completely different view of the period. The fact that 300 years of economic theory and practice tend to be lumped together under the label of 'mercantilism', as if it were a homogeneous mass, alone points to a rather superficial treatment of a long period with much variety. The common view today is that mercantilism was 'an irrational social order' (Ekelund & Tollison 1981: 6), the basic feature of which was that economists collectively made the serious mistake of confusing gold with wealth. This practice is referred to as the 'Midas Fallacy' (*chrysohedonism*), after the mythological king whose touch converted everything to gold. Starting with Adam Smith, this Midas Fallacy has been the common interpretation of mercantilism, the one also found in today's histories of economic thought. The Midas Legend had, however, been known as a warning since Roman times, and the so-called mercantilists themselves used it to explicitly refute this view of wealth (Barbon 1696). Fairly recently, two American authors have offered what appears to be an alternative interpretation of mercantilism, that of a society seeking rents, presumed to be non-productive (Ekelund & Tollison 1981).

Both these standard interpretations, of mercantilism, and of pre-Smithian economics in general, present serious problems. How is it possible that human civilization as we know it, from the birth of modern cities to the Industrial Revolution, is recognized as the product of genius in all human endeavours but economics? A field whose practitioners supposedly 'did not rely on any "true" empirical knowledge of economic reality whatsoever' (Magnusson on Heckscher, in Magnusson 1994: 15), but were committed to hideous methodological errors, wrong

economic policies, and false goals? Mercantilism has, in a sense, been set up like an irrational ‘hell’, a strawman against which classical and neo-classical economic rationality increases its splendour. But, is it possible that the Industrial Revolution, which Adam Smith lived through without even noticing, came into being *in spite of* the stupid and irrational economic policies of the preceding period? Only in the bigoted historiographical tradition of ‘manifest destiny’, that the greatness of the United States is God-given regardless of policy, is it possible to ignore the fact that the American economy was built on key principles of mercantilism for well over 100 years, starting with Alexander Hamilton in 1791. The titles of the most influential US economics books at the time testify to their mercantilist origins (Carey 1822).

Or, do we dare think that the mercantilist policies actually carried out, to a large extent, were in fact wise policies, given the circumstances? In this article, we shall claim the latter is the case; indeed, we argue that the production-focused mercantilist policies have been a mandatory passage point for nations that have taken the step from poor to wealthy, from England starting in 1485 to South Korea in the 1980’s. This ‘mercantilist’ toolbox of the generic developmental state, the basic principles of which have changed very little over the years – gaining somewhat in sophistication over time, but keeping to the same basic doctrines – is reproduced in Appendix 1. We argue that this represents a collection of economic principles and policy tools typical of mercantilism across Europe, including its local variants—Cameratism in Germany and Colbertism in France.

One fundamental problem of interpreting mercantilism is that few historians of economic thought actually read the original texts. Magnusson (1994: 50), discussing the previously mentioned work of Ekelund and Tollison, argues ‘They also seem totally uninterested in what the mercantilist writers actually wrote’, a criticism that may be extended to many histories of economic thought. Furthermore, the analysis of mercantilism frequently suffers from what Perrotta (1993: 21) calls ‘percursorism’, that any idea – instead of being judged by its relevance in a given context – is either hailed as a surprising early anticipation of a healthy neo-classical economic principle, or as an example of hopelessly ill-conceived theories (Ashley 1920: II, 381).

Additionally, few studies of mercantilism cover more than one or two language areas. The truly pan-European distribution of common principles and policies, particularly in the period from 1650 to 1770, is therefore seldom noticed. The matter is further complicated by the fact that the long-recognized authority on the

mercantilist system, the Swede, Eli Heckscher (1931)<sup>2</sup>, made a rather static analysis of a tradition, for which he had little sympathy, and therefore depicted as primitive and pre-analytical. Likewise, the first compiler of Spanish mercantilist literature, Manuel Colmeiro, was a recent convert to economic liberalism, and was therefore also fundamentally opposed to the system he was attempting to describe. All in all, the modern history of mercantilism has largely been written as if Attila and his Huns had been put in charge of writing the history of the Roman Empire.

Our interpretation of mercantilism relies on the insights provided when the mercantilist texts themselves are studied in the historical context in which they were written. This interpretation coincides with recent views from the European periphery, by Cosimo Perrotta (1988, 1991, 1993) in Italy, Ernest Lluch (1973, 1997, 2000) and others in Spain, and Lars Magnusson (1991, 1994) in Sweden. This 'new' and context-specific interpretation largely corresponds to the view of mercantilism held by the German Historical School, in that most of them acknowledge the interdependency of mercantilism and state-building.<sup>3</sup>

We shall, however, grant some validity to the two other theories of mercantilism because – although both arrive at conclusions that, in our view, are fundamentally incorrect – they grab different tails of the problems that mercantilists attempted to address. This applies both to Smith's Midas Fallacy approach and to the Ekelund & Tollison rent-seeking approach. Indeed, the outflow of bullion in the form of gold and silver was an acute *symptom* of a set of economic problems that affected most nations, and, therefore, a matter contemporary writers had to attend to.<sup>4</sup> Early mercantilist policy advice falls into two broad categories: bullionism attempting to cure these symptoms in the financial sphere simply by manipulating financial variables, and mercantilism proper, which sought to identify and resolve the underlying causes of the problems in the sphere of production<sup>5</sup>. The most heated of all mercantilist debates were between these two types of theorists – 'monetarists' and 'productionists' – between de Santis and Serra in Naples (1610-1613) and between Misselden and Malynes in England (1622-1623).

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2 Also the father of the Heckscher-Ohlin trade theory.

3 Brentano (1827-1829), Eisenhart (1881), Laspeyres (1863/1961), Schmoller (1897/1967), (Sombart 1902/1928, 1913a, 1913b).

4 This would be similar to a balance-of-payment problem in Third World countries today, of what Celso Furtado once called 'the break-down of the capacity to import'.

