For more articles, enter:
"cheap labor" and "sweatshops" in the keyword search.

Web Resources

BEHIND THE LABEL

www.behindthelabel.org

This site contains news items regarding various international anti-sweatshop campaigns.

SCHOLARS AGAINST SWEATSHOPS

www.peri.umass.edu/Scholars-Against.252.0.html

This site, which is housed at the Political Economy Research Institute, has links to a number of articles relating to sweatshops, the idea of a living wage, and international labour standards.

INTERNATIONAL LABOUR ORGANIZATION

www.ilo.org

This official website of the United Nation's International Labour Association has an extensive amount of materials on issues such as child labour and international labour standards.

GLOBAL EXCHANGE

www.globalexchange.org/campaigns/sweatshops/backgroundandresources.html

This website contains resources on a number of global issues including sweatshops. Look under the resource section for an extensive list of links to various anti-sweatshop campaigns and organizations.

THE UNOFFICIAL PAUL KRUGMAN ARCHIVE

www.pkarchive.org

You will find here an archive of many of the academic writings, newspaper articles, and interviews by Paul Krugman on international trade and other economic issues.

CLEAN CLOTHES CAMPAIGN

www.cleanclothes.org

A leading Dutch anti-sweatshop campaign, the Clean Clothes site contains information regarding a variety of campaigns around the world. Reflecting European sports interests, it contains extensive information about cheap labour and the production of soccer balls.

Issue 5

Does Outright Debt Cancellation Ignore the Real Problems of Africa?

✔ **YES**

GEORGE AYITTEY, "Smart Aid for Africa," *African Dialogue Series*, no. 773 (2005). www.utexas.edu/conferences/africa/ads/773.html

✘ **NO**

MOSES OCHONU, "The Case for Debt Cancellation and Increased Aid to Africa," *The Nigerian Village Square* (2005). www.nigeriavillagesquare.com/content/view/1137/55/

In the run-up to the G8 Summit scheduled for Gleneagles, Scotland in 2005, a group of high-profile celebrities gathered to present the case for debt relief as a solution to the problem of poverty in African states. A campaign for broad-based debt relief for all developing nations had been gaining steam at the grassroots for several years. The Jubilee 2000 Campaign, based in the United Kingdom and spreading to dozens of other countries, had been working hard to publicize its case for massive debt elimination as a means of giving developing nations a leg up. In 1998, it had mobilized a massive group of demonstrators for the G8 Summit in Birmingham. In the years following, a series of networked groups began to press "drop the debt" campaigns in order to redress the massive dislocations that had come of debt accumulation and structural adjustment throughout the global South.

There had been policy responses to these debt campaigns. Back in 1996, the IMF had launched the Heavily Indebted Poor Country (HIPC) Initiative. The initiative offered debt restructuring and eventual reduction of debt to heavily indebted countries that displayed an ongoing commitment to reducing their dependence on sustained debt. Amid complaints that the criteria for the HIPC Initiative were overly stringent, the program was modified in 1999 and supplemented by the Multilateral Debt Relief Initiative (MDRI) in 2005. Outside debt relief programs, the United Nations' set of Millennium Development Goals (MDGs) laid out in 2000 committed the world to addressing some of the chronic problems of poverty and underdevelopment.

Likewise, previous G8 Summits had occasioned hope for consideration of African economic problems. In 2001 in Genoa, African leaders had presented the New Africa Initiative (NAI), a pledge to own up to African leadership on economic issues while seeking a financial partnership with developed nations. The following G8 Summit held in Kananaskis, Alberta in 2002 had been billed as the summit for African development, featuring an updated version of the NAI known as the New

Partnership for African Development (NEPAD), whereby government aid and debt forgiveness would come with demonstrated improvements in governance and curtailment of corruption. However, African development had been consigned to secondary status in the 2003 and 2004 summits and it was not clear that poverty would remain a significant point in the agenda of the organization.

So in the months previous to the Gleneagles Summit, debt relief activists and concerned celebrities combined to organize a live around-the-world series of concerts in combination with a campaign that came to be known as "Make Poverty History". The key spokesmen for the cause were Bob Geldof and U2 frontman Bono, both of whom came to become the public faces of the global drop-the-debt campaign. Well-known actors, musicians, and entertainers lent their time and their images to publicize the event and a multinational petition was launched to be proffered to host Prime Minister Tony Blair at Gleneagles. The "Live 8" concerts held on July 2, 2005 were pitched not as a worldwide benefit as in the case of 1985's Live Aid so much as a means to bring public pressure to bear on the leaders of the G8 to make debt relief a priority.

Despite the remarkable public attention brought to the debt relief campaign, economists and policy makers are by no means united on the utility of debt relief as a means of improving the lot of developing nations in Africa and other areas of the global South. In particular, the G8 and IMF initiatives reflect the general feeling that it is inappropriate to reward developing nations with debt relief if the underlying governance and economic dysfunctions are not addressed. For this reason, debt relief has largely been tied to improvements in the record of transparency, respect of human rights, and financial management on the part of third world governments. Many argue, however, that conditions of such relief have largely remained inconsequential and ineffective. By contrast, others suggest that debt relief programs still reflect the colonial assumptions that developing nations need to be improved through Western intervention and tutelage, and that Western states have not yet come to grips with their own role in promoting the underdevelopment and dependency of the global South.

In this exchange, George Ayittey argues that the improvement of governance through a policy of "smart aid" is a better strategy than outright debt relief. On the other hand, Moses Ochonu points out that the problem of governance is more deep-seated and requires a solution that combines debt relief with reformation of Western aid and development agencies.

✔ **YES**

Smart Aid for Africa

GEORGE AYITTEY

Mired in grinding poverty and social destitution, Africa cries for help. A cacophonous galaxy of rock stars, anti-poverty activists, and heads of state are calling on the G-8 countries to cancel Africa's $350 billion crippling foreign debt and double aid to the continent. British Prime Minister Tony Blair will make aid to Africa the centerpiece in Britain's presidency of the G-8 meeting in Gleneagles, Scotland in July. Live 8 is planned for July 2. After meeting with President Bush on June 10, modalities are being worked out to cancel at least $34 billion in debt of 27 of the world's poorest nations, mostly African. Will this African Marshall Aid Plan work?

Africa's plight follows a ten-year attention deficit cycle. Every decade or so, mega-plans are drawn up and rock concerts held to whip up international rescue missions for Africa. Acrimonious wrangling over financing modalities ensues. Years slip by, then a decade later, another grand Africa initiative is unveiled. Back in 1985, there was Live Aid and a "Special Session on Africa" held by the United Nations to boost aid to Africa. Then in March 1996, the U.N. launched a $25 billion Special Initiative for Africa. In September 2005, the plight of Africa will again take center-stage at a U.N. conference with clockwork precision. Expect another major initiative for Africa in 2015.

Helping Africa of course is noble but has now become a theater of the absurd—the blind leading the clueless. A recent IMF study estimated that Africans in the diaspora remit $32 billion annually back to Africa, with the main destinations being Ghana, Nigeria, and Kenya. About $7 billion is sent to southern Africa (Ghana News Agency, Accra, May 31, 2005). The amount Africans abroad remit back exceeds the $25 billion Tony Blair seeks to raise.

Nigerian President Olusegun Obasanjo says corrupt African leaders have stolen at least $140 billion (£95 billion) from their people since independence. The World Bank estimates that 40 per cent of wealth created in Africa is invested outside the continent. Even the African Union, in a stunning report last August, claimed that Africa loses an estimated $148 billion annually to corruption—or 25 percent of the continent's Gross Domestic Product (GDP). Rather than plug the huge hemorrhage, African leaders prefer to badger the West for more money. And the West, blinded by its own racial over-sensitivity and guilt over the iniquities of the slave trade and colonialism, obliges. This is the real tragedy of Africa.

Between 1960 and 1997, the West pumped more than $450 billion in foreign aid—the equivalent of four Marshall Aid Plans—into Africa with nothing to show for it. Contrary to popular misconception, foreign aid is not free but a soft loan. Outright debt relief and massive inflow of aid without any conditionalities, safeguards or monitoring mechanisms is absurd. It is akin to writing off the credit card debt of a drunken sailor and allowing him to keep the same credit cards.

No African government has been called upon to give a full public accounting of who took what loan and for what purpose since many of Africa's foreign loans taken in the past were misused and squandered. No government official has been held accountable; instead, irresponsible past borrowing behavior is being rewarded.

More distressing, much of the new aid money will flow directly into an African government budget—a huge black maze of vanishing tax receipts, extra-budgetary expenditure items, perks and off-budget "presidential privy accounts," redolent with graft, patronage and waste. Over the past few decades, African budgets have careened out of control. State bureaucracies have swollen, packed with political supporters. Back in 1996, 20 percent of Ghana's public sector workforce was declared redundant by the Secretary of Finance and Guinea's 50,000 civil servants were consuming 51 percent of the nation's wealth. In Kenya, civil service salaries take up half the budget; in Uganda, it is 40 percent. Zimbabwe has 54 ministers; Uganda with a population of 35 million has 70, while Ghana, with a population of 22 million, has 88 ministers and deputy ministers. With bloated bureaucracies, soaring expenditures and narrow tax bases, budget deficits have soared.

They are covered with World Bank loans and foreign aid (Ghana's budget is 50 percent aid-financed and Uganda's is 60 percent). If the aid is insufficient, the rest of the budget shortfall is financed by printing money. Even when aid is available for "budgetary support," there is no guarantee that it will be used productively to generate a return to repay the soft loan. It could well be "consumed" when it pays for the salaries of civil servants. Writing off Uganda's debt does not eliminate the aid dependency. In fact, when the World Bank canceled $650 million of Uganda's debt in 1999, the first item President Yoweri Museveni purchased was a new presidential jet!

The British Prime Minister thinks he can cajole or browbeat African leaders into curbing corruption and ensuring that resources released by debt relief are put to some good use—such as increased spending on education and health care. But the push for good governance and reform must come from within—from African civil society groups, organizations and the people. However, in country after country, chastened by diabolical restrictions, these groups have no freedom or political space to operate.

Carlos Cardoso, an investigative journalist, was murdered in November 2000 for uncovering a bank scandal in which about $14 million was looted from Mozambique's largest bank, BCM, on the eve of its privatization. The official in charge of banking supervision, Antonio Siba Siba, was also murdered while investigating the banking scandals. Such was also the fate of Norbert Zongo, a popular journalist in Burkina Faso, who was gunned down on Dec 13, 1998, while investigating official corruption. In September 2001, [Eritrean] President Isaias Afwerki closed down all the independent media and arrested its staff, quashing calls for democratic reforms. In all, the government shut down eight private newspapers and arrested its journalists, picking them up in their newsrooms and homes

and from the streets. They were held in a central jail until April 2002, when they threatened to begin a hunger strike to protest their detention. They were then transferred to an undisclosed location.

In neighboring Ethiopia, President Meles Zenawi, a member of Tony Blair's Africa Commission, just held fraudulent elections. Anticipating public outrage, he banned street demonstrations for one month and assumed full control of the country's security forces. When the opposition rallied to protest the results dribbling in, the police opened fire, killing 26; opposition leaders have been placed under house arrest. Witness the election machinations in Egypt.

The paucity of good leadership has left a garish stain on the continent. Worse, the caliber of leadership has distressingly deteriorated over the decades to execrable depths. The likes of Charles Taylor of Liberia and Sani Abacha of Nigeria even make Mobutu Sese Seko of formerly Zaire look like a saint. In an unusual editorial, *The Independent* newspaper in Ghana wrote: "Most of the leaders in Africa are power-loving politicians, who in uniform or out of uniform, represent no good for the welfare of our people. These are harsh words to use on men and women who may mean well but lack the necessary vision and direction to uplift the status of their people" (*The Independent*, Ghana, July 20, 2000; p. 2).

The crisis in leadership remains a major obstacle to poverty reduction and has many manifestations. It is characterized, among others, by the following dispositions and failings: the "Big Man" syndrome, subordination of national interests to personal aggrandizement, super-inflated egos, misplaced priorities, poor judgment, reluctance to take responsibility for personal failures, and total lack of vision and understanding of even such basic and elementary concepts as "democracy," "fairness," "rule of law," "accountability," and "freedom"—among other deficiencies. In some instances, the leadership is given to vituperative utterances, outright buffoonery, stubborn refusal to learn from past mistakes, and complete absence of cognitive pragmatism.

Believing that their countries belong to them and them only, they cling to power at all costs. Their promises are worth less than Al Capone's. They stipulate constitutional term limits and then break them: Angola, Chad, Gabon, Guinea, and Uganda. African leaders themselves drew up a New Economic Partnership for Africa's Development (NEPAD) in 2001, in which they inserted a Peer Review Mechanism (PRM), by which they were to evaluate the performance of fellow African leaders in terms of democratic governance. What happened? To be fair, they acted in reversing the "military coup" in Togo in February but went on vacation when elections were stolen in Zimbabwe and Togo.

Ask them to cut bloated state bureaucracies or government spending and they will set up a "Ministry of Less Government Spending." Then there is the "Ministry of Good Governance" (Tanzania). They set up "Anti-Corruption Commissions" with no teeth and then sack the Commissioner if he gets too close to the fat cats (Kenya) or issue a Government White Paper to exonerate corrupt ministers (Ghana

in 1996). To be sure, multi-party elections have been held in recent years in many African countries but the electoral process was contumaciously manipulated to return incumbents to power. Four such "coconut elections" have so far been held this year: Zimbabwe, Togo, Congo (Brazzaville), and Ethiopia.

Ask them to place more reliance on the private sector and they will create a Ministry of Private Enterprise (Ghana). Ask them to privatize inefficient state-owned enterprises and they will sell them off at fire-sale prices to their cronies (Uganda). Or ask them to move a foot and they will demand foreign aid in order to do so. In 2003, some 30,000 ghost names were discovered on the payroll of the Ministry of Education, costing the government $1.2 million a month in salaries heisted by living workers. When Ghana demanded foreign aid to purge the payroll of these ghost names, Japan coughed up $5 million.

The reform process has stalled through vexatious chicanery, willful deception, and vaunted acrobatics. Only 16 out of the 54 African countries are democratic, fewer than 8 are "economic success stories," only 8 have a free and independent media.

