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From Poverty to Prosperity: Free Market Based Solutions

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In Memory of Zoran M. Blagojević
1947–2007
One of the CLDS' founders

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Foreword

The monograph that follows is the result of an attempt to explore possibilities for a shift from poverty to prosperity and suggest public policies based on free market solutions for that shift. The findings that follow are products of years' long research by the Center for Liberal-Democratic Studies in the area of poverty and prosperity. They are firmly based on a strong belief in the invisible hand of the free market and the personal responsibility of the individual for his/her welfare and prosperity. Coming from a country that has experienced dramatic changes in setting up institutions and creating incentives for individuals in the last 20 years, the authors have gathered vivid, first hand experience about human reactions to changing incentives.

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1. Introduction

Poverty is practically endemic to human existence. During most of history, humans, with rare exceptions, suffered toil, deprivation and oppression. Most people lived in abject poverty, subsisting, with utmost effort, just above the biological and social minimum. They face malnutrition, living in decrepit and unsanitary dwellings, dressing in rags, suffering from all diseases, illiterate and ignorant, unsure of the future.

Economic and social progress is a recent phenomenon. Certain seeds had appeared earlier, but dramatic development commenced in western Europe only two centuries ago. It was those two centuries that brought not only the hope of a better life, but also a previously unknown level of prosperity to human society. Nowadays progress has spread to most of humanity, even to many areas where poverty is still prevalent today. Particularly encouraging is the rapid growth of China and India during the past decades, holding the possibility of freedom from destitution to one third of the World population. Nevertheless, many countries, particularly in Africa, continue to be very poor, with most of their population mired in extreme poverty. In other, more advanced countries there are also many poor citizens who are poor not only by the standards of the developed, but would also of undeveloped countries.

Definition of poverty. What is poverty, and how should we describe and define it? Who is actually poor? It is not surprising that there are a multitude of various, either competing or complementary, definitions of poverty. Let us proceed from the easier, extreme end: there is no doubt that the poor is the one who is frequently hungry, has no roof over his head, gets no help from the doctor when he/she is sick and his/her children are dying of infections, did not attend school and is illiterate, does not have a job or land, lives in fear from hand to mouth and is unable to change his situation. Such an individual has been considered poor in all periods and in all environments. However, are only these people poor? Could those who have a little more, who might have a bad roof over their heads and who are not usually hungry, although the provision of basic food presents a serious difficulty to them, also be poor? They certainly are. However, where is then the demarcation line between those who are poor and those who are not, which would help us assess the state of poverty in one country and the region, as well as among humanity in general? A clear boundary, unfortunately, does not exist, nor is there a universally accepted method for its determination. Differences in opinions arise both from different conceptual, even ideological views of the world and its values, and from technical reasons (purpose of demarcation, data (un)availability etc.).

Let us take a closer look. Poverty may be nicely defined in principle as the incomplete satisfaction of basic needs. Indeed, if someone is unable to satisfy even what is considered to be a basic need, he is certainly poor. However, this immediately raises two important and related questions: first, what needs are classified as basic needs for determining poverty and second, what measure can be used to measure the degree of success of satisfying those needs.

There is no doubt that basic needs include food, housing, clothing and footwear and basic hygiene. There is also no doubt that the group of basic needs also comprises basic health care and basic education because their effects are very broad and very positive, and a private market would not necessarily provide them to the desirable degree.

Things get complicated when some attempt to enlarge this list of fundamental socioeconomic qualities to include psychopolitical qualities such as deprivation, inclusion, protection against oppression, the right to vote, participation, as well as with a wide list of developed social rights from international human rights charters, characterising these all as basic components of poverty. Then the classical concept of poverty is somehow disregarded, with left-wing political activists and the United Nations system, as the main promoter of human rights approach to poverty, remaining on the field. The basic logic appears to be convincing: poverty represents a violation of individual human rights, so the state is obliged to eradicate that evil at all cost. In other words, an individual *has a right* to a decent standard of living and someone else is depriving him of that right if he is not provided the necessary standard of living. When something is taken as a human right, then its non-exercise is automatically pronounced to be a human rights violation, i.e. unacceptable and unbearable from a moral standpoint.[1]

We believe that the entire "human rights approach" to poverty is clever political marketing, whose noble cause is to appeal most efficiently to the morals of the people in the developed world to support more generously the fight against poverty in underdeveloped countries. These proponents seem to believe that the developed world is so rich that the eradication of poverty is an easily attainable goal only if there is good will to help the less fortunate.

There are multiple problems with this concept. First, it is open to question whether one person is obligated to provide a decent standard of living to another individual. This claim is certainly at odds with the fundamental economic principle of limited resources and the fact that everyone deserves their income from investing his/her own efforts and abilities, i.e. providing something to others in return. Second, such a system would probably stifle positive incentives and the urge of individuals to work and create, pointing them in the direction of a parasitic method of realizing income for themselves and their family at the expense of others, which, when it happens brings significant economic losses. This behaviour would represent a stark contrast to the modern market economy which owes its success precisely to the ability to stimulate individuals through a combination of investments and rewards to do their best and contribute not only to themselves, but also to all others. Third, the actual human rights approach to poverty is very inoperative and mostly does not go beyond declarative principles of the most general type. It is not known what actual or alleged human rights are part of the

1 Interestingly, the entire concept of the so-called positive socioeconomic rights was entered into the UN Charter on Fundamental Human Rights of 1948 at the insistence of the communist Soviet Union, which found in the adoption of these rights certain counterweight to the insistence of the Western countries on civil rights.

 concept of poverty, the contents of those rights are unknown, the measure of rights that must be fulfilled is unknown and it is not known who is responsible for their fulfilment. Can, for example, something really serious be done with social inclusion when it is not even known what that concept precisely denotes, although it sounds excellent to many? This approach is at great risk of remaining an analytically inefficient and morally empty model, at the same time being very popular in international organizations.[2]

In the rest of this study we shall observe the classical socioeconomic approach and avoid treating poverty as an issue to be political manipulated or exploited.

Poverty measurement. Measuring poverty certainly makes sense. It enables us to see the dimensions and understand the problem of poverty in one country or region. And it creates a basis for action towards poverty alleviation or eradication.

A proper poverty analysis can answer important questions on the number of the poor and depth of their poverty, on who is poor (according to the sex, age, region, type of household, education, work (in) activity etc.) and why they are poor (issue of level of capacity, property, number of children, (lack of)education etc.). Such an analysis can help us monitor the trends of poverty in time and compare it with other countries, and, in such a way, test the effects of certain economic and social policy measures on poverty and its characteristics and adjust (target) social policy measures in line with the observed character of poverty and characteristics of the poor.

In order to be able to measure the poverty of an individual or in a country, we need a general poverty indicator which will enable us to determine, through a comparison of the value of that indicator for an individual with that for the entire society, who is poor and to what extent. In other words, we need a quantitative measure that will separate the poor from the better off, preferably a very convincing measure, since otherwise – if no one believes our measure – the entire analysis will not make sense.

2 It is interesting to observe the behaviour of the World Bank, whose main task is the fight against poverty in the world. It is attempting to make a compromise between the declarative support to human rights approach and essential preservation of the standard socioeconomic approach. See: World Bank (2000).

There are two common types of measures for determining poverty. One is the line of absolute and the other the line of relative poverty. In the first, the level of satisfaction of various needs of an individual or in a household is analyzed, whereas in the second anyone whose income is below the predetermined income threshold, expressed as a ratio with the average or median income of all individuals in the society, is deemed poor.

Let us take a more detailed look. *The absolute poverty concept* proceeds from a rational idea that poverty denotes a low level of possession of goods and services by an individual, so low that it fails to satisfy the basic needs. Therefore, anyone who fails to reach the poverty line – an objective criterion – is indeed poor.

Obviously, there is no doubt that there are various indicators which, in principle, not only well represent poverty (that there is a high correlation between those indicators with poverty), but are an expression of poverty themselves. They can be the basic ones, such as food, housing, clothing and footwear etc., but also many others, such as basic hygiene items, basic cultural activities, school textbooks or medicines. It is usually deemed that they should be included in the analysis, since the poor also have the need to satisfy their basic social and cultural needs and activities. Naturally, there are also needs which are considered to be of higher degree (luxury needs) and should not be included in the set of basic needs to be satisfied. For example, the need to own expensive art work or to consume alcohol and tobacco certainly does not belong to basic needs and will not be included in our measurement system.

The difficulty in analyzing poverty with a large number of indicators lies in the need to aggregate them into one synthetic indicator for the comparison to make sense, since they cannot be added or compared in this physical form. For example how can two thousand calories a day and a shirt be added? To avoid an analytical problem at this point, we shall find a common denominator for all of them which is fairly accessible: their monetary value. It enables us not only to aggregate different indicators into one, but it also facilitates operations with the poverty line, counting the poor and calculating the depth of their poverty.

We have selected the indicator: it is individual consumption, i.e. consumption of the household. Not the entire consumption, because some possible expenses are not recognized and because some cannot be estimated easily or at all in practical work.

The basic source of data for poverty analysis are household budget surveys, conducted at the level of certain countries. The World Bank is particularly active in these surveys, both in methodological work, developing the so-called *Living Standard and Measurement Survey* (LSMS) and contributing to the resolution of various technical issues, and in the organization and financing of practical surveys in many poor and middle-income countries.

Missing still is the poverty line. It must be admitted that it is always ultimately arbitrary, since there is no objective methodology for its determination. Despite this essential subjectivity, the problem can be reduced by using certain auxiliary objective techniques, such as the use of technical standards and econometric methods. For example, regarding food it is possible to proceed from nutritionist standards of healthy diet (necessary number of calories, necessary vitamins, minerals and protein) and translate them into necessary costs of reaching those standards. The habits of the poorer sections of the population in the consumption of other (non-food) goods should also be taken into account, then making a regression based on the existing consumption structure of the poorest, for example, quintile (fifth) of the population. Or for housing: the minimum space necessary for a household member can be assessed, while it is certainly clear that those standards cannot be completely objective. And so forth, with convenient methods being used for lesser items, e.g., for cultural and similar activities, a reasonable rate is taken relative to food costs.

Naturally, there are a number of technical complications that arise. For example, by how much do household costs increase if another member is added? The addition of this member is likely to reduce average costs per member, i.e. the costs for the second member are likely to be lower since some are fixed and do not increase with the number of members (for example, one newspaper or one TV set is sufficient), but again, by how much? Does the sex or age of this additional member make a difference? These are issues of the so-called equivalence scale. Or, what prices are used? Are they equal for the whole country and for urban and rural areas? There is no doubt that the use of uniform prices for the entire country introduces a mistake. Or, how to provide international comparability, as price systems, consumption structures and many other things vary from one country to another, making comparisons difficult?

Thus, when these and similar difficulties of determining the poverty line are finally resolved, admittedly in an imperfect manner, and imperfect data on current household consumption in one country are collected, we are ready for poverty analysis. Or, are we really? Questions again spring up. Is consumption a good indicator? Would it not be better to measure poverty by income since it speaks more directly about how individuals and their households are doing in economic life, while consumption is a result of not only the income, but also of different transfers, from government to private (from cousins, friends, local community, etc.), and it can be financed from individual savings or wealth reduction. While there are arguments in favour of selecting income as a poverty indicator, there are also problems with that method. The basic problem is that, according to experience, respondents' answers on their income are always less reliable than about consumption; many are probably uncertain that the data given to the enumerator will not end up with the tax service, so they somewhat underreport income. The result usually obtained is that, at the sample level, consumption is significantly larger than income, which is not a reasonable result.

Such difficulties in attempting to establish an objective poverty line seem to suggest that perhaps we should rely on a completely subjective approach: we simply ask people how much money they need to satisfy their basic needs and take the average of their statements, adjusted by household demographics, for the poverty line. While this is a significantly easier method of establishing a poverty line, also it has a serious shortcoming: its poverty lines are unrealistically high, so the percentage of the poor is extremely high. It is obvious that when answering this question, people do not really proceed from truly minimum basic needs at the poverty line, but from the consumption level they perceive as necessary for a life befitting people of their status and life expectations.