5 Schumpeter's recognition of Antonio Serra's 1613 treatise is particularly clarifying on this point: 'the implication being that if the economic process as a whole functions properly, the monetary element will take care of itself and not require any specific therapy' (Schumpeter 1954:195)

By the late 1600's, however, the emphasis was clearly more on the 'real economy'. Recurrent financial bubbles nevertheless recreated relatively short-lived floods of books on speculation, as was case in the 1720's.

In this chapter, we focus on the 'productionists' who were everywhere the great majority; in fact, most mercantilists are extremely clear in their analysis that the key to wealth lies in the sphere of production, rather than finance.<sup>6</sup> In this sense, present-day economics suits the standard accusation made against mercantilism, due to its predominant focus on financial and monetary values, much better than does mercantilism itself. The recent handling of the economic crisis in Argentina, de-industrializing the nation and halving its wage bill in order to pursue an arbitrarily chosen monetary goal, is the kind of policy against which the majority of mercantilists would have protested vehemently.

One of the more curious aspects of capitalist economic theory is that it does not allow for other than a 'normal' profit, identifying 'perfect competition' or 'commodity competition' as both the normal state of affairs and the goal of the system. The 'normal' participant in the economy is the farmer who has no influence over price, and the success stories of history, from the steel magnates to Henry Ford and Bill Gates, are in this view abhorred as 'rent seekers', by definition, a negative concept. The Ekelund & Tollison view of mercantilism can only be understood from this neo-classical/neo-Austrian point of view, and in a sense, they do identify an important aspect of mercantilism: the 'perfect competition' of the farmers did not and still does not produce significant wealth. Even the most efficient farmers in the world today, those in the United States and in the European Community, need heavy subsidies in order to achieve a decent income. Pre-Smithian economics can only be understood as system-building, 'Schumpeterian', dynamic imperfect competition. Two of its most successful economic institutions, *patents* and *protection* (for industrialization, rather than for revenue) were both created during the late 1400's in order to achieve this dynamic imperfect competition through artificially creating time-limited market power. As any businessman today, the mercantilists understood that 'perfect competition' is a situation where serious wealth cannot be accumulated, and economic development cannot take place. A political community therefore had to stack the cards in its favor through policies.

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6 See Seligman (1920) and Reinert & Reinert (2004) for a discussion of these debates between the bullionists and 'the mercantilists of the real economy'

It has previously been argued (Reinert & Daastoele 2004) that dynamic rents spread in the economy at three levels: 1) to the entrepreneur in the form of profit, 2) to the employee in terms of employment, and 3) through the government in terms of increased taxes. Under conditions of rapid technological change – as with the ‘productivity explosions’ of new technologies (Perez 2004) – this ‘triple level rent-seeking’ represents a hugely positive-sum game in the producing country. We argue that a core objective of mercantilism was achieving this ‘triple-level rent-seeking’. Institutions like patents, protection and apprenticeship, created 300 years before Adam Smith, and scientific academies, created almost a century before his writings, would help increase the size of the economic pie, increasing profits, the wage bill, and the governments’ ability to tax.

## Changing Mentality and the Origins of Renaissance Wealth Creation

The very idea of economic development, however, was an early mercantilist innovation. When George Soros recently claimed that ‘globalization is not a zero sum game’ (Soros 2000), he unwittingly touched upon the very problem that faced economic thinkers as the idea of development emerged at the end of the Renaissance. For the longest time, the world was considered a finite place, locked in a cyclical system of cosmic equilibrium. This traditional zero-sum model of the universe was codified by Aristotle (politics 1328b, vii, ix, 3) and, channelled by the scholastics, came to dominate the European cosmology into the early modern period.<sup>7</sup> Sir Thomas Browne [1605-1682] encapsulated this view when he argued that ‘all cannot be happy at once for, because the glory of one state depends upon the ruins of another, there is a revolution and vicissitude of their greatness’ (Browne 1643: xvii), and the early ‘balance of trade’ argument was strongly related to this theory that ‘one man’s gain must be another man’s loss’ (St. Jerome in Finkelstein 2000: 89). Economic thought and, in many ways, economic development was thus shackled by fear of social instability. This, however, slowly eroded in the late Renaissance.

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7 See, for example, the important and influential works of Paracelsus (1951: 38-44) and Michel de Montaigne (1580/1958: 48).

Several factors combined to unlock this zero-sum worldview.<sup>8</sup> Many of the necessary elements can be traced far back in time, but only during the Renaissance did they achieve a critical mass sufficient to profoundly change society in the whole Italian peninsula, and later, the rest of Europe. First of all, the undeniable urban bias of wealth creation was, at the time, identified as the result of *synergic effects*, what Florentine chancellor Brunetto Latini (ca. 1210-1294) had called the ‘common good’. This *ben comune* that made some cities so wealthy (Machiavelli in Reinert & Daastøl 1997), sprang from an organic social harmony – seeing the body as the metaphor for society – which was also an inheritance from the scholastics.<sup>9</sup> This idea of a synergic *common good* forms the axis around which many mercantilists wrote. It must be emphasized that the important discovery of the role of the individual during the Renaissance was superimposed upon the idea of a synergic common weal of society. Mercantilism had a dual vision where the interests both of society and of the individual had to be considered, and at times had to be traded off against one another.

Secondly, the Aristotelian view of society as a zero-sum game slowly gave way to an understanding that new wealth could be *created* through innovations. Indeed, the very meaning of the word *innovations* changed, from being a potentially heretical activity—as when Roger Bacon was arrested for ‘suspicious innovations’ in 1277 in Oxford—to being the new carrier of human welfare and happiness when Francis Bacon wrote *An Essay on Innovations* a little more than 300 years later (Reinert & Daastøl 1997). New scientific breakthroughs and geographical and scientific explorations slowly changed the static medieval worldview. This growing understanding of an infinite and expanding cosmos was the precondition for the mercantilist reinterpretation of the economic sphere: as cosmos expanded unendingly, so could the economy. There was a remarkable synergy observable between *innovation* and *exploration*, between theory and practice, in weaving the new European cosmology (Grafton 1996).