No amount of debt relief and increased aid will help Africa until Africa cleans up its own house. But the leadership is not interested in reform. Thus, without new leadership and genuine reform, debt relief and increased aid would compound Africa's problems and more African countries will implode. The continent is stuck in a veritable conundrum. What can Western donors do?

Smart aid would do one of two things. One, bypass the vampire state and target the people, who produce Africa's real wealth. An African economy consists of three sectors: the traditional, informal, and the modern sector. The people who produce Africa's real wealth—cash crops, diamonds, gold and other minerals—live in the traditional and informal sectors. Meaningful development and poverty reduction cannot occur by ignoring these two sectors. But in the 1960s and 1970s, much Western development aid was channeled into the modern sector or the urban area, the abode of the parasitic elite minority. Industrialization was the rage and the two other sectors—especially agriculture—were neglected. Huge foreign loans were contracted to set up a dizzying array of state enterprises, which became towering edifices of gross inefficiency, waste and graft. Economic crises emerged in the 1980s and billions in foreign aid money were spent in an attempt to reform the dysfunctional modern sector. Between 1981 and 1994, for example, the World Bank spent more than $25 billion in Structural Adjustment loans to reform Africa's dilapidated statist economic system. Only 6 out of the 29 "adjusting" African countries were adjudged to be "economic success stories" in 1994. Even then, the success list was phantasmagoric. Ghana, declared a "success story" in 1994, is now on HIPC life-support system.

At some point, even the most recklessly optimistic donor must come to terms with the law of diminishing returns: that pouring in more money to reform the modern sector is futile. Greater returns can be achieved elsewhere—by focusing on the traditional and informal sectors.

Second, smart aid would empower the African people (African civil society groups) to monitor how the aid money is being spent and to instigate reform from within. Empowerment requires arming the African people with information, the freedom and the institutional means to unchain themselves from the vicious grip of poverty and oppression.

Africa already has its own Charter of Human and Peoples' Rights (the 1981 Banjul Charter), which recognizes the right to liberty and to the security of his person (Article 6); to receive information, to express and disseminate his opinions (Article 9); to free association (Article 10); to assemble freely with others (Article 11); and to participate freely in the government of his country, either directly or through freely chosen representatives in accordance with the provisions of the law (Article 13). Though the Charter enjoins African states to recognize these rights, few do so. When President Thabo Mbeki called on June 3, President Bush should have handed him a signed copy of this Charter to be delivered to President Robert Mugabe of Zimbabwe.

The institutional tools Africans need are an independent central bank (to assure monetary stability and stanch capital flight), an independent judiciary (for the rule of law), a free and independent media (to ensure free flow of information), an independent Electoral Commission, an efficient and professional civil service, and a neutral and professional armed and security forces.

Recent events in Ukraine (November), Ghana (December), Zimbabwe (March), Lebanon (April), and Togo (April) unerringly underscore the critical importance of these institutions. Without them, President Bush's plan to spread democracy may stall. Democracies are not built in a vacuum but in a "political space" in which the people can air their opinion, petition their government without being fired on by security forces and can choose who should rule them in elections that are not rigged by electoral commissions packed with government goons.

On May 13, thousands of Egyptian judges, frustrated by government control over the judiciary, agitated for full independence from the executive in their oversight of the electoral process. "The institutions are presenting Mr. Mubarak with an unexpected challenge from within, one that will be difficult to dismiss. The fact is, major changes in this country are going to come out of those institutions, not from the streets," said Abdel Monem Said, director of the Ahram Center for Strategic Studies in Cairo.

In the past 24 years, Egypt has received more than $55 billion in U.S. aid in direct government-to-government transfers. Smart aid would assist civil society in instigating institutional reform. Since this approach carries some risks, the same objective can be achieved by funneling aid through diaspora Africans and their organizations, as was the case with Soviet dissidents during the Cold War.

Africa's long term growth prospects do not lie in rock concerts and increased dependency on Western aid but on the ability of the African people or civil society groups to instigate reform from within. Assistance to such groups—both at home and abroad—constitutes much smarter aid to Africa than all the LIVE AID concerts Bob Geldof can organize.

✗ NO

The Case for Debt Cancellation and Increased Aid to Africa

MOSES OCHONU

Recently, George Ayittey of American University went before the standing committee of the Canadian Parliament on Foreign Relations to present his thoughts and recommendations on the subject of aid to Africa. Ayittey expanded the talking points for that presentation to respond to the new British-led initiative for debt cancellation, increased aid, and Africa-friendly trade practices.

Ayittey's write up on Africa's debt crises (published as dialogue 773) raises a lot of contentious issues. Because aid and debt are two extremely important issues on which Africa's economic and social future partly hinge, it is important to respond strongly to some of the issues in the piece. I will preface this write-up with a declaration of my disagreement with the ideological and philosophical premise of Ayittey's presentation on the subject of aid in and debt "relief" in Africa. Ayittey's presentation is steeped in the widespread but erroneous notion that aid and foreign loans are charitable acts on the part of the West toward Africa and that their forgiveness, being undeserved, should be considered as acts of remarkable benevolence. This is one of the biggest myths being naively reproduced in current discussions on Africa's economic predicament. I do not subscribe to this naïve and simplistic rendering of two institutions which have been used by the West as mechanisms for controlling and self-interestedly tele-guiding African economies. As very perceptive and informed commentators have opined, the reluctance of Western countries to sign on to a program of total debt cancellation is informed partly by their anxieties regarding the potential loss of these key tools of Western economic hegemony in Africa. Back to Ayittey's talking points.

First of all, Ayittey's write-up does a disservice to the Blair plan by reducing it to yet another attempt to raise and throw money at Africa's myriad problems. This is an unfair caricature of a three-pronged, nuanced proposal, of which aid is only one aspect. Debt relief is another aspect. For me, though, the most important aspect of this proposal—and this is what makes it radical in an unprecedented way—is its courage in calling for the elimination of many anti-Africa Western trade practices, not the least of which are the agricultural subsidies which not only close Western markets to African producers but also belies the West's rhetoric of free trade and globalization. If this proposal is embraced at next month's WTO talks, it will do infinitely more for Africa than aid or debt forgiveness can do over the long term.

Secondly, the write-up's comparison of African aid to the Marshall plan is outrageous, misleading, and disingenuous. By Ayittey's own assertion, the $450 billion purportedly "pumped" into Africa between 1960 and 1997 was not free money but a plethora of soft loans, with conditions that are anything but soft. The Marshall

plan, on the other hand, was direct, free America aid, the only condition being that the nations of Europe should form a collective and devise a comprehensive plan on how to spend the money. One could say that the world has changed and that the political threats and goals which made the case for the Marshall Plan no longer exist today. That may be so, but who is to say that hunger, disease, destitution, and anger in Africa pose a lesser threat to the United States than did the advancing wave of Soviet Socialism?

Yes, aid without conditionalities is counterproductive. However, does Ayittey not know that all previous aid to Africa carried stringent conditionalities but that African leaders and states, with the active support and encouragement of Western actors and financial institutions circumvented these conditions, thus getting us into this debt conundrum? If these conditionalities have been applied to African regimes and haven't worked, isn't it time we looked at applying the same set of ethical conditionalities to the Western institutions and actors who facilitate the merry-go-round of aid, embezzlement, Swiss accounts, and more recycled aid-loans?

Ayittey argues that no African government has been called to "give full public accounting of who took what loan for what purpose." This is sadly true, and I have no doubt in my mind that the day of reckoning is coming for all the African leaders who mortgaged our collective patrimony and destiny by taking and squandering foreign loans and aid on behalf of expectant and needy Africans. I have no illusions, however, that the West will be the champion of such a project of accountability. The West will not demand such an accounting, NOT because of its historical hangovers over past injustices, as Ayittey erroneously alleges—as anyone can see, the West has since shrugged off the guilt of the slave trade and colonialism, and mainstream revisionist histories which exonerate and assuage the West's conscience now abound. The West will not initiate a full process of soul searching and accountability because such a full accounting will inevitably lead the indictment of the West itself and its complicit financial institutions. Such a probe may also implicate some respectable Western figures who have done and still do business with corrupt African leaders and who are either in power in Western countries or have politicians in these countries who are beholden to them. In short, such a process of accounting will open Pandora's Box and reveal the underbelly of the fraudulent, two-sided aid-loan-corruption poverty producing machine. This is why the West will not demand full public accounting. It will not investigate its own institutions and practices.

Ayittey's analysis is thus a one-sided one at best. If African kleptocrats have yet to be held accountable for collecting and misusing dubious aid, no Western contractors, financial institutions, bankers, and economic hitmen (apologies to John Perkins), who wickedly pushed (read imposed) dubious waste-pipe projects on greedy African bureaucrats and politicians, have been called to account for their destructive adventures on the continent. They, too, must not go scot-free.

A big chunk of the write-up is really a simplistic and uncritical regurgitation of boring, outmoded IMF and World Bank-inspired free market postulations bemoaning the size of African civil services and recommending the drastic downsizing of the public sector. If this overly theoretical and textbookish prescription hadn't already been discredited in many reputable intellectual and academic circles as a one-size-fits-all, I would spend some time on it. Perhaps Ayittey and other small government advocates can tell us how the innocent civil servants to be massively retrenched will be absorbed into other niches without further burdening the informal and traditional sectors, since the private sector is either nonexistent or stagnant in most African countries. It seems that in the journey toward the neoclassical economic Holy Grail of small government, real humans and their economic fates are expendable.

Ayittey's most contentious postulation is his argument that "no amount of debt relief and increased aid will help Africa until Africa cleans up its own house." This would be a noble assertion were it not for the fallacy which inheres in it. How can Africa not be better off, even with all the corruption and waste, if it no longer has to pay the billions of dollars that it pays annually to service debts which were dubiously collected and which ended up for the most part in the West with the active collaboration of Western institutions and persons? In any case, the example of Nigeria, where the country has spent more than four times the amount of the original debt amount in servicing and interest payment and is still left with a rapidly appreciating principal, makes repayments of the foreign debts and the withholding of so-called debt relief immoral. Both Nigeria and her creditors know that this debt can never be repaid under the existing arrangements, which are actually designed to keep the principal unpaid while the creditors reap billions of dollars in annual servicing and interest payments. Nigeria's example is a microcosm of the African debt situation. Isn't it morally unacceptable for a country to continue to pay interests and service charges on dubious debts for which servicing payments alone have eclipsed the original debt amount? If only the Ayitteys of this world would temper their economics with some morality, they'd be able to grasp the moral dimension of this discourse of debt cancellation.

Let me therefore restate that I do not believe that debt relief is a charitable gesture on the part of the West; Western countries are merely trying, rather belatedly and half-heartedly, to make right what they messed up (by design) in Africa. The recent debt cancellation gesture is an incomplete atonement and a small restitution for the Western crime of willfully participating in questionable loan schemes and dubious monetary imports from Africa, which have left the continent comatose.

Nor do I subscribe to the notion of aid as aid or aid as charity. These aids—and they need to become completely free—are also token restitutive and compensatory payments deserved by Africa and Africans as a negligible material compensation, not for the slave trade and colonialism, as Ayittey insinuates, but for ONGOING devastation of the continent through the wanton extraction of the continent's

resources by environmentally nonchalant Western companies, and the resultant destruction of the environment, livelihoods, lifestyles, not to mention the instigation and exacerbation of armed conflict and the massive repatriation of tax-free profits to Western capitals. No amount of aid will adequately compensate Africans for these Western schemes or atone for their amoral and immoral aftermaths.

It sounds good to call for a reform of African states and institutions as a prelude to increased aid and debt relief. Ayittey wants Africa to cleanse its own house before the West goes further with these new projects. But is this complete cleansing feasible or possible in Africa (or anywhere else) in the foreseeable future? Is this insistence on cleansing as a condition for aid in the interest of the suffering (and innocent) mass of Africans, some of who depend solely on foreign aid handouts for survival? Is this not tantamount to withholding food and medicine from a child until its parents "clean up their acts" and start being financially responsible?

Finally, Ayittey calls for smart aid, which he argues would bypass the "vampire state" and deliver help directly the Africans in the traditional and informal sectors through civil society organs. First, let me welcome Ayittey to the club of the realists—those who believe that needy Africans should not be starved of aid because their governments are corrupt, and that aid, especially of the non-soft loan variety, cannot be tied to slow or non-existent political and institutional reforms. I recall that when the moderator of USA/Africa dialogue posted a *New York Times* editorial some months ago calling for the same kind of aid—aid which sidesteps corrupt state institutions and delivers help directly to those who need it—Ayittey was very vehement in his opposition to it. Since Ayittey himself is cynical and pessimistic about the prospects for the expansion of liberal reform on the continent, I wonder how he expects Africa "to clean its own house" and thus attract increased aid and debt relief.

In his response to the *New York Times* piece, Ayittey had argued that bypassing the vampire state with aid was a practical impossibility since the greedy state operatives would frustrate such a project. I would like to repeat this same criticism to him as an answer to his idea of channeling aid through civil society organizations. Since the African state is quite ubiquitous in terms of the exercise of power, the so-called smart aid will not work as state officials will resist and/or undermine this usurpation of what they consider their jurisdictional prerogative. It is illusory to expect that state bureaucrats will not pounce on or interfere with the implementation of such a smart aid package.

More importantly, the idea that civil society organizations and the informal sector are corruption-free and could thus serve as an accountable, efficient, and effective channel for aid distribution and implementation reveals a mindset that is hopelessly out of touch with African realities on the ground. It is founded on an overly theoretical insistence on separating African leaders from their people, the modern sector from the informal and traditional sectors. Such insistence on separateness ignores the symbiotic relationships between the public and private

sectors of African political and economic life. These sectors, contrary to Ayittey's argument, are separated by the thinnest and blurriest of lines. In fact, they are connected in a complex web of patron-client, familial, lineage, clan, ethnic, political, and socio-economic ties of mutual dependence and benefits.

My own knowledge, which is experientially rooted in Nigeria, reveals a more nuanced and variegated picture of corruption in which there are both private and public actors, in which there are actors from the so-called traditional and informal sectors and civil society. Corruption is not only rampant in the private and informal sectors of the Nigerian economy; the civil society organizations that Ayittey venerates are also very corrupt. In fact, the corruption in the Nigerian NGO and human rights communities, which no one talks about, is just as alarming as governmental graft. It is now so bad that human rights advocacy and NGO affairs have become autonomous domains of profit-oriented business and money-making. In this domain, the relationship between donors and recipient and partner organizations has an unsettling resemblance to that between so-called Western lenders and financial institutions on the one hand and African governments and leaders on the other.

