PART II

The strategy of success: nineteenth-century United States and Germany

3. The views of the German historical school on the issue of international income distribution

Jürgen G. Backhaus

The title of this chapter needs a few words of explanation. First, the views discussed here are theory-based and tested against specific policies within well-defined institutions. Second, the reference to the German Historical School is purely a convenience; these views are likewise held in different language areas, such as the French, the Dutch and the Italian traditions, but when the institutions through which economic policies are to be carried out differ, then specific policies informed by the same basic outlook will differ as well. Third, the term 'Historical School' refers to a body of literature before the advent of econometrics, which used historical evidence systematically in order to test theories against empirical evidence. Historical economics also tended to be defined more broadly than economics is today; institutions, legal issues, rules of law and customs as well as issues of geography and technology tended to be part of the explanatory apparatus. We can refer to Friedrich List (1789–1846), Wilhelm Roscher (1817–1894), Gustav von Schmoller (1838–1917) and Werner Sombart (1863–1941), in chronological order.[1] The list could easily be augmented with authors from other language areas.

In a nutshell, the views of the Historical School on the international distribution of income resulting from international trade were inspired neither by nationalism (the issue of state building) nor by anti-market sentiment (the choice of state command rather than market forces as the preferred allocation mechanism). Nor were the Historical School's views based on unbridgeable methodological differences from free-market advocates. Rather, the questions asked by members of the Historical School were different from those asked, for example, by David Ricardo or Adam Smith and therefore demanded different answers. Typically, members of the Historical School emphasized the dynamic process through which an economy grows, and their basic question was not what causes the wealth of nations, but what causes productive forces to spring up so as to produce the wealth of nations.

The argument in this chapter develops in five steps. First I contrast Ricardo's (1772–1823) basic argument in *Principles of Political Economy and Taxation* (first published 1817), repeated in a simpler form in so many textbooks, with the standard body of theory then taught on the European continent. Second, I briefly explain the leading economic doctrines of cameralism and mercantilism as they were taught on the Continent when Adam Smith's *Wealth of Nations* appeared in 1776. Third, I examine the emphasis on money and the importance of gold within this body of doctrines. Fourth, I offer a summary assessment of the British free-trade argument as it was commonly held on the European continent. Finally, using the concept of protective tariffs as developed by Friedrich List, I explain the purpose of this economic policy instrument and why it continues to be frequently misunderstood.

The standard wisdom about the views of members of the Historical School on international trade is that they were critical of the distribution of income resulting from international trade and therefore subscribed to protectionist arguments. It is then generally implied that these authors were anti-market to begin with and tended to ignore or at least discount classical economic theories. A few examples may illustrate these points. One of the leading textbooks on the history of economic thought sketches the views of the Historical School thus:

> *The older historical school.* The important writers of *the older historical school* are Friedrich List (1789–1846), Wilhelm Roscher (1817–1894), Bruno Hildebrand (1812–1878), and Carl Knies (1821–1898). They contended that classical economic theory did not apply to all times and cultures and that the conclusions of Smith, Ricardo, and J.S. Mill, though valid for an industrializing economy such as England, did not apply to agricultural Germany. There was a great deal of nationalistic feeling in the economic analysis of these writers. Furthermore, they asserted that economics and the social sciences must use a historically based methodology and that classical theory was mistaken in attempting to ape the methodology of the physical sciences, particularly in the hands of Ricardo and his followers. Some of the more moderate members of the school acknowledged that theoretical/deductive methods and historical/inductive methods were compatible. But others, particularly Knies, objected to any use of abstract theory.
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> List expressed particularly strong nationalist views and refused to admit that the laissez-faire conclusions of classical theory were applicable to countries less developed than England. Where classical theory held that national well-being will result from the pursuit of individual self-interest in an environment of laissez faire, List argued that state guidance was necessary, particularly for Germany and the United States. He contended that whereas free trade would be beneficial to England, given the advanced state of its industry, tariffs and protection were necessary for Germany and the United States. (Landreth and Colander 1994, p. 325)

In fact, Harry Landreth and David Colander's argument echoes a similar argument made by Wesley Mitchell (1967, Chapter 19). There, to our amazement, we read:

> List wrote his great *Das nationale System der politischen Ökonomie* (The National System of Political Economy) in 1842 on national economics as a man who was interested in the unification of Germany, who believed in building up a strong nation, and who thought that the application of protection with the principles was desirable in the view of that larger political aim. Whether or not for the time being the country was better off under free trade or under protection from a stricter material point of view made comparatively little differences in his eyes. To him, the major controlling consideration was the ultimate construction of a powerful Germany . . . So when economics seemed more and more to be running out to the practical conclusion of free trade in England, it was running more and more counter to the disposition of the Germans under the influence of such ideas as List represented. (p. 535)

It is difficult to see where Mitchell got this. As the editor, Joseph Dorfman, points out in an appended footnote, Mitchell wrote this passage in 1918 (when the United States was at war with Germany). In fact, List recommended to other countries – including the United States – the same economic development policies in order to achieve industrialization, and argued that Germany should form a customs union with England.