Instead of the absolute poverty line and absolute poverty derived from it, in some countries a *relative poverty line* is used, thus obtaining relative poverty analysis. The idea is to determine a population segment by income or consumption and pronounce it to be poor, without attempting to establish a poverty line objectively. For example, in European countries all those whose income is below one half of median income are frequently assumed to be poor.[3] This poverty line is very convenient for targeting social policy programs towards the poor section of the society, but is less informative about the actual number of the poor. It, in fact, presents a measure of inequality in income distribution rather than a proper poverty line. Namely, the number of the 'poor', according to this method, does not depend on the average income or consumption on the level of satisfaction of needs or subjective feeling, but on the curvature of the income distribution line in the given country: the greater the inequality, the more poor there are; if there is little inequality, there may be no poor.

The problem with this method of poverty measurement lies in the fact that the number of the poor does not depend at all on economic development: the given country may develop at exceptional growth rates and the income of the 'poor' may increase at the same rates, but their number will remain unchanged. On the other hand, in another country the number of the poor may be reduced even if there is no economic growth, but there is a reduction of inequality through redistributive actions. Indeed, despite economic development, the percentage of the poor remains unchanged in the European countries, since there are no greater changes in income distribution inequality. And the measure of poverty which is highly sensitive to income distribution inequality and completely insensitive to the income level and dynamics of both the poor and the entire society is not a good measure.

By this we have touched upon another issue as well: how the poverty line and the number of the poor change in a country during its economic development. Shall we keep the line at the same level and cause the number of the poor to decrease inevitably over time, or increase the line more or less in accordance with income and maintain an equal number of the poor. We have

3 The median value is not the average. Whereas the average is calculated as a sum of all incomes of individuals (households) in the country divided by the number of individuals (households), the median value is the income of the household that has the middle ordinal number when individuals (households) are ranked by income level. The income median value is always lower than the average.

mentioned in the previous paragraph that we believe the latter to be bad. However, preserving one absolute poverty line over many decades, as the USA does, is probably not a good strategy either: because it is natural that the contents of the notion of poverty change at least to a certain extent along with development, or that a basket of goods and services that are considered as basic needs is supplemented either with new products or with the quantity of the old ones as the income increases and the country becomes richer. In other words, it is hard to believe that it is good to have the same poverty line for a poor country and a rich country.

Where does poverty come from? The most fundamental question about poverty has always been who or what causes it. The opinion of the West has been fluctuating between the two extremes, or diametrically opposed positions, since ancient times. According to the first, the poor are to blame, generally for not trying enough to find and keep a job, while, according to the second, it is circumstances beyond the control of the individual that are responsible. Their solutions are different as well: while the first demands that those poor people who are physically capable try harder in order to earn more and believe that government intervention merely increases the dependence of the poor on government aid and makes the situation worse, the second calls for major government intervention that should compensate for alleged or real weaknesses of the socioeconomic system that handicaps some people.

The debate about the causes of poverty has not yet ended. Quite the contrary. However, it is no longer acceptable in many circles ("politically correct") to object to the behaviour of either individuals or countries and blame them at least for part of the responsibility for their poverty. The discussion has turned towards objective factors, while the mentioned causes may partially fit into the old schemes.

Nowadays, basic limitations are deemed to include resource limitations and institutional limitations. Resource limitations cap the level or, at least, the rate of development which may be reached, while institutional limitations reduce that potential level or that potential pace of development unless regulated properly.

We find several categories among resource limitations. The first are natural resources, including fertile soil. It used to be considered the most important. Countries were divided into those that were fertile and rich in lumber and mineral resources and those that were not. Later, with the emergence of industry, it turned out that many countries lacking natural resources managed to climb very high on the development ladder, while some other countries, with abundant natural resources, lagged behind.

The second category is geographical position, because a more favourable position certainly reduces transport costs and facilitates inclusion in competitive international trade in comparison with remote regions. Thus, maritime countries had an important advantage over landlocked states with no sea access, since sea transport is the least expensive. However, the progress of other transport modes (rail, road and air traffic) has reduced significantly all transport costs and connected those remote regions at relatively low rates.

The third is capital. For a long time the limitation in capital availability was thought to be crucial, for it is obvious that underdeveloped countries possess significantly less capital than the developed ones: the banks are of considerably more modest sizes, there are fewer factories, the property is less valuable, the infrastructure is poorer, etc. However, the prevailing opinion is that the shortage of capital, although certainly relevant, is nevertheless a secondary factor of poverty. The globalization of the world financial market enables every country, if it is attractive for investors, to attract considerable amounts of foreign capital, which is hungry for profitable investment opportunities. And if there is no such inflow, something else is the cause.

The fourth is human capital, defined as the value of the knowledge and abilities of individual people. There is no doubt that the significant difference between developed and underdeveloped countries lies in this factor. The faster development of some countries (for example, Ireland and Korea) was, to a considerable extent, a consequence of rapid improvement of the school system, i.e. increase in education level and qualifications, which is the essence of human capital. Indeed, there is no need here to refer to popular stories about the Knowledge Economy in order to remind ourselves that the 21st century economy is decreasingly based on muscles and repetitive operations, and increasingly on intellect, knowledge and entrepreneurship. The countries that have poor human capital, such as some African countries, will hardly be able to reduce the poverty level until their strengthen their human capital.

Finally, institutions are those that primarily determine the fate of poverty in a country. If they are set up in a reasonable manner and function well – to encourage entrepreneurship and efficient investments, for example by means of low taxes and protection of private property – and if they provide an increase in the education level of the population, a decent economic development would be inevitable, regardless of the limitation in natural resources, geographical position and capital. If, on the other hand, the state is corrupt and poorly governed, with poor economic and social institutions and education system, then even abundant natural resources and a favourable position will not help it much, and it will remain backward and poor.

Market imperfections are a variant of poor institutions. The poor are poor also because they cannot borrow money on the basis of tomorrow's wages or profits in order to invest it in education, new harvests or entrepreneurial activities. Or, their access to economic activity is hindered because many collective (public) goods, such as property rights protection, security or infrastructure, are inadequately provided. Or, they lack information about market possibilities. In many of these and similar problems, it is possible, through improvement of governance and better economic policy, to increase the poor's chances to escape poverty by themselves.

The situation is similar with an individual: his/her position depends on the size of personal property (natural resources and capital) and personal work abilities (human capital), the location he lives in (prosperous or poor region), and the manner in which the government manages public affairs. In poorer countries, the importance of available resources of individuals (property and entrepreneurship) is higher for the poverty level because the governments there usually do their job more poorly, and therefore it is all the more important what the individual offers. In developed countries, the individual's energy and his willingness to work is usually more important, as the generally good institutions, including proper elementary education, make economic activity and escape from poverty possible.

The idea of poverty traps has been popular in the economic literature for decades. Namely, the story goes that there are certain mechanisms that keep poor countries in poverty by preventing their economic growth and development. For example, savings are necessary for growth financing, and they are certainly very scant in poor countries. These low domestic savings are not compensated for by a large inflow of foreign private capital, for example direct investments, because poor infrastructure and low human capital discourage such an inflow. With a low savings rate and poor inflow of foreign private capital, there is little chance for a poor country to initiate substantial economic growth, so it usually stays poor. In other words, poverty bears poverty and it is not possible to break the chains of poverty. The question, therefore, is how to initiate growth, break the chains of the vicious circle and add dynamism into the otherwise equilibrium at the low level in which the country is trapped. This topic was in the centre of attention half a century ago, and the most famous book was Walt Rostow's *Stages of Economic Growth* (1960), which inspired planners' big push of international aid which tried, and failed to bring poor countries onto the path of long-term growth. There have been similar ideas and similar attempts more recently as well, such as the Millennium Development Goals and the recent appeal by Jeffrey Sachs (2005).

How to fight poverty? Essentially, there are two ways of fighting poverty in a country. The first is through redistribution of wealth, and the second is economic growth. Naturally, their combination is also possible.

Redistribution policy is the most direct way of attempting to reduce poverty, where the government in some way, usually through taxation, takes part of the income and/or property from more prosperous citizens and transfers it to the less wealthy. Such a strategy is mostly not controversial in budget transfers directed towards the poor who are ill, old, or in another way incapable of taking care of themselves independently. However, the harder question is whether the redistribution is justified in the case of all poor people, even those fully able to work. At this point a liberal school of thought argues that it is sufficient to provide the latter with short-term financial support until they find a solution themselves in the labour market, rather than long-term support that would only encourage them not to look seriously for a job at all. The other, more welfare-oriented school will support permanent redistribution, or at least for a longer period, also benefiting those who are poor but able to work. This school of thought proceeds from a somewhat naive conviction that the people are poor due to external reasons and that they will not abuse the good intentions of the government and change their behaviour on the basis of rational calculation, which says that it is more profitable not to work and to receive social welfare than the other way around.

Obviously, there are also different philosophical theories of justice that justify and support these quite different positions. On the one hand, there is the theory of distributive justice, which deals with a normative question as to what the distribution of burden and benefits from economic activity should be like and why. The most famous contemporary theory is the one John Rawls presented in the book *A Theory of Justice* (1971), where he developed a theory of moderate redistribution on the basis of a social agreement. The individuals who conclude that agreement incorporate in it an insurance against failure and stipulate special protection for those who do the worst in life just because of the risk of outcome of economic activity. In that way, Rawls tried to preserve free market economy, but also to enable redistribution in favour of the poorest. He based this concept not on unconvincing Samaritan principles, but on the concept of rational choice of all community members.

On the other hand, there is the concept of procedural justice, whose main advocate is Robert Nozick. In his book *Anarchy, State, and Utopia* (1974) he supported the concept of justice based on fair principles of conduct such as those that free market trade rests on. When the principles are just, then the outcome is just as well. Any system based on redistribution in order to achieve some targeted income distribution, cannot be just because it violates higher moral principles, such as the principles of freedom and respect for private property.

The attitude towards redistribution in fighting poverty differs according to country, with an important role being played not only by pure politics but also by prevailing value judgments of the population. Thus, the majority of the US population believe that the position of an individual in society is primarily a result of his effort and ability, so capable poor people are considered essentially responsible for the situation they are in. The Europeans, on the other hand, believe more that the primary causes of someone's poverty include many other social and economic circumstances, so they believe that systemic and permanent governmental support to the poor is justified (Alesina and Angeletos, 2005). Such differences need not be only a consequence of different convictions, but they can also be a result of different real situations on the continents of North America and Europe: the more market-oriented economy in the USA and the less market-oriented economy in Europe.

An expression of redistribution orientation is the so-called welfare state, particularly well-developed in the countries of Western Europe after World War II, but also elsewhere. During the last several decades, the concept has been partly abandoned, not only because of its costs, but also because its effects can include creating a psychology of dependence.

In any event, the scope of poverty reduction in a country through redistribution is limited. Large income transfers are not politically attractive activities, and they often harm economic growth through an increased tax burden of productive activities as well as through discouraging hard work and entrepreneurship.

A half a century of experience shows that the best solution for reducing and eradicating poverty is certainly *economic growth*. There is no social policy that could reduce poverty in China and India in such a dramatic and thorough manner as can growth. In the words of the leading theoretician of economic growth and Nobel prize winner Robert Lucas, "the potential for improving the life of poor people through finding different ways of distributing current spending is *nothing* compared to evidently unlimited potential for increasing production" (Lucas, 2004).

When the average income per capita increases, there is no doubt that, with a normal trend in the income of the poor, the absolute poverty in a given country will decrease. In order for this not to happen, one must assume that the fruits of the country's economic progress are completely unavailable to the poor: that the wages for the work they are engaged in are neither increasing, nor is the level of their employment increasing, nor are the social transfers intended for the poor increasing from the increased budgets, nor are the quality and coverage of elementary education or basic health care improving, etc. And that would be then an unusual type of economic development, very rare in recent history.[4]

4 Economic growth in the USA in the last quarter of a century is somewhat reminiscent of the mentioned scheme: the average wage of employees in the lower income area is stagnating in real terms, while the inequality of income distribution is increasing.

We may describe a person's economic condition through his/her:

- human capital, i.e. physical abilities, professional knowledge and health,
- physical property, i.e. productive resources, such as land, buildings and access to infrastructure,
- financial property, i.e. savings and access to credit and
- social capital, i.e. social connections and obligations, which may be used for his/her own benefit.