So, what do we do?

Tony Blair's set of proposals, which actually falls short of the 100% debt cancellation (not forgiveness or relief) which many people of good conscience advocate, is a good place to start. It does not commit the error of simply throwing money at a bad situation. It marries the concerns of reform and the urgent need to save and improve lives on the continent. More importantly, it attempts to redress the anti-Africa trade practices of Western nations, who in effect have stifled African agricultural and proto-industrial production through their hypocritical subsidies and tariffs. My only disappointment with the plan (besides the failure to recommend the cancellation of all of Africa's debt) is the fact that its call for reform is one-sided. It does not demand the reform of Western financial institutions and global capital transfer practices, a reform which would make it difficult or impossible for corrupt African leaders to bilk the continent of aid money, which are then used to finance and lubricate investments and accounts overseas in a destructive cycle of corruption and hypocrisy.

POSTSCRIPT

The debate surrounding debt relief inevitably veers toward deeper issues surrounding the prescription for underdevelopment in marginalized countries. For every developing country that succeeds in improving governance along the lines set out by multilateral lending agencies another is unable or unwilling to pay the political and social costs. While improvements in the stability of governing institutions in places such as Nigeria and Liberia have contributed to a great deal of optimism, the descent of Zimbabwe into virtual economic chaos has dealt a blow to optimism for other parts of Africa.

There is no question that longstanding debt servicing has held back many parts of the developing world for decades. In the most marginalized countries of Africa and other reaches of the developing world, it stands as an insurmountable burden with or without improvements in governance. Efforts at debt forgiveness are therefore only the tip of the iceberg when it comes to addressing the broader problems of underdevelopment and poverty.

Suggested Additional Readings

Easterly, William. "Think Again: Debt Relief," *Foreign Policy* (November/December 2001). plato.acadiau.ca/COURSES/POLS/Grieve/Debt%20relief%20easterly.html

Hjertholm, Peter. "Theoretical and Empirical Foundations of HIPC Debt Sustainability Targets," *Journal of Development Studies*, 39, no. 6 (August 2003): 67–101.

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Rodino, Virginia. "African Debt, War and Imperialism are Linked," *Global Research* (August 2, 2005). globalresearch.ca/index.php?context=viewArticle&code=ROD20050802&articleId=787

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Schmitz, Andrea. "Generous Gestures: What Is the Point of G8 Debt Cancellation?" *SWP Comments* (July 2005). www.swp-berlin.org/en/produkte/swp_aktuell_detail.php?id=4842&PHPSESSID=7d60ca023a8f993b40e9dcbc600e7de1

Thomas, Melissa A. "Getting Debt Relief Right," *Foreign Affairs*, 80, no. 5 (September–October 2001): 36–45.

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Brutus, Dennis. "Africa 2000 in the New Global Context: A Commentary," *Africa Today,* 44, no. 4 (October–December 1997): 379–383.

Fosu, Augustin Kwasi. "Mapping Growth into Economic Development: Has Elite Instability Mattered in Sub-Saharan Africa?" *The American Journal of Economics and Sociology,* 63, no. 5 (November 2004): 1173–1192.

For more articles, enter:
"debt relief," "African development," or "NEPAD" in the keyword search.

Web Resources

JUBILEE DEBT CAMPAIGN

www.jubileedebtcampaign.org.uk

Founded in the late 1990s, the Jubilee Debt Campaign was the early standard-bearer of a global movement for debt cancellation.

MAKE POVERTY HISTORY

www.makepovertyhistory.ca

The Make Poverty History campaign gathered celebrities and average citizens around the world in favour of a series of anti-poverty initiatives in the run-up to the Gleneagles G8 Summit of 2005.

HIGHLY INDEBTED POOR COUNTRY (HIPC) DEBT INITIATIVE

www.imf.org/external/np/hipc/index.asp

The HIPC debt initiative was launched by the World Bank and IMF in 1996 in order to relieve the poorest countries of debts that they could not service. Analytical reports of the most heavily indebted poor countries are searchable through the IMF site.

Issue 6

Are Property Titling Systems the Key to Increased Economic Growth?

✔ **YES**
HERNANDO DE SOTO, *The Mystery of Capital* (New York: Basic Books, 2000), pp. 39–67

✘ **NO**
ALAN GILBERT, "On the Mystery of Capital and the Myths of Hernando de Soto," *International Development Planning Review,* 24, no. 1 (2002): 1–16

Modernization theory held that societies moved in a linear fashion from backward economies with an undifferentiated division of labour toward modern industrialized economies with a complex division of labour. This suggested that most societies moved from the ancient feudal system through the Industrial Revolution toward urbanized and modern society. This process granted property rights to citizens in modern societies such that they might exchange their status as tenant farmers for status as the urban proletariat. Indeed, people in most developed societies have been able to use their labour to earn sufficient capital to purchase property of their own. The ability to buy and sell land as one form of capital has become second nature in most developed societies through the development of a universally accepted system of legal title and exchange of notes that represent ownership over land and other forms of capital.

However, the movement of developing countries from feudal systems to industrialized societies has been uneven. As industrialization took root in the West, poor peasant farmers in underdeveloped nations sought to bring about change through more revolutionary means. In some countries, such as China or Vietnam, wars were fought to overturn the quasi-feudal order of the past, promoting nationalization of all property as a means of redistributing its benefits to the peasantry. In most Latin American countries, similar attempts to overthrow colonial-era landed oligarchies met with strong established resistance over the years, contributing to a series of revolutionary measures designed to redistribute property from the landed classes to landless peasants. The limited success of governments in this region to redistribute property remains a complaint among rural farmers and is frequently cited as a reason for persistently high levels of income inequality in these countries. By the same token, states such as South Korea, Japan, and Taiwan, where feudalism was disrupted by war and foreign occupation, or areas of Africa and India, where feudalism had never taken root or took a different form, have not suffered from the same level of inequality.

For these reasons and others, many development theorists have focused upon patterns of land ownership as important predictors of the success or failure of a nation to develop properly. Likewise, many developing-nation governments have championed the cause of land reform as a means of promoting social justice and equity. In some cases, it motivates large-scale social disruptions and violence, such as in the case of the Mexican Zapatista revolt in the state of Chiapas during the mid-1990s. Socialist movements elsewhere in Latin America have come to power seeking to centralize and nationalize key assets in order to encourage redistribution. Others have embraced land tenure reforms so that poor farmers can take possession of land that they have tilled for decades and pass the land down to their progeny. In addition to promoting economic incentives and prosperity in the countryside, it is hoped that rural land reform will help to prevent rapid urbanization, which has largely overwhelmed the abilities of developing states to respond with construction and services for the burgeoning populations of Third World cities.

The growth of these cities has illuminated new problems of land usage and economic management. The masses of urban poor in developing countries have clustered in large and growing shantytowns, living in makeshift dwellings known as "spontaneous" or "informal" housing. Many of these homes are built by squatters either on privately held land or land that has been essentially nationalized in response to the political demands of its inhabitants. However, for most of these city dwellers, there are no legal titles to the land that they occupy or building permits for the homes in which they live. What is more, a large proportion of the people living in these communities engage in under-the-table employment and business that operates outside government sanction in the "informal" economy. In many cases, this is because the strictures of government licensing and permission are beyond the means of the urban poor or run by corrupt political systems that make it extremely difficult for the poor to conduct their business or build their homes legally.

Writing in the 1980s and 1990s, Peruvian economist Hernando de Soto took an interest in these informal settlements and the economy that had arisen with them. In his groundbreaking 1986 work, *The Other Path,* de Soto argued that the entrepreneurial spirit was ripe among the urban poor of the developing world but stifled through overregulation and patronage that forced people into the informal economy. In 2000, the English edition of his much-discussed work *The Mystery of Capital* appeared. Here he provides the essentials of his argument about the importance of formalized legal title to capital in the developing world. Since the publication of *The Mystery of Capital*, many have criticized the practical necessity and significance of land ownership. In this vein, Alan Gilbert argues that land reforms of the sort championed by Hernando de Soto are not proving to be the sort of remarkable solution to world poverty that de Soto believes them to be.

✔ **YES**

The Mystery of Capital

HERNANDO DE SOTO

The sense of the world must lie outside the world. In the world everything is as it is and happens as it does happen. In it there is no value—and if there were, it would be of no value.

If there is a value which is of value, it must lie outside all happening and being-so. For all happening and being-so is accidental.

What makes it non-accidental cannot lie in the world, for otherwise this would again be accidental.

It must lie outside the world.

—Ludwig Wittgenstein, *Tractatus Logico-Philosophicus*

Walk down most roads in the Middle East, the former Soviet Union, or Latin America, and you will see many things: houses used for shelter, parcels of land being tilled, sowed, and harvested, merchandise being bought and sold. Assets in developing and former communist countries primarily serve these immediate physical purposes. In the West, however, the same assets also lead a parallel life as capital outside the physical world. They can be used to put in motion more production by securing the interests of other parties as "collateral" for a mortgage, for example, or by assuring the supply of other forms of credit and public utilities.

Why can't buildings and land elsewhere in the world also lead this parallel life? Why can't \$9.3 trillion of dead capital produce value beyond their "natural" state? My reply is, Dead capital exists because we have forgotten (or perhaps never realized) that converting a physical asset to generate capital—using your house to borrow money to finance an enterprise, for example—requires a very complex process. It is not unlike the process that Einstein taught us whereby a single brick can be made to release a huge amount of energy in the form of an atomic explosion. By analogy, capital is the result of discovering and unleashing potential energy from the trillions of bricks that the poor have accumulated in their buildings.

There is, however, one crucial difference between unleashing energy from a brick and unleashing capital from brick buildings: Although humanity (or at least a large group of scientists) has mastered the process of obtaining energy from matter, we seem to have forgotten the process that allows us to obtain capital from assets. The result is that 80 percent of the world is undercapitalized; people cannot draw economic life from their buildings (or any other asset) to generate capital. Worse, the advanced nations seem unable to reach them. Why assets can be made to produce abundant capital in the West but very little in the rest of the world is a mystery.

CLUES FROM THE PAST (FROM SMITH TO MARX)

[...]

Great classical economists such as Adam Smith and Karl Marx believed that capital was the engine that powered the market economy. Capital was considered to be the principal part of the economic whole—the preeminent factor (as the capital issues in such phrases as *capital* importance, *capital* punishment, the *capital* city of a country). What they wanted to understand was what capital is and how it is produced and accumulated. Whether you agree with the classical economists or not, or perhaps view them as irrelevant (maybe Smith never understood that the Industrial Revolution was under way; maybe Marx's labor theory of value has no practical application), there is no doubt that these thinkers built the towering edifices of thought on which we can now stand and try to find out what capital is, what produces it, and why non-Western nations generate so little of it.

For Smith, economic specialization—the division of labor and the subsequent exchange of products in the market—was the source of increasing productivity and therefore "the wealth of nations." What made this specialization and exchange possible was capital, which Smith defined as the stock of assets accumulated for productive purposes. Entrepreneurs could use their accumulated resources to support specialized enterprises until they could exchange their products for the other things they needed. The more capital was accumulated, the more specialization became possible, and the higher society's productivity would be. Marx agreed; for him, the wealth that capitalism produces presents itself as an immense pile of commodities.

[...]

Smith emphasized one point that is at the very heart of the mystery we are trying to solve. For accumulated assets to become active capital and put additional production in motion, they must be *fixed and realized in some particular subject* "which lasts for some time at least after that labour is past. It is, as it were, a certain quantity of labour stocked and stored up to be employed, if necessary, upon some other occasion." Smith warned that labor invested in the production of assets would not leave any trace or value if not properly *fixed.*

What Smith really meant may be the subject of legitimate debate. What I take from him, however, is that capital is not the accumulated stock of assets but the *potential* it holds to deploy new production. This potential is, of course, abstract. It must be processed and fixed into a tangible form before we can release it—just like the potential nuclear energy in Einstein's brick. Without a conversion process—one that draws out and fixes the potential energy contained in the brick—there is no explosion; a brick is just a brick. Creating capital also requires a conversion process.

[...]

This essential meaning of capital has been lost to history. Capital is now confused with money, which is only one of the many forms in which it travels. It is always easier to remember a difficult concept in one of its tangible manifestations than in its essence. The mind wraps itself around "money" more easily than "capital."

But it is a mistake to assume that money is what finally fixes capital. As Adam Smith pointed out, money is the "great wheel of circulation," but it is *not* capital because value "cannot consist in those metal pieces." In other words, money facilitates transactions, allowing us to buy and sell things, but it is not itself the progenitor of additional production. As Smith insisted, "the gold and silver money, which circulates in any country, may very properly be compared to a highway, which, while it circulates and carries to market all the grass and corn of the country, produces itself not a single pile of either."

[...]

THE POTENTIAL ENERGY IN ASSETS

[...]

Capital, like energy, is also a dormant value. Bringing it to life requires us to go beyond *looking* at our assets as they are to actively *thinking* about them as they could be. It requires a process for fixing an asset's economic potential into a form that can be used to initiate additional production.

Although the process that converts the potential energy in the water into electricity is well known, the one that gives assets the form required to put in motion more production is not known. In other words, while we know that it is the penstock, turbines, generators, transformers, and wires of the hydroelectric energy system that convert the potential energy of the lake until it is fixed in an accessible form, we do not know where to find the key process that converts the economic potential of a house into capital.

This is because that key process was not deliberately set up to create capital but for the more mundane process of protecting property ownership. As the property systems of Western nations grew, they developed, imperceptibly, a variety of mechanisms that gradually combined into a process that churned out capital as never before. Although we use these mechanisms all the time, we do not realize that they have capital-generating functions because they do not wear that label. We view them as parts of the system that protects property, not as interlocking mechanisms for fixing the economic potential of an asset in such a way that it can be converted into capital. What creates capital in the West, in other words, is an implicit process buried in the intricacies of its formal property systems.

THE HIDDEN CONVERSION PROCESS OF THE WEST

[...]

For some time now I have been looking at the law from an extralegal point of view, to better understand how it functions and what effects it produces. This is not as crazy as it seems. As the French philosopher Michel Foucault has argued, it may be easier to discover what something means by looking at it from the opposite side of the bridge. "To find out what our society means by sanity,"

Foucault has written, "perhaps we should investigate what is happening in the field of insanity. And what we mean by legality in the field of illegality." Moreover, property, like energy, is a concept; it cannot be experienced directly. Pure energy has never been seen or touched. And no one can see property. One can only experience energy and property by their effects.