The climate in which this intellectual debate took place was more complex than these assessments reveal. Mitchell makes this point explicitly, and it is well worth quoting:

> That is to say, they [the German political economists] found that classical economics with its insistence upon a thorough-going individualism, with a doctrine that it is best for the group to interfere very little in the affairs of the individual, that on the whole, society will be best off in the material sense if every man is left free to follow his economic interest as he sees it, they saw that these ideas were not compatible with the kind of social life which had produced as a home-grown product *Cameralwissenschaft*. The same class of men were engaged in teaching the two subjects. (p. 533)

But where did this difference in outlook come from?

When *The Principles of Political Economy and Taxation* appeared, political economy had not yet taken hold as an academic discipline in Britain or the United States. In Britain, William Nassau was appointed to the first chair in political economy at Oxford in 1826. On the Continent, however, the first chairs in political economy had been established a century earlier (1727) in Halle and Frankfurt on the Oder. The purpose of these chairs was to instruct future civil servants in those principles of political economy that they needed in order to help design and implement enlightened economic policies that would bring prosperity and welfare (*Glückseeligkeit*) to their respective countries, when it was understood that a country's prosperity meant that the state could also financially prosper and participate in this wealth. The major way the state participated in the wealth of its subjects was to tax transactions by means of either the excise tax or the older forms of regalia, concessions and fees. Another important source of revenue was customs duties.

Ricardo's well-known example of England trading with Portugal, where England produced the cloth and Portugal the wine, depicted a static situation which did not reflect what would happen if the agriculture-based trading partner adopted policies to broaden its industrial base. Also, the example clearly referred to a situation in which the industrial producer's raw materials came from a different country and therefore the example assumed the industrial country's reliance on the supply of raw materials, in all likelihood from its colonies. Hence, members of the German Historical School saw Ricardo's example as an apt description of England's position *vis-à-vis* its less developed trading partners but not an effective argument for free international trade. The issue at hand is not the comparative advantage at the moment but the development of commerce and industry in the agriculture-based country.

Political economy was thus taught on the European continent as the science that enabled public administrators to develop the economies of their respective countries. At the centre of such an approach, naturally, was the state with its policy instruments bent on creating markets. We can distinguish two variants of the Historical School doctrine, fitting the respective geopolitical conditions of the countries in which they were taught. Large contiguous territories with access to the sea, such as France or Spain, strongly relied on closing their markets through customs duties to both imports of manufactured goods and exports of raw materials, and on selling concessions – sometimes even public offices – as bonds.[2] In contrast, central Europe consisted largely of smaller states, some of which had far-flung and not always contiguous territories. Nevertheless, these territories required a common economic and commercial policy which could not rely on high tariffs to the same extent as countries with contiguous territories and sea access; rather, the princes of these more than 300 smaller central European states had to rely on policies to encourage the immigration of skilled workers; other state revenues would stem from public enterprises in agriculture and manufacturing, excise taxes, concessions and regalia as well as the circulation of currency. Only if the currency was considered more stable than those of competing currency issuers could the circulation of currency be a sustainable revenue source. Herein lies a basic difference between mercantilist and cameralist policies: the cameralist policy-maker always competed with other similarly motivated princes for commerce, crafts and means to industrialize the country. Many countries, such as Prussia, resorted to policies of selective immigration, thereby relieving pressure on religious minorities. Almost every prince engaged in furthering the production of knowledge, itself an export industry, by founding or expanding existing universities. Thus the chequered political landscape of central Europe gave rise to very competitive economic policies and a large university landscape, in which political economy likewise grew as a state-centred economic doctrine designed to help future administrators. [3]

Another difference between mercantilist and cameralist doctrine is the strong emphasis that cameralists placed on technology. The typical cameralist textbook emphasized not only economic principles but also a wide range of issues concerning their implementation, down to even very practical suggestions. In particular, there was a strong emphasis on introducing new technologies (for example, in mining), new types of machinery and work organization (for example, in manufacturing), and new techniques (for example, more efficient practices in agriculture and forestry). Sometimes the state directly sponsored such projects, often at great expense and not always with sufficient success. However, the state of Prussia, which went far in implementing cameralist doctrine, developed a policy that relied on market forces to support the state effort. New initiatives would be launched, and if they proved commercially viable they would be privatized in order to generate new funds for development.