Economic development has a positive impact, on the majority of the mentioned attributes:

- the total demand for workforce increases, and so (1) the employment level increases, which significantly increases the income of those poor people who become employed and (2) employee wages increase, which means, in principle, an increase in wages of the lowest paid employees as well, and these are usually the poor,
- demand increases for the products offered by the poor, whether they are engaged in agriculture or in trades or small services; often that increase results not only in an increase in production, but also in an increase in the prices of products or services, which is all profitable to the poor and increases their income,
- the increase in income enables also certain savings of those with lower income, but also increases the supply of loans which are available to all, even the poor; and loans are the most direct way of providing necessary capital to the poor who possess certain entrepreneurial talent,
- getting a job or starting one's own small business certainly increases social contacts and also improves social capital of a poor person, decreasing his/her vulnerability against future unfavourable turns of events.

However, could economic growth still be favouring the rich at the expense of the poor in real life, in spite of all the economic theory? Although such assertions are frequent, particularly in non-economic literature, and usually based on poorly selected indicators, in real life economic growth brings equal increases in income of all population segments. As shown by the extensive research of Dollar and Kraay (2002), conducted in a large number of countries and in a long time interval, the poorest social strata also have an equal share in the fruits of economic development because their income increases at equal rates as the income of other, richer strata, so the share of their income is maintained at the previous level. The real state of affairs is contrary to the widespread assertions that the poor strata always fall behind the more prosperous strata and that they are not the beneficiaries of development.

The improved development is the best incentive the government may give to the fight against poverty in a poor country. And the private sector, based on hard work and entrepreneurship, creates wealth and brings growth. The important role in this is certainly the role of government, which is in a position to have a significant impact on economic life, on the efficiency of market and competition, on more favourable conditions and lower operating costs and reduction of barriers to investors' entry in business and similar.

Several areas of government activities are of special interest for investments and entrepreneurship, and thereby for economic progress as well:

- macroeconomic stability, which means ensuring that the level of puc debt, monetary issue and inflation remain within bearable limits, that the interest rates are reasonably low, and that the exchange rate of domestic currency is real and stable, that the government spending is moderate and the financial system is developed well;
- an open market economy in which there are no unnecessary barriers to business, including barriers to foreign trade and foreign investments;
- a system of the rule of law, from the protection of contracts and private property to the fight against corruption;
- basic infrastructure in traffic, electric power industry, telecommunications and utility services, as well as in education and health care;

Economic growth in itself reduces the level of absolute poverty by increasing income of all people, including the poor. That is why it is called growth. However, can and should the government conduct such a policy of economic growth guidance which will lead to a faster increase in income of the poorer strata than the average in order to reduce poverty even faster? A positive answer came immediately from international organizations (what sounds better than the "pro-poor growth" statement?), even regardless of the fact that they did not know exactly what it was about. A research project was developed to provide an answer to the mentioned question, in which the main role was played again by the World Bank (Ravallion, 2004).

It will not surprise us that there is no widely accepted definition of “pro-poor growth”: for some it is that growth which increases the poor’s share in the total country income, while for others it is any growth which leads to the reduction of absolute poverty. Both definitions have their own problems: the first because the record Chinese poverty reduction (from 64% to 17%) is considered to be non-pro-poor growth, only because the share of their income in the total income is lower than a quarter of a century ago; the second because the growth in which there is a high increase in inequality is also considered as “pro-poor growth”, only because the income of the poor increases as well.

Inequality in income distribution, or the question whether it is possible to reduce it without endangering growth, has become the centre of researchers’ attention (Milanovic, 2005). The first results of empirical research suggested a vaguely affirmative answer, because there proved to be no correlation between these two phenomena. However, more recent empirical research (World Bank, 2007) has shown that inequality and growth go together and that, therefore, insistence on reduced inequality would lead to a decrease in the overall growth rate, and probably to a slowing growth in the income of the poor as well. The latter is in accordance with the Kaldor and Kuznec classical theory of economic development, according to which growth and inequalities go together because the rich save more (Kaldor) and because inequality in the initial stages of growth increases due to the fact that individuals move from low-productivity agriculture to the significantly more productive modern industrial sector.

In more general terms, the economic growth policy contains many specific policies. Some of them that benefit the poor stimulate overall growth, while some decelerate it: the question is what effects are predominant.

A related, but nevertheless alternative concept proceeds from the already mentioned poverty trap, in which all relevant factors intensify each other, so the country cannot break the chains of poverty and get on the path of growth. A need is always derived from this for external factors, i.e. richer countries and international organizations, to give strong financial and other aid, break the trap and initiate development. A similar proposal comes from Jeffrey Sachs's book *The End of Poverty* (2005) in the same way a Rostow half a century ago. Empirical research questions the validity of the poverty trap concept (Kraay and Raditz, 2007). However, for understandable reasons, it is still very popular in underdeveloped countries. The basic objection to such approaches is the following: what guarantees that the increased amounts of aid will not be used ineffectively, as on the past, on bribing domestic elite or on big profits of western companies and agencies, or on uneconomical projects?[5]

Poverty in the world. There continue to be many poor people in the world, many children die of diseases, and there are many of them who lack even the basic conditions for a dignified life. However, there is one piece of overriding good news: poverty is declining, particularly the extreme kind, and the world is nevertheless gradually becoming a more and more decent place to live. Let us see the basic data:

Table 1.1 Extreme poverty in the world

Share of people with less than $ 1 per day (%)	**1981**	**1990**	**2002**
East Asia and Pacific	57.7	29.6	11.6
Europe and Central Asia	0.7	0.5	2.1
Latin America and the Caribbean	9.7	11.3	8.9
Middle East and North Africa	5.1	2.3	1.6
Southern Asia	51.5	41.3	31.2
Sub-Saharan Africa	41.6	44.6	44.0
Total	40.4	27.9	19.4

Note: the value of the dollar is calculated according to purchase power parity (PPP) rather than according to the current exchange rate.

Source: World Development Indicators 2006, World Bank

5 A well-known project was that in the Nigerian city of Ajaokuta, which cost five billion dollars since 1979, and produced not one tonne of iron or steel in the following 25 years.

Extreme poverty, defined as spending per capita below USD 1 per day, has been decreasing rapidly during the last quarter of a century. The share of the extreme poor in the population of the world was halved in only two decades: from two fifths it was reduced to one fifth of the world population. The number of these individuals decreased somewhat more slowly, which is a consequence of rapid population growth in the poorer regions of the globe, from 1.5 in 1981 to 1.0 billion people in 2002, which is also an exceptional result in only twenty years and in the period when the population continued to increase rapidly.

That magnificent result, which changes the history of world poverty, was achieved in such a short time primarily owing to the economic growth that swept many countries, particularly China and India, and rapidly decreased the number of poor people through expanding free market and their inclusion in the world's economic flows. The poorest results were posted by Sub-Saharan Africa, where the same rate of extreme poverty was maintained (approximately two fifths), but also the number of people belonging to this group doubled between 1981 and 2002. Poor governance, AIDS, and a deficit in human capital and many other resources are all concentrated in Africa, and it represents the region in the world which is most threatened with poverty and whose prospects are the poorest for the time being.

Some of the larger countries with a raised or high poverty level around 2000 were: Bangladesh (36.0%) India (34.7%) China (16.6%), Ethiopia (23.0%), Madagascar (61.0%), Nigeria (70.8%), Pakistan (17.0%), Tanzania (57.8%), Philippines (15.5%).

A higher line of poverty is also used in international comparisons – USD 2 per day. It designates ordinary poverty, in contrast to extreme poverty with USD 1 per day. Also, this higher line certainly results in a larger number of poor people in the world than the lower one. In the 1981-2002 period, the number of ordinary poor people remained at approximately the same level – around two and a half billion people. However, due to an increase in the total number of population in the world, the share of poor people decreased significantly: from 66.7% to 50.0%. This is an epochal result: for the first time in the history of mankind, one half of the population is no longer poor, while there is also a real hope for the other half, or at least for a significant part of it.

2. The Role of Individuals

"*Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution... The potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production.*"

Robert Lucas (2004)

When thinking and writing about the long-term economic and social development of our civilization, we often tend to focus our attention on major forces, such as the development of science and technology, excellence of political, legal and economic institutions, the pace of capital growth and the like. And we tend to forget those who have essentially carried all that progress on their shoulders: enterprising individuals. There are entrepreneurs who seek new solutions and innovations which will enable the solving of new problems or the solving of old problems in a new, more successful manner. There is an entrepreneur in each and every one of us; every person is in pursuit of success, personal happiness and a better life. That, of course, does not mean that we have all been endowed with the same level of entrepreneurial talent, but in our search for the things we aspire to we all autonomously take decisions about our own lives. The market and its invisible hand make it possible to transform our individual quest for a better life, i.e., to make the self-interest of individuals work for the general good.

 As a consequence, not only is the personal welfare of individuals increasing, but also the welfare of society as a whole.

The market is a mechanism which functions without duress – it enables exchange which is based on voluntary decisions of all actors, all participants in market competition. No one can force anybody in a free market to sell or buy something if that other party does not want to do so. Each participant in market competition analyses the utility arising from each potential market transaction and on the basis of the parameters of that transaction (the quantity, quality, price, etc.) makes a decision on whether to proceed with that particular transaction or not. A market actor will embark upon any given transaction only if it increases his welfare. The exchange is beneficial to both sides – to the seller and to the buyer of goods, services or factor services alike.

Freedom, Responsibility, Results

In addition to the freedom of making business decisions without any duress, the market, together with the system of private property rights and their protection, also creates accountability for these decisions. Namely, all the advantages of a good business decision are appropriated precisely by the one who took it, and nobody else, but in the same manner all the costs/losses incurred owing to a wrong business decision, are covered only by the one who made that mistake. This mechanism of individualisation of benefits and costs generates strong incentives to each market participant to act in a responsible manner against the backdrop of uncertainty – to think carefully and consider thoroughly each of his business decisions. This contributes to market discipline that actually is the responsibility of each individual for his own welfare and prosperity, which enhances economic efficiency and the prosperity of society as a whole. Consequently, there is no doubt that the responsibility of an individual without freedom for taking decisions is a hollow formula, just as real freedom is not possible without responsibility for one's own acts.

In other words, in order to achieve economic rationality and efficiency, there has to be a direct link between the investment made by an individual and an amount that was generated by that individual as his personal income. People's natural drive to generate income and assets for themselves and their family is so strong that it inspires them to the greatest mental and physical efforts, but only in those situations where they know, or have a reason to believe, that no one will systematically confiscate the fruits of their labour. Of course, the link between investment of labour, capital or entrepreneurship and the results achieved on that basis is not always predictable, not only because it is only the market which can verify the quality of that investment, but also because the final outcome is often affected by many factors that are not under the control of a given individual. We can label these as coincidences. However, it is extremely important for an individual to be convinced that these other factors are really circumstantial or, more precisely, that they are not under someone's conscious control which could be used at his expense, and that they will not vitally erode the value of his labour.

If there were no link between investment and results – no matter whether someone is systematically expropriating the results of the actors, or the role of coincidences is crucial – an individual would have a hard time finding a motive for participating in such a game, except maybe where the risk premium is especially high, which is rarely the case in a reasonable and balanced economy. Business activity, in an economy with a weak or non-existent link between investment and results, will certainly be low, to the detriment of all. Gross domestic product will be lower than the potential one, and with it also wages, profits and pensions.

Decades of experience in collectivistic societies, like communist regimes, have shown that the separation of benefits and responsibility from the individual leads to the creation of bad incentives. It is always somebody else's merit, or responsibility, or it is always somebody else's "fault". Somebody else is always expected to solve the problems, and people become inert. They stop being actors and turn into mere passive observers of the things that are happening to them, with the only adjustment in their behaviour being related to redistribution – specifically in demands for compulsory redistribution and attempts to improve their chances for such redistribution in their favour.

The weakening of the link between investment and results can be a consequence of different factors – from the weather in agriculture to sudden changes on stock exchanges. These factors are of an objective, impersonal nature and no one considers them to be unjust, despite the difficulties, or gains and losses, which they bring. But some of the factors are considerably less objective and in the eyes of individuals they constitute not only an undesired, but also an unjust phenomenon. When, for instance, a judge renders a biased decision in a dispute over property, or when taxes are excessively high, or when a poor macroeconomic policy is pursued, or when income is redistributed from one group to the other on a large scale, an individual can then be rightfully dissatisfied and scale down his engagement. Not because he is dissatisfied and angry, but because he has estimated, with reason, that maximum activity is not in his best interest. And the economic damage is already inflicted, be it through lower investment, or inferior work methods, or export of capital to other countries, or a waste of talents on unpredictable activities, and the like.