From my viewpoint in the extralegal sector, I have seen that the formal property systems of the West produce six effects that allow their citizens to generate capital. The incapacity elsewhere in the world to deploy capital stems from the fact that most of the people in the Third World and in former communist countries are cut off from these essential effects.

Property Effect No. 1: Fixing the Economic Potential of Assets

The potential value locked up in a house can be revealed and transformed into active capital in the same way that potential energy is identified in a mountain lake and then transformed into actual energy. In both cases, the transition from one state to another requires a process that transposes the physical object into a man-made representative universe where we can disengage the resource from its burdensome material constraints and concentrate on its potential.

Capital is born by representing in writing—in a title, a security, a contract, and in other such records—the most economically and socially useful qualities *about* the asset as opposed to the visually more striking aspects *of* the asset. This is where potential value is first described and registered. The moment you focus your attention on the title of a house, for example, and not on the house itself, you have automatically stepped from the material world into the conceptual universe where capital lives. You are reading a representation that focuses your attention on the economic potential of the house by filtering out all the confusing lights and shadows of its physical aspects and its local surroundings. Formal property forces you to think about the house as an economic and social concept. It invites you to go beyond viewing the house as mere shelter—and thus a dead asset—and to see it as live capital.

[...]

Legal property thus gave the West the tools to produce surplus value over and above its physical assets. Property representations enabled people to think about assets not only through physical acquaintance but also through the description of their latent economic and social qualities. Whether anyone intended it or not, the legal property system became the staircase that took these nations from the universe of assets in their natural state to the conceptual universe of capital where assets can be viewed in their full productive potential.

With legal property, the advanced nations of the West had the key to modern development; their citizens now had the means to discover, with great facility and on an ongoing basis, the most potentially productive qualities of their resources. As Aristotle discovered 2,300 years ago, what you can do with things increases infinitely when you focus your thinking on their potential. By learning to fix the economic potential of their assets through property records, Westerners created a fast track to explore the most productive aspects of their possessions. Formal property became the staircase to the conceptual realm where the economic meaning of things can be discovered and where capital is born.

Property Effect No. 2: Integrating Dispersed Information into One System

[...] Most people in developing and former communist nations cannot get into the legal property system, such as it is, no matter how hard they try. Because they cannot insert their assets into the legal property system, they end up holding them extralegally. The reason capitalism has triumphed in the West and sputtered in the rest of the world is because most of the assets in Western nations have been integrated into one formal representational system.

This integration did not happen casually. Over decades in the nineteenth century, politicians, legislators, and judges pulled together the scattered facts and rules that had governed property throughout cities, villages, buildings, and farms and integrated them into one system. This "pulling together" of property representations, a revolutionary moment in the history of developed nations, deposited all the information and rules governing the accumulated wealth of their citizens into one knowledge base. Before that moment, information about assets was far less accessible. Every farm or settlement recorded its assets and the rules governing them in rudimentary ledgers, symbols, or oral testimony. But the information was atomized, dispersed, and not available to any one agent at any given moment. As we know too well today, an abundance of facts is not necessarily an abundance of knowledge. For knowledge to be functional, advanced nations had to integrate into one comprehensive system all their loose and isolated data about property.

Developing and former communist nations have not done this. In all the countries I have studied, I have never found just one legal system but dozens or even hundreds, managed by all sorts of organizations, some legal, others extralegal, ranging from small entrepreneurial groups to housing organizations. Consequently, what people in those countries can do with their property is limited to the imagination of the owners and their acquaintances. In Western countries, where property information is standardized and universally available, what owners can do with their assets benefits from the collective imagination of a larger network of people.

[...]

Property Effect No. 3: Making People Accountable

The integration of all property systems under one formal property law shifted the legitimacy of the rights of owners from the politicized context of local communities to the impersonal context of law. Releasing owners from restrictive local arrangements and bringing them into a more integrated legal system facilitated their accountability.

By transforming people with property interests into accountable individuals, formal property created individuals from masses. People no longer needed to rely on neighbourhood relationships or make local arrangements to protect their rights to assets. Freed from primitive economic activities and burdensome parochial constraints, they could explore how to generate surplus value from their own assets. But there was a price to pay: Once inside a formal property system, owners lost their anonymity. By becoming inextricably linked to real estate and businesses that could be easily identified and located, people forfeited the ability to lose themselves in the masses. This anonymity has practically disappeared in the West, while individual accountability has been reinforced. People who do not pay for goods or services they have consumed can be identified, charged interest penalties, fined, embargoed, and have their credit ratings downgraded. Authorities are able to learn about legal infractions and dishonored contracts; they can suspend services, place liens against property, and withdraw some or all of the privileges of legal property.

Respect in Western nations for property and transactions is hardly encoded in their citizens' DNA; it is rather the result of having enforceable formal property systems. Formal property's role in protecting not only ownership but the security of transactions encourages citizens in advanced countries to respect titles, honor contracts, and obey the law. When any citizen fails to act honorably, his breach is recorded in the system, jeopardizing his reputation as a trustworthy party to his neighbors, utilities, banks, telephone companies, insurance firms, and the rest of the network that property ties him to.

[...]

Property Effect No. 4: Making Assets Fungible

One of the most important things a formal property system does is transform assets from a less accessible condition to a more accessible condition, so that they can do additional work. Unlike physical assets, representations are easily combined, divided, mobilized, and used to stimulate business deals. By uncoupling the economic features of an asset from their rigid, physical state, a representation makes the asset "fungible"—able to be fashioned to suit practically any transaction.

By describing all assets in standard categories, an integrated formal property system enables the comparison of two architecturally different buildings constructed for the same purpose. This allows one to discriminate quickly and inexpensively between similarities and differences without having to deal with each asset as if it were unique.

Standard property descriptions in the West are also written to facilitate the combination of assets. Formal property rules require assets to be described and characterized in a way that not only outlines their singularity but also points out their similarity to other assets, thus making potential combinations more obvious. Through the use of standardized records, one can determine (on the basis of zoning restrictions, who the neighbors are and what they are doing, the square footage of the buildings, whether they can be joined, etc.) how to exploit a particular piece of real estate most profitably, whether as office space, hotel rooms, a bookshop, or racquetball courts and a sauna.

Representations also enable the division of assets without touching them. Whereas an asset such as a factory may be an indivisible unit in the real world, in the conceptual universe of formal property representation it can be subdivided into any number of portions. Citizens of advanced nations are thus able to split most of their assets into shares, each of which can be owned by different persons, with different rights, to carry out different functions. Thanks to formal property, a single factory can be held by countless investors, who can divest themselves of their property without affecting the integrity of the physical asset.

[...]

Once assets are in a formal property system, they endow their owners with an enormous advantage in that they can be split up and combined in more ways than an Erector set. Westerners can adapt their assets to any economic circumstance to produce continually higher valued mixtures, whereas their Third World counterparts remain trapped in the physical world of rigid, non-fungible forms.

Property Effect No. 5: Networking People

By making assets fungible, by attaching owners to assets, assets to addresses, and ownership to enforcement, and by making information on the history of assets and owners easily accessible, formal property systems converted the citizens of the West into a network of individually identifiable and accountable business agents. The formal property process created a whole infrastructure of connecting devices that, like a railway switchyard, allowed the assets (trains) to run safely between people (stations). Formal property's contribution to mankind is not the protection of ownership; squatters, housing organizations, mafias, and even primitive tribes manage to protect their assets quite efficiently. Property's real breakthrough is that it radically improved the flow of communications about assets and their potential. It also enhanced the status of their owners, who became economic agents able to transform assets within a broader network.

This explains how legal property encourages the suppliers of such utilities as electricity and water to invest in production and distribution facilities to service buildings. By legally attaching the buildings where the services will be delivered to their owners, who will be suing and paying for the services, a formal property system reduces the risk of theft of services. It also reduces the financial losses from bill collecting among people hard to locate, as well as technical losses from incorrectly estimating the electricity needs of areas where businesses and residents are clandestine and not recorded. Without knowing who has the rights to what, and without an integrated legal system where the ability to enforce obligations has been transferred from extralegal groups to government, utilities would be hard-pressed

to deliver services profitably. On what other basis could they identify subscribers, create utility subscription contracts, establish service connections, and ensure access to parcels and buildings? How would they implement billing systems, meter readings, collection mechanisms, loss control, fraud control, delinquent charging procedures, and enforcement services such as meter shutoffs?

Buildings are always the terminals of public utilities. What transforms them into *accountable* and *responsible* terminals is legal property. Anyone who doubts this need only look at the utility situation outside the West, where technical and financial losses plus theft of services account for 30 to 50 percent of all available utilities.

Western legal property also provides businesses with information about assets and their owners, verifiable addresses, and objective records of property value, all of which lead to credit records. This information and the existence of integrated law make risk more manageable by spreading it through insurance-type devices as well as by pooling property to secure debts.

Property Effect No. 6: Protecting Transactions

One important reason why the Western formal property system works like a network is that all the property records (titles, deeds, securities, and contracts that describe the economically significant aspects of assets) are continually tracked and protected as they travel through time and space. Their first stop is the public agencies that are the stewards of an advanced nation's representations. Public record keepers administer the files that contain all the economically useful descriptions of assets, whether land, buildings, chattels, ships, industries, mines, or airplanes. These files will alert anyone eager to use an asset about things that may restrict or enhance its realization, such as encumbrances, easements, leases, arrears, bankruptcies, and mortgages. The agencies also ensure that assets are adequately and accurately represented in appropriate formats that can be updated and easily accessed.

In addition to public record-keeping systems, many other private services have evolved to assist parties in fixing, moving, and tracking representations so that they can easily and securely produce surplus value. These include private entities that record transactions, escrow and closings organizations, abstractors, appraisers, title and fidelity insurance firms, mortgage brokers, trust services, and private custodians of documents. In the United States, title insurance companies further help the mobilization of representations by issuing policies to cover parties for specified risks, ranging from defects on titles to unenforceability on mortgages and unmarketability of title. By law, all these entities have to follow strict operating standards that govern their document-tracking capabilities, physical storage facilities, and staffing.

Although they are established to protect both the security of ownership and that of transactions, it is obvious that Western systems emphasize the latter. Security is principally focused on producing trust in transactions so that people can more easily make their assets lead a parallel life as capital.

In most developing countries, by contrast, the law and official agencies are trapped by early colonial and Roman law, which tilt toward protecting ownership. They have become custodians of the wishes of the dead. This may explain why the creation of capital in Western property happens so easily, and why most of the assets in developing and former communist countries have slipped out of the formal legal system in search of mobility.

The Western emphasis on the security of transactions allows citizens to move large amounts of assets with very few transactions. How else can we explain that in developing and former communist nations people are still taking their pigs to market and trading them one at a time, as they have done for thousands of years, whereas in the West, traders take representations of their rights over pigs to the market? Traders at the Chicago commodities exchange, for example, deal through representations, which give them more information about the pigs they are trading than if they could physically examine each pig. They are able to make deals for huge quantities of pigs with little concern about the security of transactions.

CAPITAL AND MONEY

The six effects of an integrated property process mean that Westerners' houses no longer merely keep the rain and cold out. Endowed with representational existence, these houses can now lead a parallel life, doing *economic* things they could not have done before. A well-integrated legal property system in essence does two things: First, it tremendously reduces the costs of knowing the economic qualities of assets by representing them in a way that our senses can pick up quickly; and second, it facilitates the capacity to agree on how to use assets to create further production and increase the division of labor. The genius of the West was to have created a system that allowed people to grasp with the mind values that human eyes could never see and to manipulate things that hands could never touch.

[...]

Property, then, is not mere paper but a mediating device that captures and stores most of the stuff required to make a market economy run. Property seeds the system by making people accountable and assets fungible, by tracking transactions, and so providing all the mechanisms required for the monetary and banking system to work and for investment to function. The connection between capital and modern money runs through property.

[...]

Capital, as I argued earlier, is therefore not created by money; it is created by people whose property systems help them to cooperate and think about how they can get the assets they accumulate to deploy additional production. The substantial increase of capital in the West over the past two centuries is the consequence of gradually improving property systems, which allowed economic agents to discover and realize the potential in their assets, and thus to be in a position to produce the noninflationary money with which to finance and generate additional production.

So, we are more than squirrels who store food for winter and engage in deferred consumption. We know, through the sophisticated use of property institutions, how to give the things we accumulate a parallel life. When advanced nations pulled together all the information and rules about their known assets and established property systems that tracked their economic evolution, they gathered into one order the whole institutional process that underpins the creation of capital. If capitalism had a mind, it would be located in the legal property system. But like most things pertaining to the mind, much of "capitalism" today operates at a subconscious level.

Why did the classical economists, who knew capital was abstract and had to be fixed, not make the connection between capital and property? One explanation may be that in Adam Smith's or even Marx's day property systems were still restricted and undeveloped, and their importance was difficult to gauge. Perhaps more significantly, the battle for the future of capitalism shifted from the book-lined studies of theoreticians into a vast web of entrepreneurs, financiers, politicians, and jurists. The attention of the world turned from theories to the real deals being made on the ground, day by day, fiscal year after fiscal year.

Once the vast machine of capitalism was firmly in place and its masters were busy creating wealth, the question of how it all came into being lost its urgency. Like people living in the rich and fertile delta of a long river, the advocates of capitalism had no pressing need to explore upstream for the source of their prosperity. Why bother? With the end of the Cold War, however, capitalism became the only serious option for development. So the rest of the world turned to the West for help and was advised to imitate the conditions of life on the delta: stable currencies, open markets, and private businesses, the objectives of so-called macroeconomic and structural adjustment reforms. Everyone forgot that the reason for the delta's rich life lay far upriver, in its unexplored headwaters. Widely accessible legal property systems are the silt from upriver that permits modern capital to flourish.

This is one of the principal reasons macroeconomic reforms are not working. Imitating capitalism at the level of the delta, by importing McDonald's and Blockbuster franchises, is not enough to create wealth. What is needed is capital, and this requires a complex and mighty system of legal property that we have all taken for granted.

[...]

