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Feature Article

RELIEF FOR POOR NATIONS

David L. Lindauer and Akila Weerapana

Last July, President Bush traveled the few blocks from the White House at 1600 Pennsylvania Avenue to 1818 Pennsylvania Avenue, the headquarters of the World Bank. There he delivered an address on what poor nations need to achieve economic development. The president’s speech was short, about eighteen minutes long, and short on specifics. But the president’s address serves as the best articulation yet of the present administration’s policy on international economic development and on the obstacles poor nations face in achieving more rapid economic growth. Since September 11 these obstacles, and the role that the United States should play in helping countries overcome them, have become even more important. If the roots of the terrorism aimed at the United States, ultimately, are a lack of economic and political development abroad, then not only the welfare of the emerging economies, but also America’s national security, makes it essential to formulate an effective global development strategy for the 21st century.

In order to combat global poverty, President Bush stated that we must be guided by three great goals. First, “keep the peace and promote prosperity”; second, “ignite a new era of global economic growth through a world trading system that is dramatically more open and more free”; and third, “remove the huge obstacles to development: illiteracy, disease, unsustainable debt.” There is much of value in each of these goals. But it also is the case that some of the president’s recommendations fail to take account of decades of experience in trying to achieve economic development in poor nations. Ignoring these experiences suggests that despite the best of intentions development failures may be repeated once again. A closer look at the economics underlying the president’s three great goals is therefore in order.

It is hard to argue with the goal of peace and prosperity. World peace is valuable in its own right regardless of its impact on world poverty. Prosperity, similarly, is laudable. The president’s reference, actually, was to the prosperity of the rich nations of the world, which can serve, and has served, as an engine-of-growth for poorer countries. If not for the stellar performance of the US economy in the late 1990s, the Asian financial crisis easily might have been prolonged. US consumers, flush with cash from rising wages and a booming stock market, provided essential markets for Korean, Malaysian, and Thai exports and contributed to the economic rebound of those economies. In our hemisphere, a healthy US economy has been good for Chile and Mexico, while a looming US recession limits the prospects of recovery for the troubled economy of Argentina. Restoring First World economic prosperity is of great importance to the developing world, but will be a formidable challenge given the globally synchronized nature of the current economic contraction and the dampening effects of increased risks and uncertainties in the post-September 11 world.

In his speech, President Bush called for a “new strategic framework” that “addresses the threats of a new century such as cyber-terrorism, weapons of mass destruction, missiles in the hands of those for whom terror and blackmail are a very way of life.” Little did the president know last July how prescient these remarks would be. But even in the aftermath of the terrorist attacks on the World Trade Center and Pentagon, perhaps even because of them, we must not forget “the dirty little wars” that plague so much of Africa, that have wreaked havoc in the Balkans and that continue to destabilize nations in Latin America. It is these wars, the threats of the last century, that are an immediate barrier to any chance for economic
revival in the countries affected. A vision is needed both on how to handle the terrorist threat facing America and on ending the strife that daily consumes the lives and energy of so many poor nations.

The president’s second great goal concerns a world of freer trade. According to the president’s speech, the World Trade Organization initiating a new round of global trade negotiations and Congress giving the president “trade promotion authority” (a euphemism for preventing Congress from amending trade agreements negotiated by the executive branch) are the policy instruments that will result in a freer trading system and help the developing world’s poor climb out of their poverty. There is much to recommend the president’s strategy: no one doubts that outward-looking South Korea is infinitely more successful than inward-looking North Korea. But there are two problems with these prescriptions, first, can domestic political forces in the developed nations, that push for selective trade liberalization, be overcome; and, second, to what extent are trade and openness panaceas for growth and poverty alleviation in developing nations?