Thirdly, religion loosened its grip on society and opened up to innovations. With the fall of Constantinople to the Turks, Byzantine philosophers moved to Italy and brought with them religious views that were more open to Man’s role as a co-creator, rather than merely a caretaker, in God’s plan. Man’s creation in the image of God indeed made a life of invention and innovation a *pleasurable duty*

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8 We discuss the factors in more detail in Reinert & Reinert (2004)

9 Schumpeter (1954:177) refers to ‘the old scholastic Public Good’. See also Sophus Reinert (2003).

(Reinert & Daastøl 1997). Thus, around 1600, as in Francis Bacon's *New Atlantis*, a never-ending frontier of new knowledge was drawn up for Mankind, that had been transformed 'from a spectator into an owner and master of nature' (Koyré 1957: vii).

The Italian economic historian – and, many times, Prime Minister – Amintore Fanfani, encapsulated the shift from scholasticism to mercantilism: 'while scholasticism thinks of an order in equilibrium, mercantilism thinks of an order in growth' (Fanfani 1955: 149). We would argue that neo-classical economics, with its focus on the allocation of scarce resources and equilibrium, in many ways, represents a return to scholasticism (Reinert 2000a).

## Observing Spain and the Dutch Republic: Mercantilism as National Benchmarking

'Mercantilism was born in response to the failure of Spain', says Perrotta (1993:19), referring to the 1500's. We could add that mercantilism further developed – during the 1600's and 1700's – in reaction to the successes of the Dutch Republic and Colbert's France. The best mercantilist writers were practical men, not people dedicated to what used to be called 'metaphysical speculations'. One logical approach to establishing a national economic policy was to look for what had worked, and not worked, in other nations. The European scene provided examples of both poor and rich areas, and the observations of these successful and unsuccessful economies became a major source of inspiration for the economic theory and policy of laggard nations. Economics as a science was therefore not born in wealthy and successful areas – in Venice or in the Dutch Republic, where wealth only seemed 'natural' – but in the poorer cities and nation-states (Laspeyres 1863/1961) that were trying to understand what factors had created the few 'islands' of wealth in an otherwise poor Europe (some were islands in more than one sense, which is part of the clue).

We argue, then, that one of the key tools of mercantilism, as well as its inspiration, was benchmarking successful and less successful nations, a practice already existent during the late 1400's (Defoe 1728). Starting from around 1550, Europe provided one outstanding experience of national economic failure, Spain, and two examples of unquestionable economic success, Venice and the Dutch Re-

public. The basic question was a relatively simple one. Everyone knew that huge amounts of gold and silver flowed into Spain from the Americas. Starting around 1550, however, it became increasingly clear that this flow of bullion did not cause generalized wealth in Spain. The gold and silver ended up elsewhere, in nations that generally had no mines. Wealth left the nations producing raw materials – even if the raw materials were gold and silver – and accumulated in the nations housing a diversified manufacturing sector.

Spain became increasingly indebted to foreign bankers after about 1550, and gradually lost its financial independence. The monopolies of Spanish agricultural supplies, like wine and olive oil for the American colonies, caused very high food prices in the peninsula and, with the inflow of species, contributed to rampant inflation. Spanish industries, which had previously been competitive in European markets, like silk, iron and steel, died out. The country was de-industrialized and flooded with imports, which caused the species that flowed in from the American colonies to leave the country at the same speed, or even faster. Wealthy farmers, protected by a monopoly and a very inelastic supply of wine and oil, could purchase noble titles that exempted them from paying taxes. Church property and organizations were also exempt from taxes, leaving the tax burden on the few artisans and industrialists who survived the flood of imports. The powerful *Mesta*, the organization of sheep farmers, fortified its power with loans to the Crown, and worked like a state within the state. Large tracts of mortmain<sup>10</sup> land belonging to the church remained uncultivated. A huge clerical class added to a general contempt for manual work; huge unemployment, underemployment, and large numbers of beggars complete this brief picture of Spain in rapid decay. Money was made in Spain from financial transactions that did not promote the productive system, from *censos*, i.e. financial loans and mortgages, and from *juros*, i.e. privileges, titles and rights granted by the king in exchange for loans. A very interesting aspect here is the extent to which Spanish economists at the time clearly saw the forces behind the economic ills of the country and provided theoretical and practical remedies. ‘History records few instances of either such able diagnosis of fatal social ills by any group of moral philosophers or of any such utter disregard by statesmen of sound advice’ as Earl Hamilton rightly argued (Hamilton 1932:237).

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<sup>10</sup> Mortmain is land that cannot be sold.

On the other side of the European economic spectrum, we find the united Dutch provinces. Many mercantilist tracts, starting with Giovanni Botero (1588/1621), contain descriptions of their wealth, and, after the death of ‘the Great Colbert’ in 1683, similarly, of the success of French policies. In various forms, the statement that manufactures were the real gold mines, much more valuable than the actual gold mines themselves, is found all over Europe during the 1600’s and 1700’s, from Giovanni Botero (1588), Tommaso Campanella (1602) and Antonio Genovesi (1770’s) in Italy, to Anders Berch, the first economics professor outside Germany, in Sweden (Berch 1747). The Spanish mercantilist Geronimo de Uztariz (1724/1752, and foreword to Goyeneche 1717), whose main work was translated into both French and English, commented from a particularly good vantage point, being a Spaniard and having lived in Holland and Italy for 23 years. Uztariz’ conclusion is in line with the contemporary mainstream: ‘[Manufactures] is a mine more fruitful of gain, riches, and plenty, than those of Potosi’<sup>11</sup>.