✗ NO

On the Mystery of Capital and the Myths of Hernando de Soto

ALAN GILBERT

Hernando de Soto's bestseller, *The Mystery of Capital* (2000), attributes the failure of capitalism in the Third World to the lack of property titles. While this is hardly a new argument, it is likely to acquire renewed momentum because his is a very influential voice in Washington. Latin American governments, which have long been active in distributing title deeds, will continue to implement this policy on an even larger scale.

The question addressed in this paper is: what difference does the 'gift' of a title deed actually make to the lives of the poor? Do title deeds enable them to borrow money from the formal sector, as de Soto and the World Bank claim? Do they open up a new world of capital accumulation to the poor because property may be transferred legally from one 'owner' to another? Or do they, in fact, make so little difference that most of the so-called advantages of legalisation are a sham?

Using data gathered in the now legalised self-help settlements of Botogá, I will question the main benefits of legalisation. I will show how sales are sometimes more frequent when people do not have legal titles, how informal finance is available from the initial information of an illegal settlement, and how little formal finance is forthcoming after legalisation. Most importantly, I will show that there is not much indication of secondary housing markets developing in legalised settlements. It is hard for the poor to make money from ownership when they are unable to sell their houses.

[...]

THE 'NEW' CONVENTIONAL WISDOM ABOUT LEGAL TITLE

According to de Soto, very little needs to be done to make capitalism work well in Africa, Asia and Latin America. Because the poor save money and have developed a variety of business skills, all they need is the means to increase their turnover. The key element required to turn them into successful businesspeople is access to formal credit. The legal title to their property will enable them to gain entry into the world of formal banking. If they can use their capital assets as collateral, the world will be their oyster.

[...]

THE NEED FOR A LAND TITLE

De Soto is undoubtedly correct in his belief that the lack of legal titles can inconvenience the poor. The occupants of newly formed settlements often feel insecure; even in long-established neighbourhoods, female-headed households, immigrant

communities and minority groups may feel insecure without formal title. The absence of legal titles may complicate the process of buying and selling property and obtaining credit. No doubt this partly explains why so many Latin American governments have staged massive land-titling programmes.

However, it is widely recognised that security of tenure does not require the issue of full legal title (Durand-Lasserve, 1986; McAuslan, 1985; Fernandes and Varley, 1998). In practice, the vulnerability of informal settlements varies considerably. It depends on many factors including the identity of the original owner, the location of the land, alternative uses for the land, the nature of the government and the date of the next election.

As such, many argue that massive titling programmes are being conducted for reasons that have nothing to do with helping the poor. Such programmes are popular because they are cheap; it is much less expensive to issue property titles than to provide settlements with services. In addition, the authorities and international agencies can actually make money from titling programmes. The World Bank has long recognised that the profits made by a government agency may be used to finance upgrading programmes elsewhere (McAuslan, 1985, 62). Indeed, many people in Washington argue that issuing legal titles on a large scale can only be justified in the beneficiaries are prepared to pay the full cost of the process.

[...]

LEGAL TITLE AND HOUSING IMPROVEMENT

Does the issue of legal titles accelerate the process of housing improvement? In practice, there is plenty of evidence that settlers improve their homes even when they do not possess anything resembling a title deed (Gilbert and Ward, 1985; Payne, 1989; Razzaz, 1993; Varley, 1987; Riley, 2001). As Payne (1989, 44) puts it:

> perceived security of tenure is more critical in releasing investment for housing consolidation than legal status as such, and clearly the provision of public utilities is regarded by residents as strong evidence that they are officially accepted and enjoy de facto security tenure.

The perception of security is the key. Razzaz (1993, 349) argues that:

> empirical evidence points to a continuum of security in illegal settlements that depends less on the exact legal status and more on occupants' perceptions of the probability of eviction and demolition (enforcement), as well as the availability of services and passage of time.

In Guayaquil, Lanjouw and Levy (1998, 1) 'find the informal sources of property rights confer many of the same advantages as formal rights'. Even in the *barriadas* of Peru, legal tenure does not seem to be critical: 'Tenure matters, but for the average squatter with 10.4 years at a site, the chance of eviction around Lima was known to be low' (Strassmann, 1984, 747).

In settlements that are not threatened with removal, illegality seems to have little effect on the willingness of poor people to build (Varley, 1987; Skinner et al., 1987, 236). Riley (2001, 5) observes that in a *favela* close to Copacabana, 'illegality of tenure has not acted as a barrier to residents investing in their homes over time'. In the pirate urbanisation of Bogotá, security of tenure seems to be assumed from the start; settlers build homes as soon as they have receipts for their payments for plots of land. Most are prepared to build without titles to their land. Insofar as they have doubts, they are reassured when the authorities provide services to the settlements. Once water and electricity are available, there is no real barrier to self-help construction. Two- or three-storey buildings appear despite the absence of legal titles. Although there is no doubt that legalisation is sometimes necessary to provide assurance to particularly insecure settlers, the direction of causality if often reversed. Not infrequently, it is housing investment that brings out the granting of legal titles (Hirschman, 1984; Razzaz, 1993, 350).

Even where legal title has been granted, complementary measures are required to bring forth investment. Service provision has unleashed housing investment in Cartagena and Medellin (Columbia), Lima, Lusaka, Nairobi, Rawalpindi and Tunis (Strassmann, 1984, 751).

DOES LEGAL TITLING IMPROVE THE FUNCTIONING OF THE HOUSING MARKET?

According to de Soto (2000, 47), 'any asset whose economic and social aspects are not fixed in a formal property system is extremely hard to move in the market'. In my experience, this is simply wrong. In Latin America, informal and illegal markets function effectively for a wide range of products, including invaded land, contraband imports, stolen goods and drugs. Illegality rarely stops a market developing; it merely affects the prices in that market. In the case of drugs, illegality increases the transaction price; in the case of low-income land, it reduces it.

In Bogotá, an active market for plots of land exists despite the lack of legal titles, and similar markets have developed in most poor countries. In Mexico, *ejido* land is sold despite the threat of legal sanctions (Azuela, 1989; Gilbert and Ward, 1985; Varley, 1987). Even in settlements founded by invasions, land transactions occur. In Valencia (Venezuela), for example, most of the inhabitants of two invasion settlements had bought into the settlement: 23 per cent of the total settlers had bought a house, 32 per cent had bought a plot with a shack, and 11 per cent had bought an empty plot (Gilbert and Healey, 1985, 122).

In his customarily contradictory way, de Soto recognises this fact. Why is a formal property title so important? Because with 'no property to lose', sellers 'are taken seriously as contracting parties only by their immediate family and neighbours. People with nothing to lose are trapped in the grubby basement of the precapitalist world' (de Soto, 2000, 56). They can buy and sell, but only at reduced prices. Despite these low prices, 'the total value of the real estate held but not

legally owned by the poor of the Third World and former communist nations in at least US$8.3 trillion' (2000, 35).[1] If a property market of such importance already exists, what is the point of title deeds?

[...]

Despite poor home-owners possessing the title deeds, the self-help housing market is extremely flat and possibly dead. This is true even in cities in which land and housing markets are very buoyant in high-income or commercial areas. You cannot accumulate capital if there is no market in which to trade your asset. If title deeds are not the problem, what is?

DO LEGAL TITLES IMPROVE POOR PEOPLES' ACCESS TO FORMAL FINANCE?

The sale of property in self-help settlements is quite common, even when the 'owners' do not have legal titles and have 'stolen' the land. The problem with the self-help settlements is not the lack of a market, but its limits. Many people buy and sell plots of land, shacks and even two-room houses. However, it is uncommon to find sale of two- or three-storey homes. You don't need much money to buy a shack, but you need a lot to buy a well-constructed house. In the low-income areas of Bogotá, owners of such homes were asking between US$20,000 and US$50,000 in the summer of 1997. There were few sales because no one could afford to buy them. Self-help home-owners can sell quality homes only with great difficulty, and/or at a very low price (Gilbert, 1999).

According to de Soto, the possession of legal title would remove this problem by unleashing a flood of formal financing. Support for this belief comes from experience in the US, where 'the single most important source of funds for new businesses ... is a mortgage on the entrepreneur's house' (de Soto, 2000, 6). Banks will lend to the poor in these circumstances because the property title may be used as a security against the loan, and the banks have something that they can repossess in the case of default. Lanjouw and Levy (1998, 45) agree: 'just as transfer uncertainty limits a household's ability to sell its property, it limits a bank's ability to repossess property, lowering the value of property as a collateral asset'.

Bankers and Slums

My evidence from Bogotá, fully supported by studies from other parts of the worlds, suggests that the possession of a legal title makes little or no difference to the availability of formal finance. In Turkey, Ozuekren (1998, 11) recognises that 'there are very few opportunities for households to obtain home-owner loans from financing institutions'. Mexico's 'sophisticated housing finance system' also has a poor track record in terms of progressive options and community-based finance (Siembieda and López Moerno, 1998, 22), and experience in recent years in South Africa has been very similar (Bond and Tait, 1997; Goodlad, 1996; Tomlinson, 1998). Even the

World Bank and the IADB recognise how difficult it is to reach poor families (Rojas, 1995; World Bank, 1993, 121). Government efforts to lend to the poor have often proved an embarrassing failure; most of the funds end up in the hands of middle-income groups or favoured labour groups (Bhattacharya, 1990; Daniere, 1999; Laun, 1976; Persaud, 1992; Rakodi, 1995; Struyk, 1989; Datta and Jones, 1998). Formal financial systems face various difficulties in reaching the poor:

> Regulations governing mortgage lending are usually biased towards completed owner-occupied housing, making it unattractive or impossible for financial institutions to lend for the purchase of rental or condominium housing, or for house improvements or unfinished core houses on serviced sites. (World Bank, 1993, 118)

> Individual freehold titles are the tenure solution favoured by many international agencies and national governments. However, even in situations in which they are the most appropriate option, they are unlikely to increase access to formal credit significantly, since it is low incomes that deter finance institutions from lending to the poor. (Balamir and Payne, 2001, 9)

Even when incomes are adequate, 'mortgage lenders have difficulty verifying self-employed income and developing an accurate estimate of self-employed income from analysis of tax returns' (Ferguson, 1999, 187). In Bogotá, few lending institutions have rules that can deal with independent workers. Lending procedures are based on the ability of potential borrowers to demonstrate that they have a regular income. Of course, few independent workers are able to do this. In addition, lenders lack confidence in the ability of poor people to repay their loans, and the final straw is the low profitability of lending to the poor (UNCHS, 1996, 370).

[...]

Micro-finance programmes have also failed to make much impression on the poor's need for housing finance (Almeyda, 1996). Micro-finance institutions have tended to follow the practice of Bangladesh's Grameen Bank, building up their lending portfolios on the basis of frequent small loans. This approach presents difficulties in the housing field, which requires much greater sums of money. Even when cooperatives are prepared to finance low-income housing, their programmes are severely limited by financial constraints and by their preference for funding housing construction (Avila, 1995, 26).[2] They do not provide loans for upgrading or for the purchase of used housing, and this seems to be a worldwide problem (Ferguson, 1999).

Do the Poor Want to Borrow?

If the banks are reluctant to lend to the poor, the latter seem reluctant to borrow. Among the recipients of housing subsidies in South Africa, those 'who said they did not want a mortgage loan outnumber those who did by three to one'

(Tomlinson, 1999, 1357). Perhaps, as the World Bank admits (2000, 74–5): 'Poor people are often discouraged and simply do not seek loans since they believe that they will be denied credit or will not be able to fulfil bank requirements'. However, this reluctance may be due primarily to anxiety about the consequences of failing to repay the loan. For very poor families, a loan is a burden that may endanger the whole household's financial viability. As Rogaly and Johnson (1997, 119) put it, lending 'can harm as well as enable poor people. Financial relationships, especially those of debt, are one way in which the powerlessness of groups of poor people is entrenched.' In Bogotá, few low-income families borrow against the title of their home, and lending agencies seem to be less convinced of the virtues of land title (Gilbert, 2000).

Most poor families build and improve their homes using personal savings and loans from informal sources (Boleat, 1985; Calderón, 2001; Renaud, 1987; World Bank, 1993; Macaloo, 1994; Napier, 1999; Ozuekren, 1998; UNCHS, 1996). These sources include:

> individual and group savings, windfalls, fabrication of their own building materials, sweat equity, small loans from neighbourhood money lenders, barter arrangements and communal self-help, and remittances from family living abroad. These funding sources share a common problem. They dribble in unevenly and, often, slowly because they remain unconnected to formal institutions and markets. The overall result is that much of the built environment in cities improves unevenly and slowly. (Ferguson, 1999, 189)

Ironically, the largest property loans made in Bogotá's low-income areas are those provided for the purchase of land. These are unsupported by any sort of collateral or property title, and are provided by illegal subdividers. Subdividers tend to sell plots on the basis of a down-payment of 10 per cent, the remainder being payable in monthly instalments over three or four years (Gilbert and Ward, 1985). In a survey in four older settlements that I conducted in 1997, most families that had occupied an empty plot received informal financing through an illegal subdivider. 33 buyers of empty plots participated in the survey, and very few had paid the full amount in cash. Of the 29 who provided details, 75 per cent paid an initial deposit and provided the rest of the sum in instalments. Of the remainder, only three had paid the whole sum in one payment.

[...]

In short, the largest loans in low-income settlements in Bogotá are received from illegal subdividers when there is no semblance of legal title. When families have acquired title deeds they borrow little or nothing through formal financial institutions. Their sources of credit would be much the same without title deeds.

[...]

CONCLUSION

Most poor urban families are glad to receive title deeds. This explains why so many governments have taken up this housing option. No doubt governments are also attracted to this approach because it is cheap, particularly when the poor are prepared to pay the costs or will start to pay property taxes as soon as they receive their deeds.

I do not believe that title deeds hold many dangers for poor families. There is unlikely to be much downward-raiding and, even if there was, some poor families would appreciate being given the opportunity to make capital gains. In Africa, parts of Asia and the Latin American countryside, the situation may be different, particularly when customary rights are overridden by a new commercial logic. However, in most cities title deeds cannot do a great deal of harm beyond accelerating the introduction of taxes on land and housing in poor settlements.

However, I am worried about the rhetoric of Hernando de Soto and his advocacy of the supposed advantages of legalisation. In Bogotá's self-help settlements, property titles have not resulted in a healthy housing market or a regular supply of formal credit. The uncomfortable truth is that, in practice, the granting of legal title has made very little difference.