Entrepreneurship and Competition for Rents

The freedom of taking business decisions and the assumption of full responsibility for their results are very well known to capital holders. In all that, it is very important to notice that profit is a return on capital, i.e., on its investment (placement). The one who is investing his capital, just like the one who is investing his labour, wants to get returns on that investment. Why should someone invest in something if he cannot receive any returns on that investment? Without appropriate returns, there are no incentives for investment of resources. Risks associated with investment of capital are high – invested resources are not necessarily recoverable, and they can also be completely lost, for a number of reasons. The amount of the returns on capital is commensurate with the risk, i.e., with the probability that the investment will be recovered. The higher the risk carried by the holder of the capital, the entrepreneur, the higher the expected profit rate as a risk premium. Without the existence of such a risk premium, there can be no investment of capital. Pursuant to all the above, rate of profit, constitutes the usual, competitive return of the holder of capital on the resource in his possession, which he invests under the conditions of uncertainty and risk, without any guarantee that his investment will be recovered. Furthermore, capital is a highly movable resource – it moves easily from economy to economy. If sufficient returns, or lower risks, cannot be secured in one place, it will easily head for another place, where returns will be high enough to cover the risk premium. And all these decisions are taken on the capital market, where there is demand for and supply of that resource and where capital holders carry the risk of losing all their assets.

Profit as return on capital has long been considered to be solely a consequence of the exploitation of the working class, that is, of the poor. According to this stereotype, rich capitalists are taking advantage of the unenviable position of the working class and the poor, who have no choice. The basis for this stereotype comes in ignoring the operation of the labour market, where there is competition, both on the supply side and on the demand side. In other words, the incomes of the labour force, be they the working class, the poor or other allegedly exploited groups, are competitive incomes, which are a result of competition on the market. Capitalists offering wages below the market level (or managers who are doing that on their behalf) cannot count on employing the work force, and, consequently, on their returns on the placement of capital.

The character of market transactions is a big issue, irrespective of whether the market at issue is the market of goods, capital or labour. The market and exchange on it are not a zero-sum game, where the one who wins acquires exactly as much as the one who loses has lost. In such a game, there is no change in the total value, which is just redistributed. Compulsory redistribution is a typical zero-sum game – the amount lost by one party is the amount gained by the other. In the market, however, decisions are freely taken and market actors agree to a transaction only if that transaction will leave them in a better position after it has been performed, such as if their welfare is increased, compared to the alternative of doing nothing. In such a manner, everybody has an incentive to take part in market transactions and to achieve his own prosperity in them. The role of the state is to create an institutional framework in which the market will operate, and to eliminate all obstacles which stand in the way of efficient operation of the market.

The Role of Individuals

In such a framework, the key preconditions for the progress of human society are entrepreneurship and innovation. For that reason, the key question is to which extent, and in which manner, entrepreneurship generates economic growth and prosperity. Unfortunately, and in line with human nature, entrepreneurship (with accompanying innovations) is not necessarily invested in those activities which create added value, or prosperity. The theory of alternative allocation of entrepreneurship (Baumol, 1990) deals precisely with this phenomenon. Entrepreneurship can be alternatively allocated to productive (those that create added value), distributive (those that exclusively redistribute value, such as rent seeking), and directly destructive activities (those which, in addition to the redistribution of value, also result in the destruction of value or resources).

Entrepreneurship that is allocated to productive activities results, primarily through entrepreneurial innovations, in the creation of added value and in economic growth.[1] Very often this kind of entrepreneurship is erroneously identified with entrepreneurship in general, and innovations in this field of human activities with innovations as such. This identification creates much confusion, which is a consequence of the fact that such identification is simply not justified. More specifically, as it has been shown, (Baumol, 1990, Murphy et al., 1991 and Acemoglu, 1995), entrepreneurship, entrepreneurs and their innovations also exist in two other fields of human activities: distributive and destructive. Consequently, the total supply of entrepreneurship in a society should not be identified with the quantity of entrepreneurship allocated to productive activities. A sharp drop in the supply of entrepreneurship in a society, in fact, constitutes just a decline in the entrepreneurship allocated to productive activities.

In this context, distributive activities can be identified with rent seeking, provided that we declare any redistribution of value, for the performance of which certain resources are used, to be rent seeking (Shleifer and Vishny, 1993). Redistribution of value to serve one's own purposes is a motive for distributive activities, and their content comprises all those activities which are neces-

1 Baumol (2002) sees three main reasons for that in the characteristics of innovations: they have a cumulative character, properties of a public good and a self-accelerating character.

sary for performing this redistribution.[2] The social damage from rent seeking lies precisely in the fact that these resources have their own opportunity costs. In other words, alternative allocation of those resources into productive activities would result in the generation of added value and a rise in social welfare. Accordingly, entrepreneurship that is allocated to distributive activities cannot be allocated to productive ones at the same time. These include legal methods for redistribution of income, as new types of taxes and subsidies, or illegal, such as new kinds of fraud or embezzlement.

Destructive activities by their nature result in a decline in welfare/wealth. They do that directly, since the results of such activities include destruction of resources, by generating a negative utility for economic agents. They also do that indirectly, in the same manner as distributive activities, by engaging resources which have their own opportunity costs and can be alternatively allocated. In other words, entrepreneurial innovations that appear in destructive activities leave productive activities devoid of such innovations. The damage which is caused by enterprising and innovative robbery ringleaders is obviously multiple.

Since the thesis is widely accepted that entrepreneurship, and the innovations that go with it, constitute one of the key factors of economic growth, the key question for the future of any nation is whether innovations will emerge in productive or in distributive, i.e., destructive activities. Entrepreneurs in productive activities are certainly entrepreneurs in the narrow sense of the word, and their achievements, or innovations, have enabled a fascinating growth of market-based, capitalist economies over the last two centuries (Baumol, 2002). Unfortunately, entrepreneurial achievements and innovations in distributive and destructive activities should by no means be underestimated, regardless of whether these are entrepreneurs in the private or in the public sector.

Indeed, regardless of considerable differences, all entrepreneurs, no matter in which activity their entrepreneurship is engaged or

2 If redistribution is achieved without any engagement of resources, such redistribution will not belong to distributive activities, since it does not belong to any activity (it does not give rise to resource engagement), it is rather pure («free») redistribution.

 manifested, have certain common, almost inevitable entrepreneurial characteristics: courage, perseverance, energy and imagination (creativity). Each individual has been endowed, to a lower or higher extent, with these virtues. Whether human creativity will be used for the creation, redistribution or destruction of value depends on the incentives to which they are exposed. In other words, incentives are critical to the behaviour of all people and entrepreneurs hidden in them. Incentives make people assume risks and responsibility, that is, become entrepreneurs and innovators.

Entrepreneurs choose an activity to pursue based on relative returns which they expect; they compare the expected returns on alternative activities into which they could invest themselves. In other words, when it comes to allocation of entrepreneurship, only expected relative returns are relevant. These returns do not include only cash revenues such as expected wealth, but also social power and the recognition which arises from pursuing an activity. There are numerous examples of civilizations in which distributive and destructive activities were glorified. Entrepreneurs in these activities were celebrated, while productive activities were scorned, as were those who pursued them.[3]

In this manner, it is possible to consistently explain total supply of entrepreneurship, i.e., the entrepreneurial talent of people in a society, with its alleged appearance, disappearance and reappearance. This is not to mean that entrepreneurship appears and disappears - it rather moves from one group of activities to another. Consequently, instead of futile efforts to analyse factors that generate entrepreneurship as a production factor, the analysis should focus on those factors which generate incentives to entrepreneurs, such as those that determine expected relative returns on the engagement of entrepreneurship in alternative activities. The

3 According to Finley (1985), in the Roman Empire acquisition of wealth was respected as long as that wealth was not a consequence of the performance of productive activities (crafts and trade). In other words, only those involved in distributive and destructive activities could count on high social status. Moreover, as indicated by Veyne (1961), productive activities were voluntarily pursued exclusively by liberated slaves (of course, together with slaves, who did not have a choice). Precisely this value system, alongside with the operation of some other factors, most probably was one of the most important causes of the economic crisis of the Roman Empire, i.e., of the economic causes of its fall.

first among these factors refers to economic freedoms: the freedom to decide into which of the mentioned activities to allocate resources. The second factor is the protection of private property rights: the protection of the results of entrepreneurial activities. These property rights can be violated in two basic ways. One is violations committed by private persons, robbers, swindlers and their kind, and which violate the law. The other one is violations committed by the state, be they based on excessive taxation or on arbitrary regulatory decisions, which are, in most of the cases, based on law.

If there are no economic freedoms and if private property rights are violated in one or both ways, expected relative rates of return in value-generating activities will decline. They will be lower than in the case of alternative allocations, resulting in the shift of entrepreneurship and other resources into activities that do not generate value, and into activities which reallocate that value, no matter whether it is done in a legal or an illegal manner. The higher the tax rates, the higher the frequency of arbitrary regulatory decisions, and the more violations of private property rights, which reduce incentives to entrepreneurs to invest in productive activities, thus thwarting the chances for prosperity.

High and very often progressive tax rates and ample transfers constitute the main mechanisms for compulsory income redistribution. Of course, only the state can offer this type of redistribution, since only the state has at its disposal a legal force to carry out such redistribution. That offer is a response to the demand for redistribution, and demand for compulsory redistribution in a society, through progressive taxation and direct transfers to the poor, usually comes from those who are below the average income or average individual wealth. However, the mere fact that someone is (relatively) poor does not mean that he or his household, will necessarily be on the side of demand for redistribution. The key question is how each individual perceives his future and opportunities to enhance his own welfare. If an individual who is at a lower level of the current social ladder (whose income is, for example, below the median income) believes that, by relying on his/her own powers, entrepreneurial potential and work efforts, he/she can manage to raise himself/herself above the average in a given society, then he/she will oppose income redistribution. With a person's high expectations vis-à-vis his/her future income, his/her demand for redistribution will decline. If I can expect to be rich in the future, then taking a good portion of my income through progressive taxation and reallocating it to the poor is certainly not in my interest. The higher a person's expectations in this regard, the lower the demand for redistribution. Conversely, the lower a person's expectations, the less he believes in his/her own abilities, and the higher the demand for redistribution. A person will request higher redistribution if he thinks that it will increase his future income.

What do the expectations of individuals depend on? They depend on the system and the rules of the game prevailing in a country. To the extent to which an individual perceives the rules of the game as impartial and to which he expects that his private property rights will be protected, not only now, but especially regarding the expectations in this field for the future. Included in these expectations is also the question of compulsory redistribution in the future, since the strengthening of compulsory redistribution, through, for instance, progressive taxation, threatens private property rights. In other words, if a higher degree of redistribution is expected in the future, more people will opt for demanding redistribution.

There often emerges some kind of a redistribution trap: society slides into an equilibrium in which large numbers of people pursue exclusively redistribution. A high level of redistribution gives rise to expectations that this level will remain high, which results in a further growth of demand for redistribution and this, in turn, raises rational expectations regarding redistribution in the future. All that increases compulsory redistribution in a society. And, of course, politicians respond to the demand for redistribution with demagogy, so they will not only meet it, but also increase it.

Through the mentioned mechanism, compulsory redistribution reduces incentives for individuals to take care of and solve their problems by themselves. They will expect somebody else's solutions, and they will expect the state to take care of them through compulsory redistribution, by taking from those who create value. In this manner, not only are there no incentives created for individuals to take care of themselves, but also parasites are bred, those who are not able to create value by themselves, but cling to government authority and defend it at any cost. People like that want no change whatsoever, and, in such circumstances, not only that there is no growth or economic prosperity, but there is also no democracy or freedom. Without free individuals, those who are willing to assume the responsibility that goes hand in hand with freedom, there can be no human freedoms in any society.

In such societies, powerful individuals and interest groups will easily articulate their own private interests as social interests and all key decisions that will be taken will be collective decisions. These are indubitably the decisions in which possible benefits and responsibilities are divided; hence no one has an incentive to improve economic efficiency and kick start society on its path to prosperity. That would require going back to the realm of individualism, individual decisions and strong incentives for each individual to take care of his own welfare – only that will bring prosperity in a society.

Redistribution

Besides redistribution in the process of rent-seeking, there is a more benevolent one – redistribution of income in favour of relatively poor individuals and population segments. Its purpose is by all means noble: to enable the poor to live their lives in dignity. Certain aspects of redistribution – its morality and the technologies used to perform it in the contemporary world – are discussed in other chapters of this book, and here we would like to say a couple of words from the economic standpoint.