Josiah Child, a governor of the British East India Company and one of the more famous mercantilists, encapsulates this benchmarking attitude to economic policy by arguing ‘If we intend to have the Trade of the World, we must imitate the Dutch, who make the worst as well as the best of all manufactures, that we may be in a capacity of serving all Markets, and all Humors’ (Child 1693: 90). Similarly, Child opens his 1668 book with a comment on ‘the prodigious increase of the Netherlanders’ which is ‘the envy of the present and may be the wonder of all future generations’. ‘And yet’, he adds, ‘the means whereby they have thus advanced themselves, are sufficiently obvious, and in a great measure imitable by most other nations..., which I shall endeavour to demonstrate in the following discourse’ (Child 1668). The French observers of the period, Huet (1712/1722) perhaps being the most detailed, found not only a country specialized in manufacturing – where close to 30 per cent of the labour force was already engaged in manufacturing in the early 1500s – but also a system of synergies which brings to mind the old Italian idea of a *ben comune*. It was clear to most astute observers that the wealth of Holland rested on the synergic interdependence of manufacturing, long-distance trade and fisheries, where ‘one factor gave strength to the other and vice versa’, as Antonio Serra explained the Venetian system.

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11 Potosi, at about 4.000 metres above sea-level in present-day Bolivia, was the richest of all mines in the world. At the time, it was the second largest city in the world after London.

A brief case-study of the Dutch city of Delft in the 17<sup>th</sup> century shows how synergies created by a diversified base of activities created knowledge and spill-overs between seemingly unrelated activities. In Delft, it is indeed possible to identify a closely-knit maritime-scientific-artistic cluster, where innovations leapt to and from very different sectors of the economy. The case of Delft brings together, in the very same productive-scientific cluster, the sectors and elements that, in the German tradition, are seen as being the important driving forces of capitalism, all in an interwoven whole:

- The quest for military power, in this case through the navy, as in Werner Sombart's 'War and Capitalism' (Sombart 1913a).
- The quest for luxury, in this case art, as in Sombart's 'Luxury and Capitalism' (Sombart 1914b).
- The quest for scientific knowledge, as in Sombart's 'Modern Capitalism' (Sombart 1902/1928).

These three forces interact in creating serendipitous economic development in Delft, and a profession curiously uniting the three seemingly unrelated fields – maritime warfare, art and scientific development – is that of the producer of glass lenses, *the lens grinder*.

Dutch artists invented oil painting and painting on canvases. The raw materials for these inventions – linseed oil, linen and hemp fibre – were widely used in Dutch shipbuilding and readily available, but would not be as readily available to the artists of other schools. Taking over the leadership from Florence, in the 17<sup>th</sup> century, Delft emerged as a centre for the scientific glass production of lenses. Important improvements to the microscope were also made there (Ruestow 1996). Delft natural scientist and microscope maker, Antoni van Leeuwenhoek (1632-1723) found a synergy between the production of woollen cloth, the main industry of the day, and his scientific work, because the hand lenses he developed were used extensively to inspect cloth (Huerta 2003:33). Similarly, lens-making was integrated with the development of Flemish art – bringing together the history of art and the history of science – through the work of the Delft painter Jan Vermeer (1632-1675), whose painting techniques included seeing his motifs through lenses and a *camera obscura*, an apparatus similar to a primitive camera (Steadman 2001). Vermeer also keenly participated in aspects of the discoveries surrounding him in Delft: the geographical discoveries of the Dutch navy and discoveries in the natu-

ral sciences made possible by improvements of the microscope by Leeuwenhoek and his colleagues<sup>12</sup>. The navy and the merchant marine constituted, however, the largest demand for lenses for binoculars, but as mentioned, lenses were also in demand among natural scientists and producers of early microscopes. The Delft lens grinders thus formed the core of an extremely dynamic and path-breaking cluster including such diverse actors as the navy, the woollen industry, painters like Vermeer, natural scientists, and microscope builders.

Another product linking the three clusters – war (navy), luxury (art) and knowledge (science) – in Holland at the time was mapmaking. Holland's position as a seafaring power demanded not only binoculars and naval instruments, but also up-to-date maps<sup>13</sup>. Vermeer's fascination with maps and explorations is clear in many of his paintings, one author commenting on his 'mania for maps'. Such synergic cumulative causations, and the path dependency they created, were no doubt at the core of knowledge creation and the process of economic growth (Arthur 1989). They were, however, neither possible to reproduce in any meaningful way by quantitative methods only, nor apparent through the lenses of methodological individualism.

The enormous diversity of economic activities was observed and commented on by all contemporary economists who wrote about the Dutch Republic. This is also apparent in the early economic journals (Zincke 1746-1767). The role of diversity and the resulting creative serendipity bring back the issue of 'monoculture' in traditional development economics and in agricultural societies, where such creative linkages do not appear among professions that trade with each other. A community of milk producers and a nation of banana producers have very little to sell to each other. By emulating Dutch economic structure, rather than Dutch economic policies necessarily, and by avoiding the pitfalls of Spain, the mercantilists revealed their conviction in common economic principles:

- Economic development is *activity-specific*, created by some economic activities, such as manufacturing, rather than others such as agriculture, where stagnant productivity, diminishing returns, and monoculture without synergies often-most reigned.<sup>14</sup>

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12 Leeuwenhoek was to be the executor of his neighbour Vermeer's estate.

13 With the technology of mapmaking changing from woodcuts to copper plates, the same copper used by instrument makers, the Dutch took over its production from the Italians.

14 The wisdom of taxing diminishing return activities and paying bounties to increasing return activities was also recognised by Alfred Marshall, the founder of neo-classical economics (Marshall 1890: 452). Similarly, the different effects of technological

- 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).
- 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 1700's, great emphasis was put on the beneficial synergies between manufacturing and agriculture: only where there was manufacturing, was there successful agriculture (Justi in Germany, Galiani in Italy, Hume in England)<sup>15</sup>

The mercantilists are generally accused of not having a 'model' for development. In our view, the model comes out clearly and consistently both across time – from the first Spanish and Italian writers in the 1500's to Friedrich List in the 1840's – and across the European continent. The economic essence of mercantilism was to line up private and public vested interests by getting nations into increasing return industries that create virtuous circles of development.