If this is so, why should we worry about de Soto? He is dangerous because he is conjuring up a myth about popular capitalism. He is encouraging the delusion that anyone, anywhere, can become a fully fledged capitalist. Although he offers little or no empirical evidence in support of this assertion, that has not stopped Washington from rallying to his call. The danger is that his views will persuade policy makers that all they have to do is offer title deeds, and that they can leave the market to do everything else–providing services and infrastructure, offering formal credit and administering the booming property market. In the process, every householder will be able to own his or her own home and even make money from it.

It is my belief that, even in the unlikely event of a flourishing property market, there is little reason to believe that the poor will be major beneficiaries. Successful estate agents always claim that the secret of high property values in 'location, location, location'. The consolidation self-help settlements of the poor are rarely thought of as desirable locations. The promise of property wealth is as mythical to them as it is to the low-income families of the US (Edel et al., 1984; Rohe et al., 2000). Those who make money from property are likely to be drawn mainly from the ranks of the middle class; those who make the real money tend to be affluent already.

Thus, without wishing to deny the advantages that the poor can derive from home-ownership in a self-help suburb, de Soto's argument is dangerously flawed. Had anyone else proposed the same argument, it might have been better to ignore it. However, because de Soto is a big name, his message will be taken up by some powerful people. As such, the argument needs to be shown up for what it is. Instead of offering an answer to the mystery of capital, he is in danger of generating a myth about capitalism based on a populist dream.

NOTES

1. How does de Soto know that property is worth so much? Because it is easy to work out the real estate value of informal property: 'You can ascertain [its] value simply by surveying the cost of the building materials and observing the selling prices of comparable buildings' (de Soto, 2000, 31).
2. In Bogotá, institutions such as FENAVIP (National Federation of Popular Housing), SERVIVIENDA, Association for Popular Housing (AVP), Compartir and FEDEVIVIENDA operate in the housing field and were responsible for the production of around 30,000 housing units between 1990 and 1996 (Vejarano-Alvarado, 1997).

POSTSCRIPT

The premise that provision of capital is an important part of stimulating the latent entrepreneurial spirit of the poor in developing nations has become reigning wisdom among most development agencies. In addition to the land titling programs championed by Hernando de Soto, several initiatives have been designed to provide stimulus capital to the masses. Perhaps the highest profile of these has been the micro-credit scheme pioneered by Nobel Peace Prize winner Muhammed Yunus at the Grameen Bank in Bangladesh. The provision of small-scale loans to the poor for the development of entrepreneurial projects is widely held to be one of the most effective approaches to stimulating development and self-sufficiency. Given the massive popularity of the model, other programs aimed at putting capital to work in developing areas seem likely to come in the future.

Several scholars listed in the Suggested Additional Readings have engaged in studying the effects of land titling on development in the Third World. For the most part, their findings have been positive or neutral. Yet the land titling programs and expansion of capital availability for the use of the poor relies as much upon the security and stability of a society as any other major development strategy. It remains difficult if not impossible to create modern capitalist systems in countries beset by civil war or widespread internal conflict. Further, many countries remain affected by the political demands of patronage and clientelism that hinder widespread changes to land titling and reform. If anything, land titling is not a unique "magic bullet" to achieve higher levels of development so much as one of many tools that might be used.

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Lanjouw, Jean O., and Philip Levy. "A Difficult Question in Deed: A Cost-Benefit Framework for Titling Programs," *William and Mary Law Review*, 45, no. 3 (February 2004): 889–951.

Ondetti, Gabriel. "Landing Votes: Representation and Land Reform in Latin America," *Political Science Quarterly*, 120, no. 3 (Fall 2005): 544–545.

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"land tenure," "informal economy," or "mystery of capital" in the keyword search.

Web Resources

The Institute for Liberty and Democracy

www.ild.org.pe

Since 1981, Hernando de Soto's research team has been researching the informal economy and the challenges of achieving legal status in developing countries. This research team has developed into the Institute for Liberty and Democracy.

The World Economic Forum

www.weforum.org

The World Economic Forum is a Swiss-based non-profit organization that brings together leaders in corporate, charitable, and governmental capacities to discuss the problems of economic development. Under the motto of "entrepreneurship in the global public interest," it seeks business-friendly solutions to problems of world development.

Center for Global Liberty and Prosperity

www.cato.org/economicliberty

The Cato Institute provides pro-market liberal policy solutions to a wide array of policy areas. Its Center for Global Liberty and Prosperity provides resources aimed at the expansion of liberal market-friendly solutions in the developing world.

Issue 7

Do Current World Bank and IMF Lending and Aid Models Alleviate Poverty?

✔ **YES**

BRIAN AMES, WARD BROWN, SHANTA DEVARAJAN, AND ALEJANDRO IZQUIERDO, *Macroeconomic Policy and Poverty Reduction.* Prepared by the International Monetary Fund and World Bank, August 2001

✘ **NO**

ADAM DAVIDSON-HARDEN, "An 'Empty Glass': How the Bretton Woods Institutions Sustain and Exacerbate Poverty"

In the 1990s, major international lending agencies began a fundamental re-examination of how grants and loans are delivered, particularly to the poorest of the developing countries. The impetus for this review was the ongoing criticism of the lending policies of the International Monetary Fund (IMF) and the World Bank undertaken within the framework of their "structural adjustment programs" (SAPs), which many argued had failed to adequately address the needs of the poorest populations. Evaluation of the SAPs had shown that they had produced only limited results in terms of promoting sustained growth of the economy, while poverty and social inequalities often increased as a result of their implementation. Critics suggested that there needed to be greater attention to social reforms that made a more coherent linkage between macroeconomic, structural changes, and more equitable social policies. In addition, studies had shown that the conventional poverty reduction strategies pursued by many development countries have produced disappointing results because of their failure to adequately engage civil society actors and allow for more participatory forms of governance.

As a result of these discussions, in 1999 the World Bank and IMF adopted a new set of policies and procedures to guide their lending to developing countries. This approach, known as the Poverty Reduction Strategy Paper (PRSP), set out a process that very poor countries would need to follow in order to access any of the concessionary lending facilities of either of the agencies, including debt relief under the Highly Indebted Poor Countries Initiative (HIPC). IMF and the Bank saw these changes as constituting a significant departure from their previous way of dealing with low-income countries.

According to the new procedures, each country wishing to receive assistance from the World Bank and IMF is expected to develop a Poverty Reduction Strategy Paper (PRSP). This document sets out a national strategy for integrating poverty

reduction into the macroeconomic policymaking of recipient governments. In preparing this document, the recipient government confers with a broad base of stakeholders in the civil society and private sectors in regards to the formulation, implementation, and monitoring of the PRSP. The hope is that this will give the recipient country a greater sense of ownership and legitimacy of the reforms measures that are agreed to. By fostering a stronger ownership of the strategy and participation among a broader range of stakeholders, it is hoped that a more successful and sustained implementation will occur than was the case for the previous Structural Adjustment Programs.

Proponents of the PRSP also contend that the new approach will enable a shift away from the SAP's top-down approach to a more bottom-up approach that would more successfully include the poor. In explaining the new approach, the World Bank argued that by increasing the voice and participation of the poor in decision-making, not only would the new poverty reduction policies be given more legitimacy, but also the popular input would actually improve the quality and the policies and services provided. Such popular participation would ensure that a stronger political basis for the pursuit a "pro-poor growth strategy" would be built.

Both the Bank and IMF have been careful to emphasize that they are not proposing a single template for a PRSP, a common criticism of the former SAP agreements. Rather, they suggest that each nation should develop its own unique PRSP around the following five core principles. Each PRSP must be:

- country-driven and owned, founded on broad-based participatory processes for formulation, implementation, and outcome-based monitoring;
- results-oriented, focusing on outcomes that would benefit the poor;
- comprehensive in scope, recognizing the multidimensional nature of the causes of poverty and measures to attack it;
- partnership-oriented, providing a basis for the active, coordinated participation of development partners (bilateral, multilateral, non-governmental) in supporting country strategies; and
- based on a medium- and long-term perspective for poverty reduction, recognizing that sustained poverty reduction cannot be achieved overnight.

Each recipient country is expected to take the lead in designing and implementing its own development strategies. A broad level of consultation and participation among civil society and private sectors is intended to ensure both a wide consensus on policies and a more effective integration of local values into the policy initiatives. A well prepared PRSP would lay out a plan to both reduce poverty and increase sustainable economic growth. Rather than just addressing macroeconomic and structural changes designed to produce economic growth, the PRSP would address improvement in participatory governance, sectoral policies for reducing poverty, and realistic and appropriate funding levels for social programs.

Both the World Bank and IMF claim that the PRSP approach represents a radical departure to their previous lending policies. In particular, they argue that the new approach demonstrates their sensitivity to criticism and ability to adapt to demands to make their programs more focused on poverty reduction and the fostering of popular participation.

But to what extent do the current lending policies represent a new and radical departure from the past? In the first reading, a group of economists from IMF and the World Bank set out the case for the new Poverty Reduction Strategy approach. In the second reading, Adam Davidson-Harden provides a careful reading and critique of this approach. He argues that elements of the neoliberal focus on economic growth, which typified the era of structural adjustment, still undergirds the new approach. As a result, he suggests that the PRSP should be seen as more of an effort at "rebranding" of old policies that have already been called into question rather than a radically new departure.

✔ YES

Macroeconomic Policy and Poverty Reduction

BRIAN AMES, WARD BROWN, SHANTA DEVARAJAN, AND ALEJANDRO IZQUIERDO

1. INTRODUCTION

Poverty is a multidimensional problem that goes beyond economics to include, among other things, social, political, and cultural issues (see Box 7.1). Therefore, solutions to poverty cannot be based exclusively on economic policies, but require a comprehensive set of well-coordinated measures. Indeed, this is the foundation for the rationale underlying comprehensive poverty reduction strategies. So why focus on macroeconomic issues? Because economic growth is the single most important factor influencing poverty, and macroeconomic stability is essential for high and sustainable rates of growth. Hence, macroeconomic stability should be a key component of any poverty reduction strategy.

Macroeconomic stability by itself, however, does not ensure high rates of economic growth. In most cases, sustained high rates of growth also depend upon key structural measures, such as regulatory reform, privatization, civil service reform, improved governance, trade liberalization, and banking sector reform, many of which are discussed at length in the *Poverty Reduction Strategy Sourcebook*, published by the World Bank. Moreover, growth alone is not sufficient for poverty reduction.

BOX 7.1

DEFINITION AND MEASUREMENT OF POVERTY

The World Bank's 2000 World Development Report defines poverty as an unacceptable deprivation in human well-being that can comprise both physiological and social deprivation. Physiological deprivation involves the non-fulfillment of basic material or biological needs, including inadequate nutrition, health, education, and shelter. A person can be considered poor if he or she is unable to secure the goods and services to meet these basic material needs. The concept of physiological deprivation is thus closely related to, but can extend beyond, low monetary income and consumption levels. Social deprivation widens the concept of deprivation to include risk, vulnerability, lack of autonomy, powerlessness, and lack of self-respect. Given that countries' definitions of deprivation often go beyond physiological deprivation and sometimes give greater weight to social deprivation, local populations (including poor communities) should be engaged in the dialogue that leads to the most appropriate definition of poverty in a country.

Growth associated with progressive distributional changes will have a greater impact on poverty than growth that leaves distribution unchanged. Hence, policies that improve the distribution of income and assets within a society, such as land tenure reform, pro-poor public expenditure, and measures to increase the poor's access to financial markets, will also form essential elements of a country's poverty reduction strategy.

To safeguard macroeconomic stability, the government budget, including the country's poverty reduction strategies, must be financed in a sustainable, noninflationary manner. The formulation and integration of a country's macroeconomic policy and poverty reduction strategy are iterative processes. Poverty reduction strategies need first to be articulated (i.e., objectives and policies specified), then costed, and finally financed within the overall budget in a noninflationary manner. The amount of finance, much of which will be on concessional terms, is, however, not necessarily fixed during this process: if credible poverty reduction strategies cannot be financed from available resources, World Bank and IMF staff should and will actively assist countries in their efforts to raise additional financial support from the donor community. Nonetheless, in situations where financing gaps remain, a country would have to revisit the intermediate objectives of their strategy and reexamine their priorities. Except in cases where macroeconomic imbalances are severe, there will usually be some scope for flexibility in setting short-term macroeconomic targets. However, the objective of macroeconomic stability should not be compromised.

2. THE LINKS BETWEEN MACROECONOMIC POLICY AND POVERTY REDUCTION: GROWTH MATTERS

Economic growth is the *single most important factor* influencing poverty. Numerous statistical studies have found a strong association between national per capita income and national poverty indicators, using both income and nonincome measures of poverty. One recent study consisting of 80 countries covering four decades found that, on average, the income of the bottom one-fifth of the population rose one-for-one with the overall growth of the economy as defined by per capita GDP (Dollar and Kraay, 2000). Moreover, the study found that the effect of growth on the income of the poor was on average no different in poor countries than in rich countries, that the poverty–growth relationship had not changed in recent years, and that policy-induced growth was as good for the poor as it was for the overall population. Another study that looked at 143 growth episodes also found that the "growth effect" dominated, with the "distribution effect" being important in only a minority of cases (White and Anderson, forthcoming). These studies, however, establish association, but not causation. In fact, the causality could well go the other way. In such cases, poverty reduction could in fact be necessary to implement stable macroeconomic policies or to achieve higher growth.

Studies show that capital accumulation by the private sector drives growth. Therefore, a key objective of a country's poverty reduction strategy should be to

establish conditions that facilitate private sector investment. No magic bullet can guarantee increased rates of private sector investment. Instead, in addition to a sustainable and stable set of macroeconomic policies, a country's poverty reduction policy agenda should, in most cases, extend across a variety of policy areas, including privatization, trade liberalization, banking and financial sector reforms, labor markets, the regulatory environment, and the judicial system. The agenda will certainly include increased and more efficient public investment in a country's health, education, and other priority social service sectors.