The main problem with redistribution is related to its probable negative effects on economic activity, both on the side of raising funds, in relation to public revenue, and on the side of transfers to the poor.

Let us first look at the tax aspect. Taking income from one, usually more affluent, as well as productive, segment of the population raises the question of their response and overall economic effects of that response. More specifically, a loss of part of the income, usually through taxation, in those more affluent segments can result in different, but definitely negative responses.

First, high taxation, which is certainly a result, at least partially, of other non-redistributive functions of a contemporary state, inevitably causes a drop in savings and reorientation toward consumption. This can be a shift to real estate, works of art, expensive vehicles and yachts, which undermines domestic productive investment. The reason for this is twofold. First, sharp progressive taxation reduces the attractiveness of doing business and making profit, which indirectly contributes to higher consumption. Second, high taxation of income of those better-off segments unavoidably reduces national savings, as long ago shown by Nicholas Kaldor, because the savings-to-income ratio is much higher for these segments than for those poorer ones. The savings are mostly concentrated among more affluent citizens. Of course, there will be no strong foreign investment either because foreigners are also not very fond of high taxation. The logic is obvious: high taxes reduce the level of returns on capital, thus also reducing the value of investments and assets, which makes investing less attractive than before. That, of course, reduces the productive potential of the country in the future, as well as GDP, employment and household consumption.

Second, high taxation leads to exporting capital from a country where taxation is high to other countries, where the tax burden is lower. If it is not possible to achieve normal returns on capital in one's own country, due to taxes or other reasons similar to confiscation, there is no doubt that many will conclude that transferring capital to more attractive regions could be a wise option. As a tax rate of 50% in the case of profit tax, for example, halves the value of the capital compared to the situation without the tax, the logic is clear. The effect of the halving of returns (profits) is a fall in the value of capital by the same percentage, since assets are worth as much as the returns that they yield after taxation, not as much as the price that was paid initially. Thus, many developing countries have become exporters of the capital that they desperately need for development, due to poor domestic policies, but some developed countries, too (e.g., Sweden and the U.S.), have felt adverse consequences of their high rates of taxation on personal and corporate income.

Third, high taxation reorients the most productive part of the population from productive to non-productive work, or to enjoyment in leisure. If hard work, entrepreneurship and prudent investing are not bringing appropriate or expected rewards, many taxpayers will turn to other, often more entertaining and easier jobs, to the detriment of all. In the long run, a reduction of the possibility to make profit in business results in the reorientation of young and capable people to other activities, or to foreign countries, which cannot be useful for the national economy.

The high and markedly progressive taxation in the previous decades gave rise to the mentioned effects in practical life, due to the distinct sharpness in the tax burden levied on better-off segments. Of course, not every kind of progressive taxation is a problem, particularly a moderate one which compensates for the regressive nature of the sales tax, which tends to affect poor citizens more (Hayek, 1960).

Negative economic effects of excessive progressive taxation came to the fore in previous decades and it has been gradually abandoned in many countries. Thus, both the U.S. and Sweden have radically moderated the progressivism of their tax systems and improved the investment and business climate in order to attract investors and boost economic development. This process of reducing the tax burden was prompted by tax competition among more developed countries, where one group heads the race in tax rate cuts in order to attract capital from the other countries, while the others follow in order to keep the capital, setting in motion good results for all. The relaxation of the tax burden is one of the essential recommendations for accelerating development through the release of resources for investment.

With respect to government expenditure, certain categories are different from the standpoint of redistribution – some result in redistribution, some do not. Thus, transfers to the poor or to the unemployed certainly result in redistribution in favour of the poor. Naturally, there are government functions which do not involve redistribution, such as public schools attended by children from different social strata or free health care whose services are used both by the more affluent and by the relatively poor. Admittedly, the richer often use private schools and health care institutions and pay for their services separately, because of higher quality, but that falls outside the scope of public finance and redistribution. Eventually, there are government services which are of more use to the rich than to the poor, such as the legal order, the monetary system, some infrastructure systems, and the like. For instance, a modern highway is of more use to the better-off population segments, than to the poor, because the latter do not have cars and do not use highways anyway. Or, the legal order is also of more use to the better-off citizens because it provides them with the protection of assets which are much more valuable than those of the poor.

This suggests a law on the link between the degree of redistribution and government expenditure, based both on principled reasons and on the experience gained over the last decades: the lowest degree of redistribution is in the minimal, liberal, night watchman state. Since its competences almost exclusively include the protection of personal safety and security of private property and that it, as such, is of more use to those who pay higher taxes, that could be understood to mean that redistribution does not even exist or that it is, at best, minimal. With the expansion of government competences the degree of redistribution also goes up, because the state assumes the roles which are in most of the cases redistributive, in particular when revenue and expenditure are looked at simultaneously: transfers to the poor, the unemployed, etc., family protection and social services, then health care, education, etc.

As already mentioned in the introductory chapter, in the medium-developed and developed parts of the world, government support to those poor people who are not able to take care of themselves – due to their old age, sickness or other similar reasons – is not particularly disputable. The state should be engaged in these situations because the majority believes that it is good and necessary, and it usually is. And indeed, the citizens of the country who are not poor should help those who are unable. A better method to do so would probably be through private charity and humanitarian organizations, rather than the government care, but that method has proved itself to be insufficient in most of the world.

A much trickier, from both the moral and the political standpoint, is the question of whether one should support, in the same manner on a permanent basis, even those poor who are physically and mentally able to take care of themselves. Of course, there is no dispute that such individuals should be helped in the short run, when they find themselves without a job and money, but the question is whether that should also be generously done on a permanent basis.

From the moral standpoint, it is really unclear why the state, supported by citizens as taxpayers, should finance somebody who is not ready to try and secure subsistence for himself, and possibly for his family. Even in the most developed countries there is scarcity relative to the always higher needs, and the system is still in place in which it is necessary for everybody to earn their living in one way or the other, but earn by themselves, not receive government transfers for their subsistence. In other words, the state should be there for capable individuals at the moments of crisis, but not to provide them a decent living without work on a permanent basis.

The problem with long-term financing of the able-bodied is not just of a moral nature, but also of an economic-social-psychological one. More specifically, generous financing of the able-bodied poor by the state usually changes their motivational system in the wrong direction: their individual calculation tells them that it is better to receive moderate social assistance or unemployment benefits and live a life of ease, than to sweat at work trying to earn something. And avoiding employment in order to stay on the dole is certainly not a good policy for anybody. These poor develop the complex of dependency and lose their work habits, the government coffers lose money, and the economy loses resources that would enable it to have a higher total output.

There are many examples of negative effects of similar social programs. One of the most famous is a generous U.S. program of support to single mothers with children, which has ruined many marriages over the last decades, created a syndrome of dependency with generations of mothers and children and led many a child astray. As of late, it has been radically reformed, its generosity has been reduced and time limits introduced. Even more important and more well-known is the program of generous support to the unemployed, which exists in most European countries and which has contributed to an unemployment rate averaging around 10%. For, why would anyone try and find a job when things are fine even when they are unemployed? In the last ten or so years, requirements for receiving this benefit have become a bit stricter, but the model has not yet been essentially changed in a number of countries, so unemployment remains high.

The Role of Individuals

Another negative effect is that there are always other serious problems with the methods of transfers in favour of the poor, so only part of the money from the budget intended for them really ends up in their pockets. More specifically, eligibility criteria for poverty defined in legal texts are never very precise and harmonised with research definitions of poverty, nor are citizens always willing to observe them perfectly when applying. Therefore, it is normal that less than half of the money earmarked for social transfers to the poor actually reaches them (Milanovic, 2005), while the rest, which means more than half, gets to those who are not considered poor. Maybe the assistance to those who are really poor is worth this squandering of the budget resources on the wrong people, but this problem should also be taken into account in elaboration of redistributive strategies, and particularly when designing transfers in operative terms.

Economic and social progress rests on a more active role of productive individuals, and that the state should enable them to generate income and wealth and give an impulse to the economic progress of the country. The alternative is taking income and assets from them through overly high taxation and other methods, thus abolishing incentives for efforts in the area of labour engagement, entrepreneurship and investment. On the other hand, high redistribution of income and assets stifles incentives not only to productive individuals, but also to those among the poor who are able to work and earn for themselves and their families, by providing them incentives to adopt a parasitic approach. In such a manner, a noble policy of supporting poorer segments of the population can end up in a double negative position – you lose both with those from whom you are taking and with those to whom you are giving. A large-scale, wide-ranging redistribution, therefore, brings more damage than benefits and it should be avoided, in favour of moderate redistribution, targeting those for whom it would be difficult to take care of themselves and those able-bodied among the poor, for a very limited period of time.

3. Free Trade, Growth and Prosperity

From "The Petition of the Candlemakers"

...We ask you to be so good as to pass a law requiring the closing of all windows, dormers, skylights...through which the light of the sun is wont to enter... since we are suffering from the ruinous competition of a foreign rival... which is none other than the sun!

Samuelson (1980), Bastiat (1996)

Theoretical grounds for (and against) free trade

For more than two centuries, economists from John Stuart Mill (1848) to Jagdish Bhagwati (2004) have been advocating free trade as a nation's first best policy. In numerous occasions it has been proven that the superiority of free trade holds irrespectively and leads to improving the welfare of all trade participants. The underlying concepts, Adam Smith's concept of absolute advantages and David Ricardo's concept of comparative advantages, have remained at the centre stage of analysis for international economists ever since.

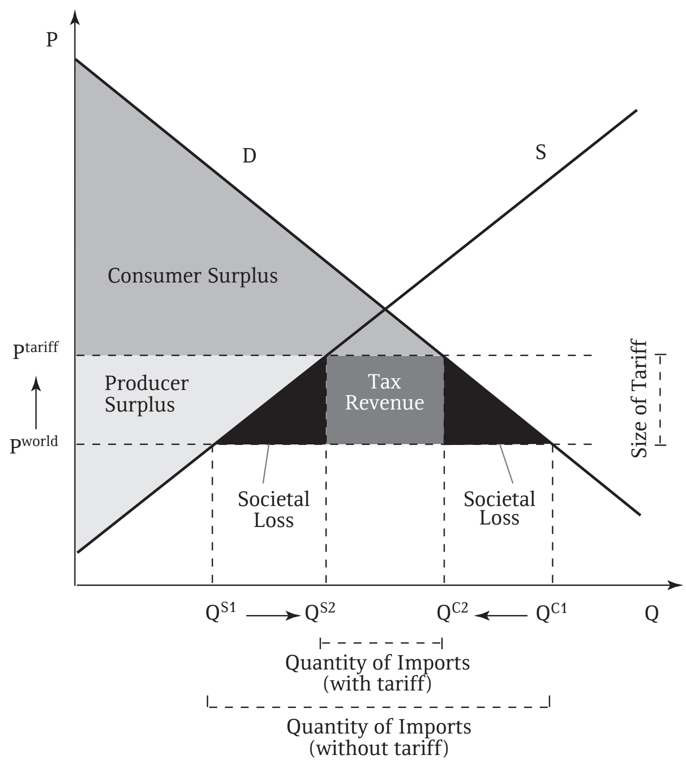
The concept of comparative advantages asserts that countries always benefit from free trade, even in cases when one country is more efficient than the other in producing every good. In that case, if a country with absolute disadvantages specialises in production of a good at which it is least bad at, i.e., where it has a comparative advantage[1], three benefits for all countries will emerge:

1 These gains are "static", i.e. gains from the reallocation of existing resources (both in terms of gains in consumption and production), while "dynamic" gains stem from from raising productivity and increasing growth rate.

 1) resources will be fully employed; 2) resources will be allocated in the most efficient industries[2]; and 3) free trade will raise overall output and consumption of all trading partners.

Even more important, this theory further asserts that imposing barriers will eventually make the *protectionist* country worse off. The losses, as presented in Figure 3.1, will consist of dark regions showing the net loss to society caused by the existence of the tariff.

Figure 3.1 Societal losses from abandoning free trade



Source: Wikipedia

2 A specialisation should emerge in that good in which production costs across countries are relatively lowest. However, neither the monetary costs of production nor even the resource costs (labor per unit of output), but *opportunity* costs of producing goods across countries should be taken into account.