We would argue that adherence to the above principles has been a *mandatory passage point* for all nations progressing from poor to rich, including Korea in the 1960's and 1970's. When classical and neo-classical economics disallowed their *de jure* or *de facto* colonies from following these principles, they were – as Friedrich List put it – in reality, 'kicking away the ladder', which they themselves had used to climb to wealth.

The most fundamental difference between mercantilist economics and neo-classical economics is that the mercantilist policy recommendations were highly context-dependent – protecting manufacturing industry could be the right thing to do in one context, while promoting free trade could be right in another – whereas the policy recommendations of neo-classical economics are independent of context.

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change in agriculture (lower prices) and industry (higher wages) in Hans Singer (1950/1964) supported arguments for the key role of manufacturing industry in development. See also Reinert (1980, 1996).

15 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).

## Mercantilist Dynamics and Institutions: Activity-Specific Growth and Context-Specific Policy

Economic institutions have been brought to the forefront in the development debate during the last decade. It is generally agreed that economic activities and their institutions co-evolve, and attempts at establishing causality – to what extent institutions are created through *demand-pull* or *supply-push* – can therefore easily run into a chicken-and-egg type of problem. The mercantilist view of institutions was, from very early on, that institution-building was fundamentally a *demand-pull* phenomenon, that *the mode of production of a society* would determine its institutions. In 1620, Francis Bacon formulated a view that was to dominate in the social sciences for almost the next two centuries: ‘There is a startling difference between the life of men in the most civilised province of Europe, and in the wildest and most barbarous districts of New India. This difference comes not from the soil, not from climate, not from race, but from *the arts*’. Francis Bacon is crystal clear on the causality in question: Man’s activities – his mode of production – determine his institutions. In a similar vein, Carlota Perez (2004) recently argued the relationship between technological change and human institutions.

When Johan Jacob Meyen, a German scientist, stated in 1769 ‘It is known that a primitive people does not improve its customs and institutions, later to find useful industries, but the other way around’ (Reinert 2000a), he expressed an understanding of causality considered common sense at the time. This view would appear to run counter to the standard World Bank view that the lack of institutions *per se* can be blamed for the poor performance of so many Third World countries. To the mercantilists, it would not be meaningful to attempt to understand the institutional development of Europe independently of the underlying strategy of industrialization that prompted the establishment of so many key institutions. The patent system was invented in Venice in the late 1400’s with this purpose, and the establishment of an apprentice system in England under Elizabeth I cannot be understood outside the context of a highly successful Tudor strategy of building English woolen manufactures during the 1500’s. The establishment of scientific academies throughout Germany in the 1700’s cannot be understood independently of their strategy of building German economic activities outside agriculture. The success of these diversification strategies, in turn, created new institutional arrangements.

These mercantilist institutions cannot be understood outside a context of nations seeking to escape a comparative advantage in producing raw materials, a strategy which cannot be understood in the neo-classical framework of the Washington Consensus. We would argue that the present focus on institutions views institutions as outside the context of what they were created to accomplish. In reality, a large number of these institutions are part of a much broader process of economic development that is incompatible with the internal logic of current mainstream economics. Seeing institutions independently of the productive system they support and sustain, is not meaningful, and attempting to establish scientific academies in hunting and gathering tribes is therefore attacking the problem from the wrong end. History shows that only societies that have achieved a certain level of manufacturing and/or other increasing return activities have ever achieved the 'right' institutions or any degree of 'competitiveness'. Hundreds of years of accumulated experience show that today's maxim 'getting institutions right' cannot be solved independently of 'getting into the right kinds of economic activities'.

Perhaps, the most fundamental methodological difference between mercantilism and neo-classical economics is that the mercantilists, in the same way as any successful businessman today, see economic activities as being qualitatively different. The whole colonial system was based on this crucial insight. 'Linen industry is proper only for countries where they can have flax and hemp cheap, and where the common people work at very easy rates', wrote the English mercantilist Charles Davenant (1696/1771). The woolen industry, on the other hand, was able to maintain much higher wages. When the English King prohibited the Irish from exporting woolen manufactures in 1699, he therefore knew that England was 'underdeveloping' its Irish colony. As Davenant (1699: 275) said, 'No Wise State, if it has the Means of preventing the Mischief, will leave its Ruin in the Power of another Country'. Mercantilists were clearly aware that they were keeping the colonies poor. Most saw this as a natural part of global power politics, while a few defended the practice by saying that since everyone else did so, England had to follow the same policy. Some, like Justi in Germany in the 1750's, thought colonialism would soon end because the people in the colonies knew they were being fooled. This was, of course, what happened in the United States, who suffered from not being allowed to establish manufacturing industries.

By establishing themselves as the workshop of the world, importing raw materials and exporting manufactured goods, England experienced the most dra-

matic increase in wealth the world had yet seen. It was therefore of vital importance to keep things that way:

That all Negroes shall be prohibited from weaving either Linnen or Woollen, or spinning or combing of Wooll, or working at any Manufacture of Iron, further than making it into Pig or Bar iron: That they be also prohibited from manufacturing of Hats, Stockings, or Leather of any Kind... Indeed, if they set up Manufactures, and the Government afterwards shall be under a Necessity of stopping their Progress, we must not expect that it will be done with the same Ease that now it may (Gee 1738: 81).

When the colonies demanded to establish their own manufactures, their attention could be diverted by allowing them to export their raw materials to other European countries:

Because People in the Plantations, being tempted with a free Market for their Growths all over *Europe*, will all betake themselves to raise them, to answer the prodigious Demand of that extensive Free Trade, and their Heads be quite taken off from Manufactures, the only thing which our Interest can clash with theirs... (Decker 1744/1751).

The parallel to today's situation is clear. A large number of Third World countries have been de-industrialised during the last decades (Reinert 2003, 2004), but they are kept politically at bay with promises of being able to export their agricultural products to Europe and the United States.