In its first ten months, the Bush administration supported some free trade initiatives, including opening US highways to Mexican trucking. But Treasury Secretary Paul O’Neill also has called for restrictions on global trade in steel and has endorsed anti-dumping petitions from American steel producers. These will limit, not encourage, steel exports from Brazil, Korea, Russia, and other middle-income producers. Steel is not the only domestic sector seeking protection from Third World imports. During the Clinton years everything from Chilean mushrooms to Chinese fireworks was hit with anti-dumping duties and there is no evidence that similar petitions will fare differently under the Bush administration. A freer trading environment to benefit poor nations should include the dismantling of US peanut and sugar TRQs (tariff-rate quotas), or removing any requirement that African garment exports must be made out of US-produced fabrics and yarn in order to enter quota and duty-free. The United States should overhaul legislation, dating as far back as the late eighteenth century, which continues to protect coastal shipping and minimizes trade in maritime services. But each of these US trade barriers has a powerful domestic lobby, strongly opposed to liberalization in its own sector, that will require the expenditure of the administration’s political capital to overcome.

The United States is not alone in needing to get its trading priorities in order. The European Union (EU) needs to dismantle, for example, its Common Agricultural Policy that heavily subsidizes Europe’s farmers. This policy simultaneously hurts Third World agricultural exports to the EU and floods developing nation markets with surplus EU farm products further dampening the demand for the developing nations’ own farm production. But a pro-poor nation approach to trade liberalization does not yet appear as a priority on the “North’s” trade agenda. Instead, if there is a new round of global trade negotiations, it is more likely to focus on intellectual property rights protections for rich nations than on dismantling First World trade barriers confronting Third World exports.

The second problem with the strategy on free trade and growth is that the link between the two may be far less than often assumed. No one doubts that exports played a huge role in the success of many economies. Less known is that the share of trade out of GDP (Gross Domestic Product) in Sub-Saharan Africa is roughly the same as the share in East Asia. In other words, relative to the size of their respective economies, slow-growing Africa exports and imports about the same amount as does fast-growing East Asia. Therefore, there must be more to economic growth than trade. Domestic policies matter too. Another key argument is that fast-growing Asian economies, whether China or Korea, Malaysia or Vietnam, may encourage exports but are far from embracing free trade and open markets.

For several decades, standing on a street corner in downtown Seoul one barely saw an imported car. It was not because Koreans were unable to afford automobiles. It was because imported cars, at times, faced taxes of close to 100 percent, including import duties, luxury taxes and other costly regulations discouraging purchase. At those prices, a Hyundai was a more than adequate substitute for a Ford, Toyota, or even a Mercedes. Korea and much of East Asia’s approach was to encourage exports and discourage imports of consumer goods—hardly textbook examples of free and open trade. This is not meant to endorse the East Asian strategy on trade, but it does suggest that the relationship between free trade, openness and economic development is not straightforward and an excessive focus on open-
ness may fail to produce desired growth outcomes.

The first two of Bush's three great goals, a prosperous peace and trade-driven economic growth, apply to developed as well as to developing countries. The third of the great goals, removing obstacles to economic development, outlines the Bush administration's specific vision for developing economies. In his speech, the president identified three major obstacles to economic development: illiteracy, disease and unsustainable debt.

On education, the few specifics that the president offered highlight similarities between his domestic and proposed international agenda on education: more resources, better teacher training and greater accountability. Increasing US and multilateral aid to hire and train more teachers will improve educational opportunities but the call to "tie support more directly to clear and measurable results" may be taking one page too many out of the domestic playbook. The efficacy of testing is controversial in the United States. Testing is supposed to provide information to governments and parents about alternative forms of schooling, whether the local public school, private schools, parochial schools, or charter schools. This information, in principle, could then be used by parents to pick the best place to send their children and by governments to allocate resources to the top-performing schools. In developing countries, the choice often is different: education at the local government school or sending a child to work. It is not clear what testing, even if it were to be done in a meaningful manner, would reveal to policy makers or to parents in poor nations.

Only in the most corrupt settings will increased educational resources fail to improve educational opportunity. But the real concern should be on the best allocation of available funds to achieve economic development. Should bilateral donors and multilateral development agencies increase the share of their funding devoted to education? Is this the right priority? Is it in the best interest of poor nations to allocate more money to education versus to roads, telecommunications or other competing needs?