Macroeconomic Stability Is Necessary for Growth

Macroeconomic stability is the cornerstone of any successful effort to increase private sector development and economic growth. Cross-country regressions using a large sample of countries suggest that growth, investment, and productivity are positively correlated with macroeconomic stability (Easterly and Kraay, 1999). Although it is difficult to prove the direction of causation, these results confirm that *macroeconomic instability has generally been associated with poor growth performance*. Without macroeconomic stability, domestic and foreign investors will stay away and resources will be diverted elsewhere. In fact, econometric evidence of investment behavior indicates that in addition to conventional factors (i.e., past growth of economic activity, real interest rates, and private sector credit), private investment is significantly and negatively influenced by uncertainty and macroeconomic instability (see, for example, Ramey and Ramey, 1995).

[...]

Macroeconomic Instability Hurts the Poor

In addition to low (and sometimes even negative) growth rates, other aspects of macroeconomic instability can place a heavy burden on the poor. Inflation, for example, is a regressive and arbitrary tax, the burden of which is typically borne disproportionately by those in lower income brackets. The reason is twofold. First, the poor tend to hold most of their financial assets in the form of cash rather than in interest-bearing assets. Second, they are generally less able than are the better off to protect the real value of their incomes and assets from inflation. In consequence, price jumps generally erode the real wages and assets of the poor more than those of the non-poor. Moreover, beyond certain thresholds, inflation also curbs output growth, an effect that will impact even those among the poor who infrequently use money for economic transactions. In addition, low output growth that is typically associated with instability can have a longer-term impact on poverty (a phenomenon known as "hysteresis"). This phenomenon typically operates through shocks to the human capital of the poor. In Africa, for instance, there is evidence that children from poor families drop out of school during crises. Similarly, studies for Latin American countries suggest that adverse terms-of-trade shocks explain part of the decline of schooling attainment (see, for example, Behrman, Duryea, and Szeleky, 1999).

Composition and Distribution of Growth Also Matter

Although economic growth is the engine of poverty reduction, it works more effectively in some situations than in others. Two key factors that appear to determine the impact of growth on poverty are the *distributional patterns* and the *sectoral composition* of growth.

If the benefits of growth are translated into poverty reduction through the existing distribution of income, then more equal societies will be *more efficient transformers of growth into poverty reduction.* A number of empirical studies have found that the responsiveness of income poverty to growth increases significantly as inequality is lowered. This is also supported by a recent cross-country study that found that the more equal the distribution of income in a country, the greater the impact of growth on the number of people in poverty (Ravallion, 1997). Others have suggested that greater equity comes at the expense of lower growth and that there is a trade-off between growth and equity when it comes to poverty reduction. A large number of recent empirical studies, however, have found that there is not necessarily such a trade-off and that equity in its various dimensions is growth enhancing.

The *sectoral composition* of growth can determine the impact that growth will have on poverty. Conventional wisdom has been that growth in sectors of the economy where the poor are concentrated will have a greater impact on reducing poverty than growth in other sectors—indeed, this is almost a tautology. For example, it is often argued that in countries where most of the poor live in rural areas, agricultural growth reduces poverty because it generates income for poor farmers and increases the demand for goods and services that can easily be produced by the poor. Various country-specific and cross-country studies have shown that growth in the agricultural and tertiary sectors has had a major effect on reducing poverty, while growth in manufacturing has not. This reinforces the case for duty-free access to industrial country markets for agricultural exports from low-income countries. The links may be more complex over the long run, however. While faster growth in agriculture may address rural poverty in the short-term, reliance on agricultural activity may also intensify output variability, which, in turn, would contribute to increasing rather than decreasing poverty. A more diversified economy with a vibrant manufacturing sector might offer the best chances for a sustainable improvement in living standards in the long run.

What are the implications of these empirical findings for macroeconomic policy? First, in light of the importance of growth for poverty reduction, and of macroeconomic stability for growth, the broad objective of macroeconomic policy should be the establishment, or strengthening, of macroeconomic stability. Policymakers should therefore define a set of attainable macroeconomic targets (i.e., growth, inflation, external debt, and net international reserves) with the objective of maintaining macroeconomic stability, and pursue macroeconomic policies (fiscal, monetary, and exchange rate) consistent with those targets. In cases where macroeconomic imbalances are less severe, a range of possible targets may be consistent with the objective of stabilization. Precise targets can then be set within that range, in accordance with the goals and priorities in the country's poverty reduction strategy (see the section on fiscal policy later in this [essay]).

Second, most developing countries will likely have substantial scope for enhancing the quality of growth, that is, the degree to which the poor share in the fruits of such growth, through policies aimed at improving income distribution. These policies (e.g., land tenure reform, changes in marginal and average tax rates, increases in pro-poor social spending, etc.) often are politically charged, and usually require supporting structural and governance reforms that would empower the poor to demand resources and/or ensure that resources intended for them are not diverted to other groups of the population. As these topics pertain more broadly to political economy, rather than exclusively to macroeconomics, they are beyond the scope of this [essay]. But they reinforce the point that economic growth alone is not sufficient for poverty reduction and that complementary redistributional policies may be needed to ensure that the poor benefit from growth.

Finally, while issues regarding the composition of growth also go beyond strict macroeconomics, several general policy observations can be made. There is a general consensus that policies that introduce distortions in order to influence growth in a particular sector can hamper overall growth. The industrial policies pursued by many African developing countries in the 1960s have long been discredited (World Bank, 1982). Instead, strategies for sector specific growth should focus on removing distortions that impede growth in a particular sector. In addition, policymakers should implement policies that will empower the poor and create the conditions that would permit them to move into new as well as existing areas of opportunity, thereby allowing them to better share in the fruits of economic growth. The objectives of such policies should include creating a stable environment and level playing field conducive to private sector investment and broad-based economic growth; removing the cultural, social, and economic constraints that prevent the poor from making full use of their existing asset base and accessing markets; and increasing the human capital base of the poor through the provision of basic health and education services. Using these policies, and the redistributive policies described above, policymakers can target "pro-poor" growth—that is, they can attempt to maximize the beneficial impact of sustained economic growth on poverty reduction.

[...]

Sources of Instability

There are two main sources of economic instability, namely exogenous shocks and inappropriate policies. Exogenous shocks (e.g., terms of trade shocks, natural disasters, reversals in capital flows, etc.) can throw an economy into disequilibrium and require compensatory action. For example, many low income countries have a narrow export base, often centered on one or two key commodities. Shocks

to the world price of these commodities can therefore have a strong impact on the country's income. Even diversified economies, however, are routinely hit by exogenous shocks, although, reflecting their greater diversification, shocks usually need to be particularly large or long-lasting to destabilize such an economy. Alternatively, a disequilibrium can be "self-induced" by poor macroeconomic management. For example, an excessively loose fiscal stance can increase aggregate demand for goods and services, which places pressure on the country's external balance of payments as well as on the domestic price level. At times, economic crises are the result of both external shocks and poor management.

Stabilization

In most cases, addressing instability (i.e., stabilization) will require policy *adjustment*; whereby a government introduces new measures (possibly combined with new policy targets) in response to the change in circumstances. Adjustment will typically be necessary if the source of instability is a permanent (i.e., systemic) external shock or the result of earlier, inappropriate macroeconomic policies. However, if the source of instability can be clearly identified as a temporary shock (e.g., a one-time event) then it may be appropriate for a country to accommodate it. Identifying whether a particular shock is temporary or is likely to persist is easier said than done. Since there is often a considerable degree of uncertainty surrounding such a judgment, it is usually wise to err somewhat on the side of caution by assuming that the shock will largely persist and by basing the corresponding policy response on the appropriate adjustment.

In most circumstances where adjustment is necessary, both monetary (or exchange rate) and fiscal instruments will have to be used. In particular, successful adjustment to a permanent unfavorable shock that worsens the balance of payments will often require a sustained tightening of the fiscal stance, as this is the most immediate and effective way to increase domestic savings and to reduce domestic demand—two objectives typically at the center of stabilization programs.

Adjustment policies may contribute to a temporary contraction of economic activity, but this contingency should not be used to argue against implementing adjustment policies altogether, as the alternative may be worse. Attempting to sustain aggregate demand through unsustainable policies will almost certainly aggravate the long-run cost of a shock, and could even fail in the short run to the extent that it undermines confidence. In the long run, greater benefits to the poor are to be had as a result of the restoration of macroeconomic stability. The appropriate policies to protect the poor during adjustment are to maintain, or even increase, social expenditures and to adopt, where feasible, compensatory measures that would insulate or offset temporary adverse impacts to the fullest extent possible. This is best done by devoting resources to the establishment of effective social safety nets, as an enduring part of a country's poverty reduction strategy, rather than as a response to crisis. Countries that lack such resources/safety nets could be forced to either subject their poor to the short-term adverse effects of stabilization or to delay the pace with which macroeconomic adjustment proceeds (and put off the corresponding long-term benefits to economic growth and poverty reduction).

Countries in macroeconomic crisis typically have little choice but to stabilize quickly, but for countries in the "gray" area of partial stability, finding the right pace may prove difficult. In some cases, a lack of financing will drive the pace of stabilization. Where financing is not a constraint, however, policymakers will need to assess and carefully weigh various factors on a case-by-case basis in choosing the most appropriate pace of stabilization.

Elements of Macroeconomic Stability

Macroeconomic policies influence and contribute to the attainment of rapid, sustainable economic growth aimed at poverty reduction in a variety of ways. By pursuing sound economic policies, policymakers send clear signals to the private sector. The extent to which policymakers are able to establish a *track record of policy implementation* will influence private sector confidence, which will, in turn, impact upon investment, economic growth, and poverty outcomes.

Prudent macroeconomic policies can result in *low and stable inflation.* Inflation hurts the poor by lowering growth and by redistributing real incomes and wealth to the detriment of those in society least able to defend their economic interests. High inflation can also introduce high volatility in relative prices and make investment a risky decision. Unless inflation starts at very high levels, rapid disinflation can also have short-run output costs, which need to be weighed against the costs of continuing inflation.

By moving toward *debt sustainability*, policymakers will help create the conditions for steady and continuous progress on growth and poverty reduction by removing uncertainty as to whether a government will be able to service new debt. By keeping domestic and external debt at levels that can be serviced in a sustainable manner without unduly squeezing nondebt expenditure, policymakers can also ensure that adequate domestic resources are available to finance essential social programs.

Inappropriate exchange rate policies distort the composition of growth by influencing the price of tradable versus nontradable goods. Household survey data for a number of countries indicate that the poor tend to consume higher amounts of nontradable goods while generating relatively more of their income from tradable goods (Sahn, Dorosh, and Younger, 1997). Hence, in addition to distorting trade and inhibiting growth, an overly appreciated exchange rate can impair the relative incomes and purchasing power of the poor.

By building and maintaining an *adequate level of net international reserves*, a country can weather a temporary shock without having to reduce essential pro-poor spending. External shocks can be particularly detrimental to the poor because they can lower real wages, increase unemployment, reduce nonlabor income, and

limit private and net government transfers. The level of "adequate" reserves depends on the choice of exchange rate regime.

[...]

Fiscal Policy

Fiscal policy can have a direct impact on the poor, both through the government's overall fiscal stance and through the distributional implications of tax policy and public spending. Structural fiscal reforms in budget and treasury management, public administration, governance, transparency, and accountability can also benefit the poor in terms of more efficient and better targeted use of public resources. As indicated above, there is no rigid, pre-determined limit on what would be an appropriate fiscal deficit. An assessment would need to be based on the particular circumstances facing the country, its medium-term macroeconomic outlook, and the scope for external budgetary assistance. The terms on which external assistance is available are also important. There is a strong case, for instance, for allowing higher grants to translate into higher spending and deficits, to the extent that those grants can reasonably be expected to continue in the future, and provided that the resources can be used effectively.

With regard to the composition of public expenditure, policymakers will need to assess not only the appropriateness of the proposed poverty reduction spending program, but also of planned nondiscretionary, and discretionary nonpriority, spending. In so doing, they will need to take into particular consideration the distributional and growth impact of spending in each area and place due emphasis on spending programs that are pro-poor (e.g., certain programs in health, education, and infrastructure) and on the efficient delivery of essential public services (e.g., public health, public education, social welfare, etc.). In examining these expenditures, policymakers should evaluate the extent to which government intervention in general, and public spending in particular, can be justified on grounds of market failure and/or redistribution.

Policymakers must also ask themselves whether the envisaged public goods or services can be delivered efficiently (e.g., targeted at the intended beneficiaries) and, if not, whether appropriate mechanisms and/or incentives can be put in place to ensure such efficient delivery. Countries should begin by assessing in a frank manner their administrative capacity at both the national and subnational levels to deliver well-targeted, essential public services in support of poverty reduction. In this regard, policymakers should consider the extent to which both technical assistance and the private sector can play a role in improving the delivery of these services.

In the context of medium-term budget planning, policymakers should consider the scope for reallocating existing government spending into priority areas and away from nonproductive spending, including areas where a rationale for public intervention does not exist. Operation and maintenance expenditure tied to capital spending should also be reviewed with a critical eye. The quality of public

expenditure could be assessed in the context of a public expenditure review with the assistance of multilateral and/or bilateral donors. Policymakers could then assess the new poverty reduction projects and activities that have been identified in the context of the poverty reduction strategy and integrate them into the preliminary spending program. In so doing, they should attempt to rank the poverty programs in order of relative importance in line with the country's social and economic priorities, the market failure/redistribution criteria identified above, and the country's absorptive capacity in the light of existing institutional and administrative constraints. If spending cuts are deemed necessary in the context of the integrated poverty reduction/macroeconomic framework, policymakers should refer back to the ranking of the spending program based on the relative importance and priority assigned to each activity.

A key aspect of any poverty reduction strategy will be an assessment of the impact of the present tax and nontax system on the poor. An important medium-term objective for many developing countries will be to raise domestic revenue levels with a view to providing additional revenue in support of their poverty reduction strategies. The existing revenue base should be reviewed relative to its capacity to provide for the poverty spending requirements from nonbank domestic financing. Revenues should be raised in as economically neutral a manner as possible, while taking into consideration equity concerns and administrative capacities.

In a developing country, taking account of allocational effects means that the tax system in particular should not attempt to affect savings and investment—experience indicates that aggregate savings and investment tend to be insensitive to taxes, with the result that the tax system typically only affects the allocation of those aggregates across alternative forms. As regards equity, the tax system should be assessed with respect to its direct and indirect impact on the poor. It is difficult to have a tax system that is both efficient and progressive, particularly in those countries without a well-developed tax administration. Therefore, governments should seek to determine a distribution of tax burdens seen as broadly fair rather than use the tax system to achieve a drastic income redistribution.