As already mentioned, two important mercantilist institutions – both invented in the late 1400's – have been *patents* (in order to protect new knowledge) and *protection* (for industry-building, rather than for revenue purposes). Both institutions, of course, go against the basic tenets of neoclassical economics. It is curious how the twin institutions, *patents* and *protection* – children of the same basic understanding of the dynamics of a knowledge-based economy – are today considered to be heroes and villains respectively. Patents and their rights, creating artificial rents in order to promote new knowledge, are heralded as an indispensable ingredient of world growth, while protection, creating manufacturing rents in order to spread this production into new geographical areas, is considered the greatest of all evils. This is particularly problematic since all historically successful catching

up strategies – starting with England’s in 1485 and lasting there for more than 300 years – have depended on the nourishing, promotion, and protection of economic activities subject to increasing returns. The Washington Bretton Woods institutions now defend the mercantilist institution that helps rich countries (i.e. patents), but seek to eliminate its twin institution that could help the poor (i.e. protection).

The main institution that the mercantilists built was, of course, the state (Reinert 1999). Cosimo Perrotta saw mercantilism as an import substitution strategy, while Gustav Schmoller saw mercantilism as an exercise in state-building and nation-building. These are complementary, rather than contradictory views of mercantilism. As Schmoller describes mercantilism:

The essence of the system lies not in some doctrine of money, or of the balance of trade; not in tariff barriers, protective duties, or navigation laws; but in something far greater: - namely in the total transformation of society and its organizations, as well as of the state and its institutions, in the replacing of a local and territorial economy by that of the national state (Schmoller 1896: 51).

Mercantilist economic policy therefore became highly context-specific, whereas, from a mercantilist standpoint, neo-classical economic policy suffers from the same weakness as cure-all medicines in the Old West; they come across as what used to be referred to as ‘snake oil’.

## Why Successful Mercantilism Carries the Seeds of its own Destruction, or Adam Smith, the Misunderstood Mercantilist

We agree with Cosimo Perrotta that mercantilism, at its core, is an import substitution policy (Perrotta 1988, 1994), a policy aimed at establishing national comparative advantage in increasing returns areas.<sup>16</sup> In the language of Thomas Mun (1621), the transition is from ‘natural activities’ to ‘artificial activi-

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16 This is a fundamental *Leitmotif* in sixteenth, seventeenth, and eighteenth economic thought, and formed the basis of successful industrialization policies across Europe. It appears in English mercantilist texts, e.g. Misselden (1623), Mun (1664), Child (1693: 3, 18, 100-101), Cary (1695: 1), Barbon (1696), Davenant (1696), King (1721) and in William Petty.

ties', or in the language of Michael Porter, from a 'natural comparative advantage' to a 'created comparative advantage'. Porter (1990) provides a stage theory of economic development that is perfectly compatible with mercantilism (Reinert 2000b).

If this was the strategy, we should expect mercantilists to stop arguing for protectionism once this goal of industrialization has been reached. And indeed, this is what we see. Most mercantilists, and all the most sophisticated ones from Jean-Baptiste Colbert (1619-1683) to Friedrich List (1789-1846) and the 19<sup>th</sup> century American economists<sup>17</sup>, saw the end of industrial protection and, indeed, argued that international trade between nations specialized in manufactures was a positive-sum game. After the Tudor Plan in England, the first successful system – originating in the writings of Laffemas (1597) – was that of Colbert during the reign of Louis XIV. The many volumes of Colbert's collected papers (Clément, (ed.) 1861-1872) show the manager of 'France Inc.' building manufacturing and infrastructure, facilitating internal trade, and attempting to recreate, on a national level, the synergies which earlier observers (Botero 1590) had confined to city-states (Cole 1931, 1937). Already, however, Colbert, saw mercantilist policies as temporary, and 'spoke of protective duties as crutches by the help of which manufacturers might learn to walk and then throw them away' (Ingram 1888: 41). The contemporaries could observe that for long periods of time, the leading nation of the period, the Dutch Republic, had relatively low tariffs, raising their tariff barriers only when their decay was obvious and advanced in the 1720's.

The English mercantilists John Cary (1696), Theodore Janssen (1713), and Charles King (1721) spelled out a system of 'good' and 'bad' trade, which is completely in line with Paul Krugman's (1980) trade theory – later recanted<sup>18</sup> – based on increasing and diminishing returns (see also Graham 1923). Janssen and King's system was very influential throughout the 18<sup>th</sup> century. This was judged on a nation by nation basis. 'Good trade' is with nations from which you import raw materials and export manufactured goods, 'bad trade' is with nations from which you import manufactured goods and export raw material. And finally, exchanging manufactured goods for other manufactured goods is 'good trade' for both nations involved. This is also Friedrich List's principle (List 1841), which explains why List is, at the same time, both an important mercantilist and the first supporter of a European Union with free trade between manufacturing nations (Rein-

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17 See Hudson (2004) for a discussion of 19<sup>th</sup> century US industrial strategy.

18 Bhagwati (2002:31) confirms '(Krugman's) firm retreat back to free trade'.

ert 1998). List too saw mercantilism as a mandatory passage point on the road towards global free trade among equals. In other words, successful mercantilism carried with it the seeds of its own destruction: the type of protection that would initially help manufacturing, would later, by limiting production only to the national market, be an obstacle to manufacturing success. The assumption of increasing returns in manufacturing underlies most mercantilist writings, and is clearly spelled out by Antonio Serra (1613). It was James Steuart (1767), however, who produced the most mature mercantilist work in England, integrating important elements like technology, innovations, and institutions in his analysis of economic development – elements that were later to be removed from economics by Adam Smith. Two immediate translations into German testify to Steuart's international popularity and influence at the time.

Throughout the early modern 'mercantilist' period, it was clear to all that universal free trade was only in the interest of the wealthiest nations, Venice and the Dutch Republic in the 16<sup>th</sup> and 17<sup>th</sup> centuries, England later. In the United States, the same type of economic analysis that recommended industrial protection in the 1820's (Raymond 1820; Carey 1821) recommended free trade for that country in the 1880's and 1890's. The new and changed message is already clear from the book title, 'The Destructive Influence of the Tariff upon Manufacture and Commerce' (Schoenhof 1885). Writing in the United States, Friedrich List already foresaw this development around 1830: some time in the future, when the United States had industrialized after a century of protection, when its population had reached 100 million, and its navy was the most powerful in the world, then, the period would come when the United States would proclaim free trade to the world (Reinert 1998). It is impossible to understand Friedrich List's work without seeing that his 'mercantilism' was only a mandatory passage point towards free trade, which would be desirable when a symmetrical situation had been created in which all nations have a comparative advantage in dynamic, increasing return activities.