At first glance rapid economic growth in East Asia seems to provide all the evidence one needs to champion the essential role of education in economic development. A well-educated labor force fueled East Asian growth and helped support the transformation of Pacific Rim economies, first, out of agriculture and into industry, and then out of textiles and toys into consumer electronics and steel. But looking only at the cases of success provides a biased perspective. In 1970, on the eve of the East Asian miracle, several South American nations had more educated work forces but failed to experience more rapid development. Even within East Asia, school enrollment rates in the Philippines long have exceeded those in Thailand, but Thailand has had much more rapid growth and enjoys greater life expectancy than does the Philippines. Over the past quarter century some of the greatest relative gains in educational attainment have been realized in Africa, the world's poorest region. Starting from an admittedly low base, Africa has invested heavily in primary schooling. But in terms of economic growth and development there is virtually nothing to show for it.

The evidence does not tell us that education is unimportant to achieving economic development. But neither is education "a silver bullet." Investment in education like investment in physical capital can be wasted. In a bad environment, whether the result of bad policies or a poor geographical endowment, even an educated citizenry cannot guarantee increases in productivity. Most successful economies witness the first signs of modern economic growth in agriculture or in light manufacturing. Education can help but is not essential to these processes: more schooling, initially, is not required to raise farm output or work on a sewing machine. Once modern economic growth takes hold, families want better for their children and seek out schooling for their young. New skills then fuel the next round of economic and structural transformation. To claim that the process begins with education is a misreading of economic history and of the development process.

Influential economists, like Jeffrey Sachs of Harvard, have made a strong case that disease is a primary obstacle to economic growth in poor, tropical countries. Sachs has argued that developed countries have the moral obligation to provide resources for research on vaccines, treatments and other public goods to fight the diseases of the tropics. One could also argue that if not altruism, then self-interest should lead the advanced economies to devote considerable resources for combating infectious diseases because the latest strain of a deadly disease, whether Ebola, West Nile virus or AIDS is no more than a trans-oceanic flight away. AIDS and other deadly dis-
cases may have the potential to destabilize nations in both Africa and Asia, but viewing disease as a key obstacle to development is another misreading of the development record. Sub-Saharan Africa’s growth tragedy is twenty-five years in the making and predates even our awareness of HIV. Economists have identified a host of factors such as political instability, weak financial systems, large government deficits, and inadequate infrastructure that are associated with slow growth in Africa. In addition, the direction of causation between disease and growth remains suspect. Other nations have faced the challenge of disease, but more often than not economic growth came first and then came cures.

The final obstacle to economic development identified in the president’s speech is unsustainable debt. Many poor countries are struggling with levels of external debt that are unsustainable in that these countries are taking out new loans in order to make interest and principal payments on past loans. This is the area in which the president revealed the most dramatic of his proposals, calling for “up to 50% of the funds provided to the poorest countries [to] be provided as grants...”, a dramatic shift away from the current practice of development agencies providing concessionary loans towards a system of providing outright grants.

These ideas are not entirely new. The World Bank and the International Monetary Fund (IMF) are currently working with some of the worst affected countries under the HIPC (Highly Indebted Poor Countries) Initiative to help them emerge from under their debt burden. The goal of the program is to help reduce their foreign debts so that more funds can be utilized for poverty reduction and economic development. Under the HIPC initiative, the cost of rescheduling and partial forgiveness of existing debt is estimated at $30 billion. This indicates how much money has been thrown at the development problem in the past, and how much money needs to be spent in the future.