[...]

The scope for domestic budgetary financing will depend on a number of factors, including the sustainable rate of monetary growth, the credit requirements of the private sector, the relative productivity of public investment, and the desired target for net international reserves. Sacrificing low inflation (through faster monetary growth) to finance additional expenditure is generally not an effective means to reduce poverty because the poor are most vulnerable to price increases. At the same time, since private sector development stands at the center of any poverty reduction strategy, governments need to take into account the extent to which public sector borrowing "crowds out" the private sector's access to credit, thereby undermining the country's growth and inflation objectives. At times,

public sector borrowing can also "crowd in" private sector investment by putting in place critical infrastructure necessary for private enterprise to flourish. Given that at any point in time there is a finite amount of credit available in an economy, policymakers must therefore assess the relative productivity of public investment versus private investment and determine the amount of domestic budgetary financing that would be consistent with the need to maintain low inflation and support sustainable economic growth.

The amount and type of available external resources to finance the budget will vary depending on the particular circumstances facing the country. Countries that have access to external grants need to consider what amount is available and sustainable under the present circumstances. The same is true in the case of external debt, but policymakers also need to determine whether the terms on such borrowing are appropriate and whether the added debt burden is sustainable. To the extent that a country is benefiting from, or may benefit from, external debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative, net resource flows—flows that are predictable over the medium term—will be freed up to finance poverty-related budgetary expenditure. Domestic debt reduction could also represent a viable use of additional concessional foreign assistance, since it would both free up government resources to be directed at priority poverty expenditure, as well as free up additional domestic credit for use by the private sector.

There may be a limit to the amount of additional external financing that a country would deem to be appropriate, however. For example, there may be absorptive capacity constraints that could drive up domestic wages and prices, as well as appreciate the exchange rate and render the country's exports less competitive, thereby threatening both stability and growth. The extent of such pressures will depend on how much of the additional aid is spent on imports versus domestic nontraded goods and services. There may also be uncertainty regarding aid flows, especially over the medium term, as well as considerations regarding long-term dependency on external official aid. In the absence of medium-term commitments of aid, policymakers may therefore wish to be cautious in assuming what levels of assistance would be forthcoming in the future.

[...]

External Shocks and the Choice of Exchange Rate Regime The choice of exchange rate regime—fixed or flexible—depends crucially on the nature of the economic shocks that affect the economy, as well as the structural features of the economy, which may either mitigate or amplify these shocks. Choosing a fixed exchange rate regime when these underlying features of the economy are not supportive leaves a country more exposed to the possibility of an external crisis, which can result in the ultimate abandonment of the peg. In addition, shocks to output can have a strong impact on the poor. Since different exchange rate regimes have different insulating properties vis-à-vis certain types of shocks, choosing the regime that best insulates the economy will serve to moderate fluctuations in output, and thereby best serve the poor.

For example, if the predominant source of disturbance to an economy is shocks to the terms of trade, a flexible exchange rate regime may be best because the nominal exchange rate is free to adjust in response to the shock and bring the real exchange rate to its new equilibrium (see, for example, Devarajan and Rodrik, 1992). Alternatively, if domestic monetary shocks predominate, such as shocks to the demand for money, output may be best insulated by a fixed exchange rate that allows these shocks to be absorbed by fluctuations in international reserves. Of course, one of the challenges facing the policymaker is to identify which shocks are in fact predominant in a particular economy.

The structural features of the economy may also affect the impact a particular shock has on the economy, as well as the insulating properties of exchange rate regimes. For example, if an economy is characterized by a significant degree of nominal wage rigidity, wages will not fully adjust (at least in the short run) in response to small real shocks, and hence the effect of those shocks on output will be amplified. In these circumstances, even if domestic monetary shocks are important, a flexible exchange rate regime may well be preferable (in contrast to the conclusions above). Another important structural feature is the degree of an economy's openness. Typically the more open an economy is, the greater is its exposure to external shocks. This would argue generally in favor of a flexible exchange rate regime. However, if an open economy is sufficiently diversified (i.e., it trades a wide range of goods and services) and if its prices are sufficiently flexible, then a fixed exchange rate may be preferable because the volatility of flexible exchange rates may impede international trade, and thus lower external demand (although the evidence on this is mixed). In conclusion, these various pros and cons of fixed versus flexible exchange rate regimes need to be carefully assessed and weighed on a case-by-case basis—again, there is no universal "right answer."

Policies to Insulate the Poor Against Shocks

Given that the poor are adversely affected by macroeconomic shocks, what should governments do about it? The question can be divided into two parts: How should economic policy be designed to cushion the impact of shocks on the poor, in particular during times of crisis and/or adjustment? What specific policies can governments undertake to insulate the poor from the consequences of shocks by removing existing distortive policies?

Social Safety Nets Sound macroeconomic policies will help a country to reduce its exposure to macroeconomic shocks, but there is no cost-effective policy that will insure against *all* possible shocks. It is therefore crucial to have *social safety nets* in place to ensure that poor households are able to maintain minimum consumption levels and access to basic social services during periods of crisis. Social safety net measures are also necessary to protect the poor from shocks imposed on them during periods of economic reform and adjustment. Safety nets include public work programs, limited food subsidies, transfers to compensate for income

loss, social funds, fee waivers, and scholarships for essential services such as education and health. The specific mix of measures will depend on the particular characteristics of the poor and their vulnerability to shocks and should be well-targeted and designed in most cases to provide temporary support.

Equally important, the resources allocated to social safety nets should be protected during economic crises and/or adjustment, when fiscal tightening may be necessary. Governments should have budgetary guidelines approved by their legislatures that prioritize and protect poverty-related programs during periods of crisis and provide a clear course of action that ensures access of the poor to basic social services during periods of austerity (see Lustig, forthcoming). As will be discussed below, countercyclical fiscal policies can also ensure the availability of funds for financing safety nets during crises.

Another important factor to consider is that safety nets should already be operating before economies get hit by shocks so that they can be effective in times of distress (for a more detailed account, see World Bank, 2000). However, if a shock occurs before appropriate safety nets have been developed, then "second-best" social protection policies may be necessary. For instance, food subsidies have been found to be inefficient and often benefiting the non-poor, and most reform programs call for their reduction or even elimination. However, after a severe shock such as the 1997–98 East Asian financial crisis, when countries like Indonesia lacked comprehensive safety nets, existing food subsidies were probably the only means of preventing widespread malnutrition and starvation. In the context of a country's reform process, however, these subsidies should be replaced with better targeted and less distorting transfers to the poor.

[...]

Finally, and most important, governments can do a lot to reduce the pro-cyclical nature of their fiscal policies by saving rather than spending windfalls following positive shocks and ideally using those savings as a buffer for expenditures against negative shocks. A cautious approach would be for the government to "treat every favorable shock as temporary and every adverse one as permanent," although judgment would also depend on, among other things, the availability of financing (Little, and others, 1993). However, even this rule of thumb may not be enough. Governments need to find ways of "tying their hands" to resist the pressure to spend windfall revenues (Devarajan, 1999). For example, when the source of revenue is publicly owned, such as oil or other natural resource, it may be appropriate to save the windfall revenues abroad, with strict rules on how much of it can be repatriated. Countries such as Colombia, Chile, and Botswana have tried variants of this strategy, with benefits not just for overall macroeconomic management, but also for protecting the poor during adverse shocks, since saved funds during good times can be applied to financing of safety nets during crisis.

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An "Empty Glass": How the Bretton Woods Institutions Sustain and Exacerbate Poverty*

ADAM DAVIDSON-HARDEN

INTRODUCTION

As the international community continues in a project of seemingly earnest self-scrutiny concerning the feasibility of reaching the modest targets reflected in the Millennium Development Goals (MDGs)—the successor to earlier, failed benchmarks—citizens of both the global South and North remain the principal witnesses to the track record of the Bretton Woods Institutions (BWIs), the World Bank and International Monetary Fund (herein referred to as the Bank and Fund), in their stated intentions and associated efforts to alleviate global poverty. The outstanding question casting a long shadow on these institutions is whether the proverbial glass is seen as "half-full" or "half-empty" in this regard. With respect to the track record of these international financial institutions (IFIs) as arbiters of development finance and policy, culpability of the Bank and Fund for their failures in helping to address global poverty has been routinely dismissed along with promulgated visions of progress "around the next bend" or "over the next hill". With only that further commitment to initiatives of trade liberalization, privatization, or investment deregulation, it is argued by the BWIs that paradise is seemingly around the corner. Skeptics question both the earnestness and truthfulness of the Bank and Fund (as well as the northern economic and political powers behind them), however, and see these institutions' potential for development as an either nearly or completely "empty glass," to follow the saying.

In particular, the term "structural adjustment" stands as a damning icon for the destructive social impact and legacy of the BWIs in the global South. With increasing global recognition—including within the BWIs themselves—that structural adjustment policies have hurt rather than helped the world's poor, the turn of the 21st century has seen a momentous "re-branding" of the way the Bank and Fund seek to manage the odious debts of the global South and its beleaguered citizens. The term "poverty reduction" is now as ubiquitous as "structural adjustment" once was in the lexicon of the BWIs, and its use as a mantra to help legitimate and justify the current modus operandi of these institutions has been well established. Though ever-eager to take advantage of any meagre concessions in terms of debt relief and allowance for social policy shifts favouring investment in crucial social services such as health and education, both observers of and participants in the deliberately inclusive Poverty Reduction Strategy Paper (PRSP) processes in heavily indebted countries continue to grapple with a set of core conditions that act as an unalterable foundation for the Bank and Fund, rooted in

policies and economic ideologies of "free trade" or global economic integration, as well as financial liberalization, privatization, deregulation, and restrictive regimes for social spending (a policy recipe known to critics and proponents as economic neoliberalism, or colloquially, the "Washington Consensus"[1]). This set of prescriptions—known among insiders as "structural conditionalities" on loans and aid—remain consistent with the policy-based lending formulas stubbornly adhered to by the BWIs throughout the "era" of structural adjustment. This regime of conditionality, referred to as the "Washington Consensus," is very much alive and continues to act as a frustrating barrier toward effective models of human development. Through the ideological furtherance of unfair rules and systems of debt, aid, and trade, the Bank and Fund work to sustain and exacerbate global poverty, particularly in the countries that are most susceptible to imposed conditionalities. This article will briefly touch upon two essential characteristics of the BWIs' ideological framework, which, if unchanged, will continue to be responsible for the immiseration of a substantial portion of humanity into the 21st century. These are a) the proffering of false arguments concerning the state of global poverty and the role of the BWIs' preferred policies in alleviating it; and b) the ongoing entrenchment of market-based or "neoliberal" solutions for development as conditions for loans and aid within current BWI frameworks for "poverty reduction," in the context of an unfair global trade system.

COMING TO TERMS WITH THE NUMBERS ON POVERTY AND THE BWIs' CULPABILITY

The approach to development finance espoused by the BWIs remains rooted in essentially myopic approaches to measuring "success" with respect to outcomes related to poverty. Despite musings and discussions about more holistic measures, the Bank and Fund remain committed to more simplistic economic definitions of poverty as opposed to multidimensional and comprehensive interpretations. In addition, the principal criterion underlying all of the BWIs' methodology in evaluating poverty reduction programs remains the consideration of aggregate economic growth as a precondition for addressing poverty. Consequently, a standard set of macroeconomic adjustment policies are assumed to be the only means of achieving such growth by the BWIs, policies that themselves are contributors to poverty and inequality, as this article will endeavour to show. A principal paradox of this stubborn approach to development economics is evident in the fact that economic growth measures themselves are insufficient, indeed incapable, of constituting any valid measure of social or ecological progress, because of the simple fact that economic growth rates (whether measured through changes in Gross National [or Domestic] Income/Product) only take into account aggregate economic output. Indeed, this is their only purpose. However, inequality, poverty, or ecological degradation may all increase along with positive economic growth.[2] Measures of aggregate economic growth are at best an extremely limited means of measuring progress in development, and at worst, a completely misrepresentative tool for this goal, one continually taken for granted by the BWIs in current strategies and planning around policies for "poverty reduction".[3] Consequently, the piece by Bank and Fund authors included in this volume, "Macroeconomic Policy and Poverty Reduction,"[4] is an excellent example of how the discourse of the BWIs concerning poverty remains rooted in disingenuous arguments about the effectiveness of these institutions' policies in the global South.

Associated with an ongoing, drawn-out debate surrounding economic growth and its relationship to global poverty, a sharp, detailed, and comprehensive critique of the BWIs' proffered numbers and statistics suggesting a decline in global poverty rates has surfaced in recent years.[5] Through pointing out the fact that data used to calculate rates of poverty by the Bank and Fund are insufficient, inaccurate, and based on incommensurable sources and datasets, it has been suggested that the BWIs consistently obtain lower global poverty rates than could be expected from more effective, comprehensive, and comparable measurements. For instance, accepting an arbitrarily low international poverty line based on a crude figure of U.S. dollars per day, per capita income, Pogge and Reddy effectively argue that the purchasing power of those in poorer countries is erroneously conflated with that of citizens of richer countries by the Bank and Fund. One example of this error is evidenced by the necessity of the global poor to rely on purchases of basic necessities such as food and water to survive, whereas aggregate measures conflate more expensive commodities and services—which only the comparatively wealthy can afford—along with commodities necessary for survival, thus making poverty as measured by crude income seem less prevalent.[6] An alternative measure of poverty might focus, it is suggested, on attempts to measure for multiple dimensions through more qualitative rather than economic and purely quantitative tools. For instance, multidimensional conceptions of poverty can focus on levels of human deprivation seen through the lenses of lack of access to basic needs (shelter, food, water, health services, education, a clean environment), or lack of fulfillment of basic human "capabilities" (in terms of malnutrition, life expectancy, literacy rates, etc.).[7] Economistic conceptions of poverty preferred by the BWIs in the main focus myopically on inaccurate measures of income in dollars per day, per capita, and as such paint a much too optimistic appraisal of the state of global poverty today.[8] Still more accurate measures come from consultation with those affected by BWI programs and policies; one important example of such research will be discussed below.

Considering that the deficiency of the IFIs' predominant method of measuring poverty relates to essential dynamics of global inequality (for instance, in terms of purchasing power), it is perhaps unsurprising that other researchers have forcefully argued that the BWIs employ a related "glass mostly full" approach when it