The Prussian Trading Corporation (Preussische Seehandlung), founded in 1772, may be a good example to make the point. The trading corporation started to borrow from private lenders and without any state guarantee. In 1804 it offered 4 per cent interest (later 3 per cent) and borrowed a total of 25 million taler. Its assets were Prussian bonds which could not be redeemed in 1806. Instead of liquidating, the bank received a state guarantee in 1810 and henceforth started to combine the activities of a state bank with those of an industrial development corporation with activities in road and rail construction, shipping, wool and salt trade, mills, mechanical weaving, paper factories, engineering and shipbuilding. Because not all of these enterprises could be operated successfully, it was the practice of the trading corporation to sell unprofitable undertakings and retain those that were profitable. In this way the company not only managed the very considerable public debt – the extent of which was among the best-kept secrets of the Prussian state – but it even made net contributions to the state's budget to the tune of about 0.2 per cent of net state revenues. In addition, the company made an important contribution to the process of industrializing Prussia. It should be noted in this context that the company enjoyed no legal monopoly.

Since these development strategies involved the transformation of almost exclusively agricultural economies into commerce- and crafts-based economies with the advent of industrial production in manufacturing, market penetration of the self-sufficient agricultural economies in order to further the division of labour clearly required money. Hence, both the mercantilists and the cameralists were bent on increasing the use of money and keeping enough money in circulation. Where these countries did not own gold or silver mines, an ancillary concern was the need to keep enough precious metal within the home economy. Precious metals are not an end in themselves in these doctrines, however; they are the means to monetize self-sufficient economies in order to introduce markets and deepen the division of labour.

When free-trade arguments appeared in larger numbers, originally inspired by the British literature but rapidly spread into France, Germany and Italy, the consensus among the established writers nevertheless remained that each country adopted a trade policy in order to further its own advantage. While the policies internally were designed to foster the development of markets, this meant externally that these same emerging markets had to be protected against international competition which would erode the local base from which the developmental take-off could be launched. In summarizing the mercantilist and cameralist consensus in the literature, Schmoller (1919–23, vol. 1, p. 87) says:

> The literature in the various European nations which took part in this intellectual movement are mainly different in that according to the specific geographical position and the general national interests different state administrative measures are being suggested. In Holland one praises the admiralties, large monopolistic trade companies and all those regulatory measures which make Amsterdam the centre of international trade. Outside the Netherlands one generally suggests the imitation of this small but active people of merchants, but in England one insists above all on national navigation acts mainly aimed at the Netherlands, on supporting ocean fishing, on the East Indian trade, on depressing the rate of interest and on supporting domestic industry. In Germany above all measures against the import of foreign products of manufacture are suggested in order not to endanger local commercial lives through overwhelming foreign imports. The different measures are different indeed, but the goals are the same everywhere: The egotistical support of one's own economy with all the measures the state has available.[4]

In many ways Friedrich List presents the best example of how this developmental strategy had been designed.

Friedrich List was the first professor of administrative practice at the University of Tübingen, the state university of the newly created kingdom of Württemberg. The kingdom had been created as a consequence of the

Napoleonic occupation of Germany and comprised a large number of formerly independent territories and free cities. List had risen through the state tax service and had been employed by the prime minister's office for various special tasks. For instance, he was charged with an inquiry into the causes of mass emigration from Württemberg to North America; in his report, based on interviews with emigrants in the port of Heilbronn on the Neckar river, he emphasized the harsh tax system – which did not take into account individuals' ability to pay – as a major cause of emigration. The country had had to contribute an army to Napoleon's Russian expedition, and many farms and businesses had lost their major breadwinners, who had either died or returned as disabled veterans. These war-related burdens were simply put onto the taxpayers without regard for their sustainability. At the time of List's appointment to the University of Tübingen, which trained the kingdom's future civil servants, political economy was taught by Friedrich von Fulda (1774–1847) in the physiocratic tradition, a doctrine rightly considered impracticable. List's appointment against the express wish of the faculty was unusual in that he had not passed the usual university qualifying exams.[5] The prime minister's wish in appointing List was not only that he turn out more practice-oriented graduates but also that he design a tax reform for the kingdom of Württemberg. In this tax reform, the protective tariff was of pivotal importance.