Normally, one would see Friedrich List and Adam Smith as opposite poles when it comes to economic policy, one the archetypical protectionist, and the other the archetypical free trader. However, Adam Smith can be read in a variety of ways, and he is an author who is more quoted than read. Not only are there important differences between Adam Smith's views before and after his meetings with the French physiocrats, the *Wealth of Nations* also contains passages that are more or less 'mercantilist'. The variation within *The Wealth of Nations* opened the way for selective translations, as in the case of Sweden, where the most mercantil-

ist Smith was translated first. As a result, there is at least one Adam Smith interpretation for every European nation.

In his early work, *The Theory of Moral Sentiments* (Smith 1759/1810), Adam Smith argued passionately for ‘the great system of government’ which is helped by adding new manufactures. Interestingly, Smith argued that new manufactures are to be promoted, neither to help suppliers nor to help consumers, but in order to improve ‘the great system of government’ (Smith 1759/1810, vol. 1: 320)

In fact, it is possible to argue that Adam Smith was also a ‘misunderstood mercantilist’, someone who firmly supported the mercantilist policies of the past, but then argued that they were no longer necessary for England. In other words, Adam Smith played the same role later played by Schoenhof (see above) in the United States. Policies, like patents and protection, that had once been established in order to further innovation, were in the 1770’s partly used to hinder innovations and sold to finance the Crown. Adam Smith praised the Navigation Acts protecting English manufacturing against Holland, arguing ‘they are as wise... as if they had all been dictated by the most deliberate wisdom’ and holding them to be ‘perhaps, the wisest of all the commercial regulations of England’ (Smith 1776/1976: I, 486-487). All in all, Smith described a development that had become successfully self-sustained, a kind of snowballing effect, originating in the wise protectionist measures of the past. Only once did Smith use the term ‘invisible hand’ in the *Wealth of Nations*: when it sustained the key import substitution goal of mercantilist policies, when the consumer preferred domestic industry to foreign industry (Smith 1776/1976: 477). This is when ‘the market’ had taken over the role previously played by protective measures, and national manufacturing no longer needed such protection. If one cared to look, Adam Smith also argued for mercantilist policies as mandatory passage point as did Charles King and Friedrich List.

But Adam Smith is contradictory, and it is possible to read British vested interests into his contradictions. Undoubtedly, Alexander Hamilton – the first US Treasury Secretary – who had read Smith – noticed that, at one point, Smith argued that it would be very foolish for the people of the United States, with whom England was at war when his book appeared, to attempt to establish manufactures. In a different part of the same book, Smith convincingly argued that only nations with manufacturing industries are able to win wars. English classical economists are first Englishmen and then economists, is the implication of a remarkable passage by Lord Lionel Robbins: ‘we get our picture wrong if we suppose that the English Classical economists would have recommended, because it was good for the world at large, a

measure which they thought would be harmful to their own community’ (Robbins 1952: 10-11). It is not surprising then, that Alexander Hamilton (1791) let the English mercantilists (in particular, Malachy Postlethwayt), and not Adam Smith, be his inspiration for US industrial policy (Hamilton 1791). ‘Don’t do as the English tell you to do, do as the English do’ became a maxim in the young United States.

## Conclusion: Mercantilism as a *Mandatory Passage Point* for Development

Most economists show clear mercantilist tendencies when they advice their own children. Even the most convinced neo-classical economist will not tell his or her children that it does not matter what profession they choose – picking tomatoes or becoming a lawyer – because factor-price equalization, when wages and interest rates will be equal across the planet, is around the corner. However, when pontificating on children in the Third World, the same economists, recommend that nations specialize according to their comparative advantage, which will normally mean specializing in providing cheap labour to produce raw materials for simple assembly operations. If a job is available at all, that is.

When the future of their own children is at stake, economists understand that a career picking cucumbers and tomatoes will provide much less wealth than a skilled job in industry or services. Why, then, is the mercantilist argument so unheard that a nation where *everyone* specializes in picking cucumbers and tomatoes – growth industries in Mexico today – will be poorer than a manufacturing nation? We are tempted to refer to Thorstein Veblen, who claimed that education tends to contaminate and ruin many healthy human instincts. Of course, the enlightened economist today will add that Mexico should invest more in education. But Mexico’s comparative advantage lies in economic activities that do not require much knowledge. Hence, its comparative advantage lies in providing cheap and uneducated labor. Investing in education therefore means training either for unemployment or for migration.

In this article, we have argued that the mercantilists who influenced economic policy were obsessed with strengthening domestic production. As early as 1550, the cosmopolitan European theatre presented economic theorists and policy makers with two fascinating and revealing case studies of success and failure respectively. ‘A spectre haunted Europe in the mercantilist period’, says Perrotta,

'the fear of ending up like Spain, rich in gold, poor in production, and with a frighteningly unfavourable balance of trade' (Perrotta 1993: 18). Fortunately, two other cases – Venice and the Dutch Republic – as successful as Spain's case was unsuccessful, were also at hand.

Daniel Defoe (1728) tells how the first and hugely successful import substitution strategy, the English Tudor Plan during 1485-1603, was based on King Henry VII benchmarking the poverty of England and the wealth of Burgundy, a wealth based exclusively on English raw material. The success of England's 'Tudor Plan' in building a woolen manufacturing sector showed the world that even if the success of Venice and the Dutch Republic, in a certain sense, were products of an invisible hand of Providence – a lack of raw materials had forced them into manufacturing – it was possible, through enlightened policy, to achieve the same results, even from a very different starting point.