International agencies will not be able to afford implementation of a grant-based plan given current funding levels. Under a grant-based approach every dollar that is provided to developing countries has to come from a donor. In contrast, in a loan-based system money repaid by one group of borrowers can be reallocated to new borrowers. A simple back of the envelope calculation provides some understanding of the substantial cost differences between a loan versus a grant-based approach. Consider a $100 million contribution by the United States to the International Development Association (IDA), the arm of the World Bank that makes loans at very favorable interest rates. Under IDA’s standard loan conditions, this money will be lent out for 40 years at an interest rate of 0.75%, effectively a zero interest rate, long-term, concessionary loan. The loan is repaid in installments, following a ten-year grace period, of 2% of principal a year in years 1 through 20 and 4% of principal a year in years 21 through 40. Using the money that has been repaid over a 40-year period, IDA can make another $100 million more in loans. A rough present value calculation (assuming that a dollar today is worth 95 cents next year) shows that $100 million dollars repaid over forty years under IDA repayment terms is equivalent to about $50 million today. Moving to an effective grant-based system, therefore, would require about 30% more money upfront, which in turn requires that international assistance compete with domestic interests for a larger share of the budget. If the administration were to throw its weight behind such an expansion it surely would be welcomed by developing countries. But increasing defense needs and a faltering US economy suggest that spending priorities are bound to lie elsewhere.

Even if more donor money were allocated towards grants, it is by no means obvious that grants will achieve the intended purpose of furthering economic development. A quick glance at IDA lending terms and volume ($120 billion since 1960) reveals that both are extremely generous. Yet some countries seem to have trouble using the money effectively for poverty alleviation and paying back their loans. A perusal of the list of HIPC countries suggests a variety of potential explanations ranging from bad luck to mismanagement to misguided past lending for the high accumulation of debt with little or no results. One of the most important explanations for the mismanagement of these loans is “moral hazard” — the idea that well-intentioned protections against adverse outcomes can lead to behavioral changes that makes those adverse outcomes more likely to occur. In the context of aid, moral hazard would imply that once governments get their hands on the money, they have little incentive to spend it for the intended purpose of alleviating poverty, knowing that more money will be available from well-intended donors. As recently as 1997, prob-
blems associated with moral hazard were presented as a prominent explanation for the reckless lending and borrowing behavior of firms and banks in Thailand, Korea, and Indonesia that precipitated the East Asian currency crisis.

The World Bank and the IMF often attach stringent conditions to their loans in order to combat the problem of moral hazard. IDA's use of concessional loans instead of grants is a device for preventing moral hazard as much as it is a device for allocating more money towards development programs. By providing loans and requiring repayment, IDA, at least in principle, retains the ability to influence which unsuccessful economies are forgiven their loans (the ones who suffered bad luck) and which unsuccessful economies have to implement reforms for further assistance (the ones with bad policies). Moving to a system of grants means that the only leverage for combating moral hazard is the threat of losing future grants. If a grant-based system is to succeed, that threat has to be a more effective deterrent to irresponsible policymakers than the present threats, of denying access to future loans and refusing to renegotiate more concessionary terms. There is little evidence to support such a theory.

Grants undoubtedly are preferable to loans for countries that are suffering because of unexpected bad luck. A well-intentioned leader in such a country will be able to use the grants to implement vital poverty alleviation measures that have a high social benefit, without worrying about generating a return sufficient to pay back the loan. However, the history of development economics suggests that although there are many impoverished countries, few of them have well-intentioned leaders who are prevented from implementing development programs because of the need to pay back foreign debts. Even if such leaders do exist, donor nations and agencies have not always been able to ignore their own strategic interests and reward these nations with grants. If the president's plan to further economic development through grants that eliminate unsustainable debt is to be a success, it has to be supported in a variety of dimensions. What will be needed is more money, a greater willingness to combat the problem of moral hazard and a willingness to set aside strategic interests and reward good leaders without appealing to political ideology. This is a tall order and one even less likely to be filled as new alliances are formed in the global fight against terrorism.

Over fifty years ago, General George Marshall traveled to Harvard University and delivered a commencement address of twelve minutes, six minutes shorter than President Bush's address to the World Bank. Marshall's speech also was short on specifics but it paved the way for the Marshall Plan, which helped define America's strategy for the post-war economic recovery of Europe. Perhaps President Bush's speech is a harbinger for a similar plan by developed nations to help solve the vexing problems of economic development in poor nations in the 21st century. To transform such a vision into reality, the administration must substitute thoughtful analysis of the development record for platitudes about what makes nations grow.

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