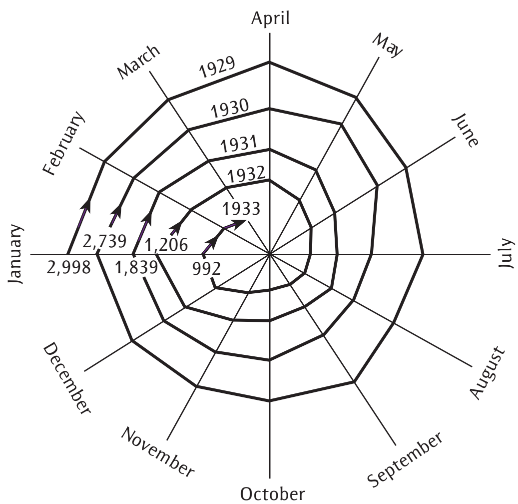
As presented on Figure 1, prior to introducing trade, local supply and demand met at point A. Free trade increased consumption to Q^{C1}, and domestic price fell to P^{world}. Although the population benefited tremendously, this policy obviously had hurt domestic producers, and tariffs were imposed. This led to an increase in the domestic price to P^{tariff}. The rise in price induced a rise in domestic output from Q^{S1} to Q^{S2} but domestic consumption fell from Q^{C1} to Q^{C2}. This has three main effects on welfare: 1) consumer surplus (green region) becomes smaller; 2) producers position improved (yellow region) and 3) government gained additional tax revenue (blue region). However, the loss to consumers is greater than the gains by producers and the government. This "societal loss" is shown by the two pink triangles, showing also the magnitude of the net gain for society from free trade. In addition, one should keep in mind that all trade barriers create a net loss to the society, and thus export tariffs, import quotas or export quotas will all invoke societal losses.

Three theoretical cases remain where protection might improve economic welfare, but all turn out to be a fallacy. These possibilities comprise cases of: 1) retaliation, 2) the famous "optimum tariff" argument; and 3) using protection as a correction for most market failures.

The first and one of the most enduring arguments, originating from Torrens (1815), claims that free trade cannot be beneficial unless it is reciprocal. Thus if a trading partner decides to impose protection, the free trade state will lose its export market, and thus its imports would either shrink or would have to be paid using gold reserves. In this case, according to Torrens, "the free trade state should abandon free trade". However, this has not proved to be the best policy. During the period 1929-1933, the spiral of protectionist measures simply wiped out all trade, leaving all countries much worse off. Deeply engaged in retaliatory devaluations (known as "beggar-thy-neighbor-policies"), these countries obviously aimed at exporting recession to other countries in order to achieve comparative advantages. But this policy turned out to be self-defeating since all other countries were doing the same. The countries then pursued a "tariff war", with each country raising its tariffs to restrict imports, thus encouraging import substitutions. Imports did fall, but so did exports, since all countries restricted someone else's exports. Everyone's fall in exports (as depicted in

 Figure 3.2 and originating from the famous textbook by Kindleberger, (1983), only deepened domestic recession. As presented, retaliation measures proved extremely effective only in creating a complete collapse of international trade.

Figure 3.2 World trade decline during the Great Depression (in US$ m)



Source: Kindleberger (1983)

Although economic history proved Torrens wrong, i.e., that "the free trade state should **not** abandon free trade", the lesson that retaliation measures can well work against its creator is still not fully accepted. Obviously, countries faced with profit opportunities from protection, or trying to retaliate, find themselves trapped in Prisoners' dilemma, failing to realise the existence of the superior, cooperative, free trade outcome. This can help to explain the need for an international supervising body like the World Trade Organization (WTO), aimed at preventing increasing protectionism or retaliatory measures from other countries. Namely, since it is the lack of cooperation which makes it difficult for countries to realise the superior free trade outcome, the role of the WTO is precisely in driving the countries closer towards Nash equilibrium in free trade, for the benefit all countries. Devaluations also seem to be a powerful instrument to increasing competitiveness and net gains from trade, which makes exports rise and imports to fall, due to rising import prices when denominated in domestic currency. But being a "beggar-thy-neighbour" kind of policy, a country which enacts it can expect retaliations. One of the reasons for forming the European Union from the start was precisely to avoid a possibility of countries making devaluations against each other. All monetary arrangements made were exactly aimed at keeping fixed parity of one currency against another, until the moment when all countries adopted just one currency and solved this problem forever.

The famous "optimum tariff argument" is another theoretical possibility in which free trade might not necessarily be the best policy of a country, providing a country was large enough in the world markets. This situation occurs when markets fail to work well, and thus prices stop reflecting "true" or social costs. In that case, namely, a country has a monopoly in the production of a good and a possibility arises to use an "optimum" tariff and, thus, gain more from trade. However, as Bhagwati (2001) put it, *"this is, of course, the same as saying that a monopolist will maximise his profits by raising his price and reducing his output."* Two objections stem from this argument. First, apart from the Organization of Petroleum Exporting Countries (OPEC), few countries have monopoly power in enough goods to turn this case into a relevant exception to the rule of free trade. Second, other countries might retaliate against the optimum tariff, as it happened in the case of the Smoot-Hawley tariff Act, which was passed in the US in 1930, raising tariffs to an average rate of 60% on many products imported into the US. But in response to diminishing their exports, some 60 foreign nations retaliated and raised their tariffs on imports from the US. Although one could argue that 60% tariff rates might be far from their optimum level, the conclusion would probably remain much the same: the likelihood of successful (i.e., welfare-increasing) exercise of monopoly power becomes quite dubious.

Nor has the third argument raised by many economists, that protection might serve as a correction for most market failures, proved to be more than a fiasco. The reason for this is that the rule must follow the principle that "one cannot kill two birds with one stone." Thus, instead of healing distortions by imposing protection, the origin of distortion has to be investigated in the first place. In the case of domestic distortions, the problem has to be solved by a domestic policy, not by protection, if a country wishes to maximise the gains from trade. For example, if wages fail to adjust quickly enough when demand falls (as was the case with US autoworkers losing out to foreign competition from Japan), the appropriate government intervention, if any, should be in the labour market, directly aimed at the source of the problem. Protection would be, at best, an inefficient way of correcting for the market failure. Only in cases where distortions are external should free trade be abandened, but that brings us back to the Torrens retaliation case.

In short, none of these three arguments against free trade holds: free trade is always a nation's best policy, at least for two reasons. First, it is rather difficult to identify "if there is any beef in this hamburger", i.e., if distortions are large enough to be taken into account. Gains from pursuing a policy of optimal departures from free trade in the case of industries characterised by imperfect competition were simply not large enough to justify intervention[3]. But in other cases, where some "beef was found", the argument is that trade intervention in case of imperfect competition in external markets could make things even worse. First of all, this might happen if protection in practice finds itself "captured" by special interests who would misuse it to pursue their own, instead pursuing national, interest. But any practical value of such arguments for implementing a trade policy may be limited because of rent-seeking or because of directly unproductive profit seeking (DUP)[4] activities that constrain government's ability to recognise appropriate contexts for trade interventions when and if they exist. Finally, the possibility of "retaliating the retaliator" has always to be born in mind, since this kind of action might then make everyone worse off.

3 Dixit (1984) and Grossman (1996).
4 Bhagwati's (1982) terminology.

The moment we allow more production factors to enter the stage, the main conclusion will remain – all countries will record net gains from free trade, but neither will everybody within a country necessarily gain from trade, nor will everybody necessarily lose from protection. Thus, potential losers from free trade might lobby for intervention, regardless that net gains from free trade remain positive when a country as a whole is concerned, and the very identification of losers and winners remains relevant and deserves attention.

But one has to bear in mind that unequal distribution of (undeniably positive) net gains from free trade is quite in line with the theory of international trade! These conclusions stem from traditional general equilibrium theory of international trade, immediately after introducing more than one production factor.[5]

What we get after enlarging Ricardo's model with another product and another production factor, (which will always be on the opposite sides of any trade policies) are the famous H-O-S (Heckscher-Ohlin-Samuelson) and the Stolper-Samuelson theorems. The HOS theorem states that each country should specialise in producing a good that intensively uses its abundant production factor.[6] If a country is relatively abundant in say, capital, it will be cheaper in production of that capital-intensive good, and hence with the opening up of trade it will export its capital-intensive good. In this theoretical framework, an interesting corollary emerges: relative factor prices among countries will equalise. Factor-price equalisation (FPE) theorem is the most significant conclusion of the HOS model (but it also is a theorem with the least economic evidence so far). Factor prices simply do not seem to consistently converge between trading partners at different levels of development, but

5 The two remaining international theory frameworks comprise the Heckscher-Ohlin framework and a framework with industry-specific and intersectorally mobile production factors. In all cases the imposition of trade restrictions can cause nothing but a net loss to society, as the losses from trade restrictions always remain larger than the gains from trade restrictions.

6 Assuming identical tastes and technologies in a two country, two-commodity, two-factor framework.

 the opening era of outsourcing (described in the Appendix to this Chapter) might eventually lead to different conclusions.

International trade in goods (from HOS theorem) translates directly into international exchange of factors services, to the Stolper-Samuelson theorem. It states that liberalisation raises real incomes of relatively abundant factors in every country, while protection would precisely do the opposite. Thus the theorem reveals how the owners of scarce factors (usually capital in poor countries) raise their incomes gain when protection inhibits imports of competitive products.

However, in a multi-commodity, multi-factor framework, the effectiveness of the Stolper Samuelson theorem as a means of predicting the losers and winners from protection somewhat diminishes.[7] This gives predominance to the Ricardo-Viner specific factor model rather than to the Heckscher-Ohlin model in the identification of policy-relevant interest groups seeking to influence trade policy. Ricardo-Viner's model refers to its distinguishing feature, that a specific factor is 'stuck' in an industry, or is immobile between industries in response to changes in market conditions.[8] Finally, as Hilman (1989) shows, industries seek protection, not coalitions or intersectorally mobile factor owners.

At this point it becomes quite obvious that "national interest" or net gains give little room for politicians to pursue free trade policies, because interest groups would predominantly influence their behaviour. Then another question arises: how would politicians choose which interest group to protect? The "new" political economy by Grossman and Helpman (1992), leads us to conclude that politicians should equally welcome the lobbying dollars of expanding industries as well as those of declining industries. This is in conflict with the well-noticed asymmetry, i.e., the preponderant share of import pro-

7 With any number of goods and factors and with no restrictions on technology, protection of one good will lower the income of some factor and raise that of another, provided that the protected good was initially domestically produced and that all inputs had alternative domestic employment opportunities. In addition, the time component appears. Protected production factors definitely gain in the short run, but their long-run gains depend on their adaptability to change sector, and production factors "stuck" in producing inferior goods lose in the long run.

8 It was developed and formalised mathematically by Ronald Jones (1971) and Michael Mussa (1974).

tection in declining sectors. This leads to the conclusion that "losers lobby harder". Cases of industries that have received protection after experiencing increasing import competition are numerous (textiles and clothing, steel, shipbuilding, and automobiles), while counter-examples are rare. The question remains whether government policy picks losers, or indeed losers pick government's policy. It is clear that this type of asymmetry is hard to justify from a social welfare point of view, and also, it threatens to halt growth. Still, a sufficient condition for sustainable growth will be that new winners (ex-losers) cannot rest on their laurels because the domestic market will remain contestable and that will enable new entrants! That way, protection will evidently hurt the economy in the short run, but new entrants would help in restoring competition, technological progress and growth.

Why are trade barriers so persistent?

Despite its theoretical superiority, no free trade advocate has ever succeeded in making the general public fully comprehend the advantages of free trade. Two centuries after Adam Smith, politicians prefer to defend "national interests" than the idea of free trade, thus being totally in line with the mercantilist idea of the harmfulness of imports (which destroy domestic jobs) over exports (which are good for the economy and employment). Little help comes from the fact that things are just the other way around: it is imports that increase consumption opportunities and exports are just the price to pay for them.[9]

A series of counter-arguments have been offered to prove that free trade was not a superior solution for everyone, and perhaps not even for a nation, but all proved to be invalid. One of the most prominent arguments of this kind since John Stuart Mill was the famous "infant industry argument", asking for the protection of newly established industries. Instead, protection of mature industries seems to prevail

9 According to the Chairman of CEA during President George Bush's first term, "… if you try to explain this fact to one of the Beltway mercantilists, the best response you can hope for is a polite, condescending smile, as he reflects on how naïve you are. More likely, he will act outraged and offended, and if you are a public official, he will call for your resignation. (Mankiw, 2006).