Standard business strategy aims at maximizing market share without necessarily spelling out the theory of increasing returns and lowered unit costs, in everything from production to finance and advertising, that underlies this strategy. In the same way, the mercantilists did not necessarily explain the underlying mechanisms behind the success or failure they observed. The identification of cumulative and synergic elements behind wealth creation is what makes Antonio Serra's 1613 work so remarkable. Yet in order to learn from most mercantilists it is necessary to spell out the mechanisms that they intuited and utilized, but often did not explain sufficiently.

We argue that some basic economic mechanisms have had an enduring influence on human societies since the beginning of the written record. The effects of compound interest were the same in Babylonia in 2000 B.C. as with Third World debt today<sup>19</sup>. The conditions of a commercial enterprise with cash-flow problems would be fairly similar today as 500 years ago, and whether costs of production would (diminishing returns) or fall (increasing returns) increase as a nation specialized will have very similar results today as when Serra wrote in 1613<sup>20</sup>. In fact,

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19 When asked what power could be stronger than the atomic bomb, Albert Einstein reputedly answered 'compound interest'. It can, in fact, be argued that the ancient Babylonians institutionalised a better solution to this problem than we have today. At varying and unforeseeable intervals, the King would cancel all non-commercial debt, thus creating a 'clean slate' for everyone. Remnants of this practice, the Jubilee Years, are found in the Old Testament, becoming the basis for the Jubilee 2000 movement to forgive Third World debt.

20 Reinert (1980) documents that developing countries tend to produce well into the area of diminishing returns, revealed when costs decrease as production is reduced. See also Reinert (1996).

we would argue that all the basic policy recommendations of mercantilism – investment in manufacturing, infrastructure, and education, an extensive division of labour, importing raw materials and exporting manufactured goods, increasing the population of the cities – all aim at creating dynamic synergies based on what Schumpeter called ‘historical increasing returns’<sup>21</sup> in order to create sustainable wealth, employment and balance of payments.

Martin Wolf (2003: 49), associate editor and chief economic commentator for the *Financial Times*, wrote an article for *Foreign Policy* where he argued the ‘gap’ between rich and poor countries ‘reflects the success of those countries that embraced capitalism and the failure of those that did not’. The fact that mercantilism lies at the root of all successful capitalism is not considered. Harvard economist Robert J. Barro, writing for *Business Week*, dismissed worries about unemployment resulting from China’s growing textile exports by arguing ‘we should not be swayed by 17<sup>th</sup> century mercantilism, which viewed imports as bad and exports as good’. When taken together, these statements, appearing in two of the world’s most influential publications on economic policy matters, frame real historical fallacies fuelling contemporary economic debates: liberalism is always ‘right’ and protectionism is always ‘wrong’. Mercantilism, probably the most contested ‘ism’ in the historiography of economic analysis (Magnusson 1994), is mostly summoned as a straw man of irrational folly representing a system of destructive rent-seekers that supposedly made the fundamental mistake of confusing gold with wealth. The diffusion of this view reflects the extent to which the economics profession is virtually united in a common misconception of its own past, both as regards theory and policy.

We argue that the basic mercantilist insights – in the right contexts – have been proved right, again and again. These are: 1) national wealth cannot be created or based on raw material production in the absence of a manufacturing/increasing returns sector. 2) an inefficient manufacturing/increasing returns sector provides a much higher standard of living than no manufacturing sector. Large-scale deindustrialization is therefore a crime to posterity (Reinert 2003, 2004). Time after time, these principles have been resurrected in times of need: with increasing poverty in Spain after 1550, with the economic downturn of Italy in the following century, during the famines in Paris in the 1770’s, with the misery in France following the Napoleonic Wars, as the basis for solving serious economic problems in the

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21 With this term, Schumpeter refers to the combined effects of technological change and increasing returns, which are separable in theory, but often not in practice, because new technology is not available in the former scale.

United States in the early 1820's, solving the 'social problem' in 19<sup>th</sup> century Continental Europe, aiding Korea, poorer than Tanzania in 1950, in creating wealth, and after the devastation of the Morgenthau Plan in Germany after World War II. We argue that although increasing return activities partly may shift from manufacturing to services, the fundamental insights about the activity-specific and synergic nature of economic development remain valid. These are, however, blind spots in standard economics. The blind spots are products of David Ricardo's approach to economic theory, today fossilized into an ideology impervious to observations of economic reality. To those nations that have not yet been through a successful mercantilist phase, generally due to a colonial past, these blind spots of economic theory create untold human suffering on a daily basis.

## APPENDIX 1. 'Mercantilist' Economic Policies of the Generic Developmental State: Continuity of Policy Measures and Tool Kit from England in 1485 (Henry VII) to Korea in the 1960's: A Mandatory Passage for Economic Development.

...the fundamental things apply, as time goes by.  
Sam, the pianist, in 'Casablanca'.

1. Observation of wealth synergies clustered around increasing return activities and continuous mechanization in general. Recognition that 'We are in the wrong business'. Conscious *targeting, support and protection* of these increasing return activities.
2. Temporary monopolies/patents/protection given to targeted activities in a certain geographical area.
3. Recognizing development as a synergic phenomenon, and consequently, the need for a diversified manufacturing sector; the goals of 'maximizing the division of labour' and the emulation of more successful economies.
4. Accumulated empirical evidence shows that the manufacturing sector solves three policy problems endemic to the Third World in one go: increasing na-

tional value added (GDP), increasing employment, and solving balance of payments problems.

5. Attracting foreigners to work in targeted activities
6. Relative suppression of landed nobility (from Henry VII to Korea).
7. Tax breaks for targeted activities.
8. Cheap credit for targeted activities.
9. Export bounties for targeted activities.
10. Strong support for the agricultural sector, in spite of this sector being clearly seen as incapable of independently bringing the nation out of poverty.
11. Emphasis on learning/education
12. Patent protection for valuable knowledge
13. Frequent export tax/export ban on raw materials in order to make raw materials more expensive to competing nations

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