List's oft-repeated ideal scenario of economic development is as follows. The country's public administration carries on its traditional tasks of establishing law and order, thereby creating a favourable business climate; of meeting the needs of public transportation, such as for improved roads and waterways as well as railways, which were of particular importance in List's analysis; of establishing a simple tax administration and of carrying out a programme of regulatory reform in order to simplify the procedures faced by business; and of supporting publications, improving public health services and increasing awareness of new technologies by organizing fairs and industrial and technological exhibitions and by setting up prototype sites of production. There is no bureaucratic expansion, since the central instrument – the protective tariff – is handled by an existing administrative body and requires no additional resources whatsoever (List 1983; see also 1930, p. 330). As a consequence of all these complementary and secondary administrative measures, of the protective tariff and of occasional direct measures such as the attraction of particular entrepreneurs, competition in home markets eventually intensifies, prices decline and quality improves at the same time (p. 389). This also affects agriculture, which is never subject to protective tariffs, by stimulating a general increase (shift) in the demand for agricultural goods and by leading to an increase in the value of land due to increased demand for land for industrial purposes (pp. 330, 389) and for housing, with the additional consequence (not mentioned by List) that yields from traditional property taxes also increase. The revenues from customs decline, since local price levels decline as well. Eventually this leads to a drying up of revenues from customs, in the case of both high and low tariff rates. True to traditional administrative practice, the (by now) insignificant custom duty (*bagatelle* duty)[6] is discontinued; and thereby the desired goal of free trade is reached.

In conclusion we can note that the views of the Historical School with respect to international trade have often been misunderstood. The scholars of the Historical School were not protectionists as such, although they advocated temporary protective tariffs for well-specified conditions, provided they carried the seeds of their own destruction. Nor were the Historical School economists anti-market. On the contrary, the trade and development policy they set out to teach and test practically was designed to further the development of markets in order to develop their respective countries economically.

NOTES

1. List's most prominent work was *Das nationale System der politischen Ökonomie (The National System of Political Economy)*. Various editions have been published in German, English and French. Roscher's most important publication for the issue at hand was *Geschichte der Nationalökonomie in Deutschland (History of Political Economy in Germany)*. Schmoller's magnum opus was *Grundriß der allgemeinen Volkswirtschaftslehre (Blueprint of Political Economy)*. Sombart's magnum opus was *Der moderne Kapitalismus (Modern Capitalism)*.
2. The bond would be redeemed through the income from the office (for example, income to a judge or a bridgemaster).
3. In 1798 in Germany alone there were already 23 chairs of political economy at universities.
4. 'Die Schriften der verschiedenen europäischen Nationen, welche an dieser geistigen Bewegung teilgenommen haben, unterscheiden sich hauptsächlich dadurch, daß sie je nach der Lage und den nationalen Gesamtinteressen verschiedene staatliche Verwaltungsmaßregeln empfehlen. In Holland rühmt man staatliche Admiralitäten, große monopolisierte Handelsgesellschaften und alle die Maßregeln, die Amsterdam zum Mittelpunkte des Welthandels machen. Ausserhalb Hollands empfielt man allgemein die Nachahmung dieses kleinen rührigen Handelsvolkes, aber man dringt in England in erster Linie auf nationale Schiffahrtsgesetze, die gegen Holland gerichtet sind, auf Pflege der Seefischerei, des ostindischen Handels, auf eine staatliche Herabdrückung des Zinsfußes und eine Förderung der heimischen Industrie: In Deutschland empfiehlt man vor allem Erschwerung und Verbot der fremden Manufaktureneinfuhr, um das gewerbliche Leben der Heimat nicht ganz durch die fremde Konkurrenz erdrücken zu lassen. Die einzelnen Mittel sind verschieden, die Ziele sind überall dieselben: Die egoistische Förderung der eigenen Volkswirtschaft mit allen Mitteln des Staates.'
5. List was forced – as was the custom – to give his inaugural lecture in Latin, a language he did not understand.
6. As part of traditional administrative procedures in continental European tax administration, there are regularly evaluations of tax yields and administrative costs. Bagatelle duties

are duties resulting in insignificantly small net revenues, with sometimes very substantial gross revenues being consumed entirely by the costs of collection. Duties found to have fallen into this category are routinely discontinued.

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