 (clothing and, shipbuilding, steel, automobiles), proving the thesis that losers, rather than winners, seek and lobby for protection (Baldwin, Nicoud, 2001). Even in cases when it was imposed on export sectors, as in the case of the US semi-conductor industry, protection tends to focus on market segments in which domestic industry was losing ground. Thus, infant-industry turned out to be the "losers" and "declining" industry argument instead! Other arguments for protection include the terms of the trade argument, arguments concerning corrections in income redistribution, and more recently, strategic trade policy arguments[10]

Box 3.1
Why free trade fails to persuade?

The first to blame for the poor persuasive power of the famous free trade argument of comparative advantages is the counter-intuitive nature of the argument itself! There is a well known anecdote of Nobel laureate Paul Samuelson, being challenged by the mathematician Stanislaw Ulam to name a proposition in all of the social sciences which is both true and non-trivial", answered *"Comparative advantage"*.
"That it is logically true need not be argued before a mathematician; that it is not trivial is attested by the thousands of important and intelligent men who have never been able to grasp the doctrine for themselves or to believe it after it was explained to them."
Source: WTO

A series of counter-arguments indicate bad outcomes of these policies. The most important include the risk of retaliation, the likelihood of incomplete or imperfect information (Bhagwati's no-beef argument) and the presence of lobbying in a democratic system, as already described in previous paragraphs of this chapter.

After curbing protectionism in one place, it often turns out live and well in another. Countries even impose protection on

10 The use of trade policies to alter the outcome of international competition in a country's favor, usually by allowing its firms to capture a larger share of industry profits.

goods they do not produce at all, which certainly indicates the existence of interest groups of selected importers and their political influence. In this case, the classical instrument of protection, like tariffs, do not benefit as much as non-tariff quantitative protection measures, like quotas. The target then is to reach the quantity that enables profit maximisation, and monopoly equilibrium (with all its adverse welfare consequences) is then reached through quotas.[11]

Non-tariff barriers need not be transparent like quotas, but they still are very effective barriers to trade. Hidden barriers of that sort may include the use and abuse of various ostensible or real quality control measures, with health and sanitary control effectively imposing quantitative restrictions. In some cases, abuses of the safeguards of anti-dumping procedures are also used as hidden barriers to import.

New means of protection, frequently used as a replacement for quotas or tariffs, include “voluntary” export restrictions (VERs) or “orderly” market arrangements (OMAs). The protectionist effect remains the same, only this time exporters earn additional profits, too, because the demand for their products remains the same, and the supply falls, due to VERs. Bhagwati (2002) showed how these measures can work against the country that imposes protection. Thus when the US forced Japan to implement VER, the quantity of imported cars fell, and the Japanese could (and did) raise prices on their exports to the US. Bhagwati argues that it might be the case that Japanese extra-profits from the voluntary export restraint may have also helped the Japanese car industry find the funds to make investments that made them yet more competitive! Another anomaly arose with VERs in the eighties, with politics (instead of markets) starting to target suppliers, winners, losers and the market allocation of goods.

“Administered protection” comes in the form of laws that protect a country from foreign competitors who subsidise or impose dumping on their exports. As Morgan Stanley estimates in Tyson (2005), removing China’s explicit and implicit export subsidies would be equivalent to a 16 percent appreciation of the currency against the

11 As described in Begović (2005), the problem remains that a substantial part of the monopoly profit (rent) dissipates in efforts to secure the monopoly position, i.e. quota-based import license.

 dollar, which partly explains the retaliation that followed, i.e., the urging from the US for China to appreciate its currency.[12]

Free trade, growth and poverty

Over the last thirty years (1980-2000) – coinciding with a very strong globalisation period – the world poverty rate declined from 15.4 to 5.7 percent! This impressive fall in the poverty rate, due to a rise in the world population, transferred into a 50% decline of poor citizens in the world, from 534 to 211 million[13] (Sala-i-Martin, 2006). Once a widespread and an especially Asian phenomenon, poverty seems to have "moved" to Africa, where out of 11 percent of the world population, live 74.5 percent of the world's poor.

The very process of poverty reduction through trade liberalisation seems to have two phases – at first trade acts to promote growth ("engine of growth") and then growth reduces poverty.[14]

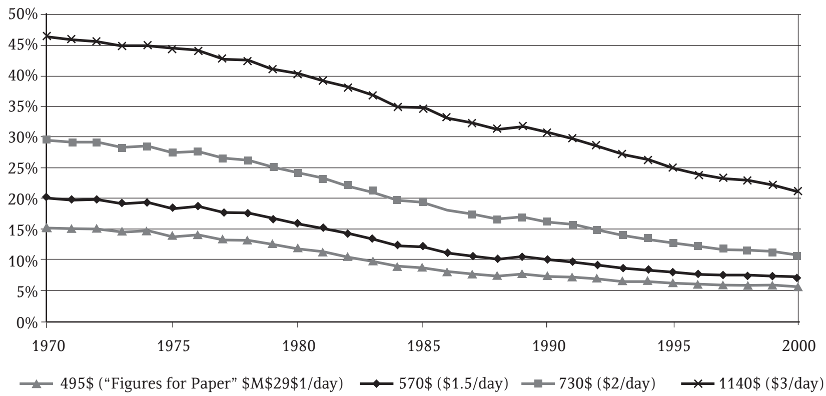
But the process is not linear and many difficulties arise during the attempt to make an empirical verification of these steps. An important exception to the rule was found in countries in transition from socialism, in countries with conflicts, and also in countries dependent on a single natural resource.

12 Retaliatory tariffs were threatened by 67 US senators who passed a resolution (sponsored by Charles Schumer and Lindsey Graham) declaring that a 27.5 percent tariff would be imposed on all Chinese imports if China failed to revalue it currency within six months. Strong opposition came from Alan Greenspan, Chairman of the Federal Reserve Bank, on the grounds that this threatens the global financial system and endangers the funding of US deficits. Senator Schumer accused President Bush's position on the yuan as having the "strength of a wet noodle". At last, in July 2005, the Chinese central bank revalued the yuan by 2.1 percent against the US dollar and announced that revaluation was just an "initial adjustment". The exchange rate system is similar to Singapore's managed "basket, band and crawl" model with currency floating within a pre-set policy band. The revaluation turned out to be "well below the 40 percent revaluation demanded by politicians and even the 10 percent increase that Henry Kissinger, former Secretary of State, suggested that would be needed to calm down the US administration)". Source: wsws.org/articles/2005/jul2005/yuan-j29.shtm.

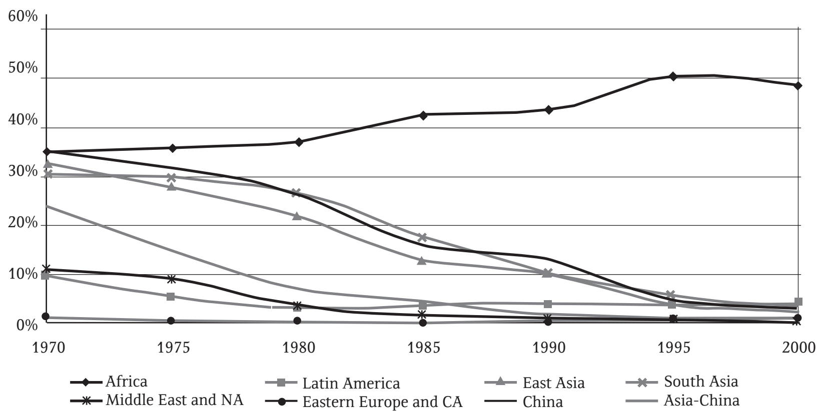
13 Sala-i-Martin (2006)

14 This is the famous 'Bhagwati hypothesis'. It is very well described in Bhagwati, (2004) and Sapsford and Garikipati (2006).

Figure 3.3 Poverty rates across the world
a) Poverty rates



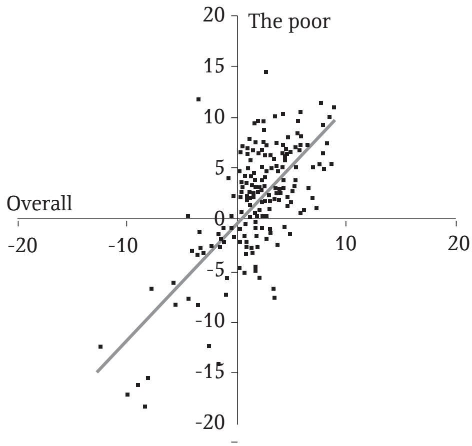
b) Regional poverty rates ($1.5 a Day Line)



Source: Sala-i-Martin (2006), pp. 373 and 380.

Four main benefits of increased trade have been recorded. 1) **Growth rates have significantly increased:** on average growth rose from below 1.5 percent a year in the 1960s and 3 percent in the 1970s to 3.5 percent in the 1980s and 5.0 percent in the

Figure 3.4 Growth is good for the poor



Note – Each point represents one coutry. Horizontal axis shows change overall in per capita income; vertical axis shows change in per capita income of the poor

Source: World Bank. *The Economist*, September 27, 2001

1990s[15]. 2) **No systematic increases in inequality have been recorded.** As for inequality, analysts of global income inequality indicate that globalisers reduce inequality faster than any other group of countries. Slower growth in Africa's per capita income then in the rest of the world widens its income gap, but most authors find that the questions of globalisation can hardly be blamed for that. It is the fact that Africa has been left out of the global economy, while in poor countries where they have succeeded in engaging themselves in freer trade things went quite differently, with fascinating results in China and India. As shown from Dollar and Kraay, 2001, inequality between countries is getting lower, while inequality within countries rise. Another significant rise in inequality is registered in non-globalisers. The concern of immiserising growth, a systematic tendency for inequality to increase when international trade increases, has not been proved. Also, 3) **Poverty has declined.** As measured by the

15 Dollar and Kraay (2001).

average income of the poorest fifth of the population, growth of a robust 5.4 percent annually has been recorded. Studies confirm that even in China, where inequality increased sharply, the poorest fifth of the population recorded growth in income of almost 4 percent annually. Experiences of India and China confirm the link between growth and poverty reduction. In India, growth seems to have been instrumental in reducing poverty levels. The proportion of population below the poverty line fell from 50 percent in late 1970s to 40 percent in late 1980s and further to 26 per cent in 2000–01 (*India Development Report*, 2005). 4) **Even the gap between the richest and poorest countries has shrunk**, but mostly because of the rapid growth of the most populated countries like India, China and Bangladesh. The estimates of growth and change in per capita income in 80 countries across the world over the past 40 years shows that incomes of the poor have risen by the same rate as happened to the overall growth.

Still, some authors argue that these main conclusions remain questionable, at least for three reasons. First of all, there is no easy way to measure openness, since it is a geographical fact rather than an economic choice of a country: small countries trade more than large ones, and remote countries trade less than countries close to main markets. Second, even if trade policies are taken as a measure of trade liberalisation, it is still not clear how to exclude all other measures which might also be responsible for boosting growth. Thus one might have two interpretations on the success of China and Taiwan. Proponents of globalisation will thus argue that China and Taiwan achieved growth only after liberalisation of their economies, while critics of globalisation can insist on the fact that these countries (as well as the Asian "tigers", South Korea, Hong Kong and Singapore) simply never stopped with government intervention of a remarkable degree, and that such a policy-mix, combined with a variety of initial conditions, makes it very difficult to judge whether trade or protectionism promoted growth. Anti-globalists frequently stress upon the "fact" that the Latin American experience undermines the case for free trade, but this simply is not the case. Chile was the only country in the region to reduce trade barriers to OECD levels, while maintaining macroeconomic stability, a fairly steady annual GDP growth rate of over 5% and a fairly low unemployment rate. The rest of the Latin American countries joined this path much later, in late 1980s and 1990s, and the important factor underlying this trend was a growing consensus on the role of trade policy in promoting development. Later on, Brazil also started to liberalise, and except for Bolivia and Venezuela, there is no strong domestic opposition to globalisation any more.

The third argument is that the problem of causation (does trade initiate growth or is it growth which boosts trade liberalisation?) is still not resolved[16]. Still, in all trade liberalisation cases a remarkable tendency was observed - that implementation of outward-looking policies tends to establish a "virtuous circle", bringing about further economic and political changes[17]. What happens is that the growth of the export sector raises the political strength of exporters and thus increases domestic support for import liberalisation of inputs and further for overall liberalisation. Still, this pattern is not universal and the case of Latin America also showed that trends can be reverted.

The debate on causation inevitably raises a question on the problem of bad governance (Washington's code word for corruption, as Jeffrey Sachs puts it), which is a precondition of successful trade liberalisation. And indeed, the problem of the lack of good governance is frequently stated as a prerequisite of free trade policies to result in favorable outcomes. But as Bhagwati (2004) states "*the question which must be asked is not whether freer trade produces significant improvement but whether protectionism would, given the same lack of good governance, produce better results. If you make a comparison of the two policies under identical handicaps, I assure you that it is hard to find convincing reasons to argue for protectionism.*"

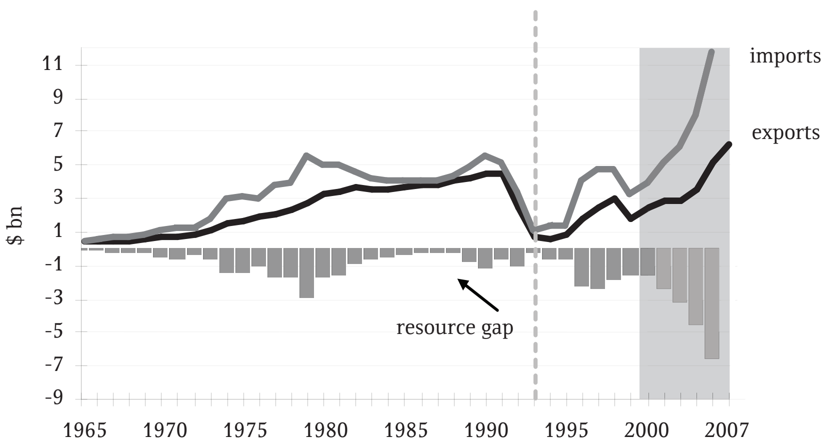
Such an approach might be helpful in resolving a dilemma stated by Dani Rodrik in The Guardian (December 12, 2005), when he compared the slow growth in Mexico, "*which is fully plugged into the global economy, but yet its economic performance is extremely poor*", with the case of Vietnam, who was under a US trade embargo until 1997, as well as under trade restrictions for many more years, and is not even a member of the WTO. If trade free trade theorists were right, Rodrik asserts that "*Mexico should*

16 Rodriguez and Rodrki (2000).
17 Krueger (1993).

be streets ahead of Vietnam. In fact, the opposite is true...", because Mexico has hardly had growth faster than 1% per annum, while Vietnam has maintained an annual growth rate of 5% for the past two decades. Poverty in Vietnam also fell, while real wages in Mexico recorded a fall. However, the case of Vietnam was not a "miracle of protectionism" at all[18]. Vietnam indeed continuously relaxed import and export controls, then it discontinued licences and replaced them with tariffs, and by 1995, lifted export quotas on all (except rice), limiting import quotas to several items. Further steps were taken to liberalise foreign investment throughout the 1990s. The growth rate of exports of goods and services was truly impressive: 28% during 1991-2001.

The case of Serbia under the UN trade embargo can provide further explanation of the mechanism of how a trade embargo destroys foreign trade flows. As presented, a dramatic fall in imports presents a fatal obstacle for resuming export and GDP

Figure 3.5 Serbia and Montenegro: exports, imports and foreign trade deficits, 1965–2007



Source: Serbian Statistical Office

18 Panagariya (2006).

 growth in an import dependent economy. But on the other hand, lifting the embargo tremendously helps in resuming growth, even if no dramatic inner reforms are implemented. Hence part of the Vietnamese growth can be attributed to the lifting of the embargo, which would also be a one-time success even if all of the above mentioned measures had not been implemented! This is particularly difficult, because during an embargo the political economy of growth changes, since import lobbyists gain crucial power in the country, which can prove fatal for further growth. After lifting the embargo, the country has to find a way to impose macroeconomic stability, good governance, and to impose the economy to freer trade, to introduce competitive exchange rate, etc. This was obviously achieved in Vietnam, and in the case of Serbia, radical improvements emerged only after the democratic changes in late 2000 (grey surface on Figure 3.6.1). But Serbia's growth in exports increased only after dramatic trade liberalisation, and especially after further encouraging FDIs through the introduction a more competitive business environment, and after enabling the privatisation of urban land, harmonising laws with the EU, etc.

Returning to the case of Mexico, it is especially striking that economic growth was far higher during the import-substitution than during the post-liberalisation phase. In the pre-liberalisation period the growth rate was over 6 percent, while since liberalisation took place it went to under 3 percent: thus the process of liberalisation coincides with growth deterioration of approximately one-half. This was obviously quite in contrast with the promises of policy-makers and academics who envisaged that NAFTA negotiations would boost the Mexican economy, especially in terms of improved export performance and growth of living standards.[19]

19 Lustig (1994) quotes a leading forecasting firm saying that "NAFTA will double both the growth rate of Mexico's overall economy and the growth rate of its wages —specifically boosting the wage growth rate from 1.2 per cent to 2.4 per cent per annum", which unfortunately never happened. Burfisher et al. (2001) say that the studies of NAFTA using general equilibrium models all conclude that "NAFTA would benefit all three member countries [Mexico, the US and Canada], with the largest relative gains going to Mexico", and they quote a pre-NAFTA survey which concluded that "the effects of NAFTA would be positive but small for the US economy, and positive and large for Mexico." Pacheco-López, Thirlwall (2004).

But as Bhagwati and Panagariya insist, it would be necessary to advise Mexico to close its borders for trade, inflow of FDIs and to put a ban on labour emigration, if those are explanatory factors for later success in case of Vietnam. What is omitted in Rodrik's analysis is that low or declining trade barriers are not a sufficient condition for rapid growth. Once taking this factor into account, slow growth in Mexico and rapid growth in Vietnam and Serbia after lifting the UN embargo (and both still not being members of the WTO) becomes easier to understand.

Evidence from most poor countries confirms that these countries suffer from poor leadership, ambivalent policies and major institutional defects (corruption, weak legal framework, poor enforcement of contracts, etc.). Thus many times poor results cannot be attributed to the lack of growth if major deficiencies were not taken care of. Otherwise, if the logic of comparison which Mr. Rodrik uses is valid, it would be impossible to explain, for instance, why Sweden for two decades (in the mid 1980s and early 1990s) recorded the lowest GDP growth rates in OECD, when simply nothing had changed in their trade policies![20] And when comparing the Swedish case to any other case in the world where a country made changes in its trade policies, we could then conclude anything we like about the effects of trade to growth! In addition, one should remember what Sachs and Warner (1995b) concluded: "*With the …exception of Haiti, – (and Rwanda – modification by the authors) there is not a single developing country that had substantially opened trade and yet failed to grow by at least 2 percent per year.*"[21].

The experiences of later reformists, like Ghana, who started radical trade liberalisation under World Bank and IMF guidance, effectively managing pressures for protection by labour unions and domestic import-competing industries, and Ivory Coast, who followed a similar path, also show how an outward orientation can bring poverty alleviation and reaching a self sustained growth path. It follows that poverty (and inequality in most cases) will also start to diminish.

20 "Swedosclerosis" is described as a process of reducing economic growth through generous welfare state policies. Nowadays economists even use the term "Eurosclerosis".

21 McCulloch and McPherson (1998, p. 36).

Cancun negotiations

In spite of all poverty reduction strategies, developed countries are heavily protecting domestic farmers with abundant agricultural subsidies, which are cited as one of the hardest obstacles to the poor for becoming successful agricultural exporters. But although this turns out to be a fallacy, powerful interest groups remain to back it up. Why is it a fallacy? This is so for two reasons. First, it is not clear that the least developed, countries would benefit at all from agricultural liberalisation because many of them (as many as 45 LDCs, out of 49) are net food importers; and as many as 33 are net importers of all agricultural products together. After the removal of European and American subsidies, LDCs will have to pay more, rather than less for their food, which won't be very helpful for reducing poverty. *What was true of cotton subsidies in the rich countries, because there are four African countries that rely on cotton exports, does not have to hold. …This is the fallacy of using an unrepresentative sample!*[22]. Second, many poor countries themselves for decades were not interested in agricultural development. They identified development with industrialisation; and their own trade policies created a substantial bias against agricultural development. *Thus, rich countries wanted to protect their agriculture; the poor countries wanted to decimate theirs, and a Faustian bargain resulted,* Bhagwati (2005).

But in the case of Mexico, removing agricultural subsidies in the US would be very helpful indeed. The Cairns group (Argentina, Brazil, Mexico, the Philippines, Thailand, New Zealand and Australia) even became a very strong lobbyist for removing these obstacles, and there is no doubt that all those countries would strongly benefit from lifting those subsidies in developed world. The effect on the poorest countries would be unfavourable, at least at the start, but anyway, that would be a good step if performed carefully and with full awareness of these immediate consequences.

22 Bhagwati (2005).

Thus one has to face the fact that liberalising agriculture might even harm many of the least developed countries. But other instrumentalities will have to be implemented to assist them, since these subsidies do not solve the problem.

Box 3.2
Who really negotiated in Cancun

Who insisted on removing agricultural subsidies …
… But I think it is mainly being driven by the interests of the middle-income developing countries, what I call the Cairns Group countries, which are Argentina, Brazil, Mexico, the Philippines, Thailand, New Zealand and Australia… the last two of them being "long frustrated by the inability to get rich-country agriculture liberalised, and have found it politically convenient to pretend that agricultural protection in the rich countries harms the poor nations of Africa." (Bhagwati, 2005).

And who was against …(and those were not small European farmers) …
Contrary to the accepted wisdom that agricultural policy should protect small farmers … large sums of money are going into European agri-business and to well-connected people. Alesina and Giavazzi (2006) state that "Prince Albert II of Monaco receives €300.000 a year for his farm in France, and the queen of England €546.000 (in 2003). The three largest beneficiaries or agricultural aid in Holland are the large companies Phillip Morris (€1.46 million in 2003), Royal Dutch Shell (€660.000) and Van Drie, and agribusiness company (€745.000)… the same pattern occurs in Spain, Nestle in UK received €11.3 million in 2004... These are the only countries for which we could obtain data … but we suspect that similar sizeable sums are paid out in France and Germany."
Since the agricultural sector absorbs almost half of the EU budget, it is clear that no small farmers could ever win such a large share of the cake. But with such strong allies in agri-business, it is much clearer now why it is politically convenient to pretend that agricultural protection in Europe is actually helping to preserve the culture of small farming communities.

Ever since Britain abandoned British Corn Laws in 1846, up to the recent experiences of Singapore, Hong Kong, Chile, Australia, New Zealand, Indonesia and India, practical examples remain of how powerful trade liberalization can be, even if it remains unilateral, not many countries seem to be eager to join the queue. To make things even harder, anti-globalisation movements around the world have raised a serious doubt about the validity of the arguments stated by liberal trade economists.

Four fallacies[23] remain which strongly influence national trade policies and which deserve to be mentioned.

Box 3.3
One size fits all, after all?

Many authors, including Jozef Stiglitz, frequently complained that globalisers and free trade advocates insist too much on a "one-size-fits all" approach taken toward development, indicating how market reforms prevent countries from freely experimenting with policies which would best suit their situations and needs.

...

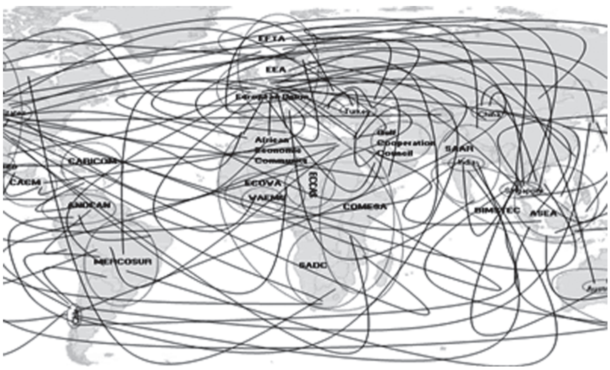
It has now become fashionable, at least in certain international bureaucracies (e.g. the World Bank in its populist phase under former President Wolfensohn), to argue that we need policies that are not universal in prescription but which reflect the fact that "one [shoe] size does not fit all". This is a silly cliché, I must say. Economics, like any science, looks for general prescriptions; otherwise, it becomes a negation of any pretension to science. Thus, in deciding on policies, we have to decide whether we want to go barefoot or to wear shoes: in terms of trade, we have to decide whether we want to push for freer trade or for protectionism. Once you have decided, for instance, to wear shoes, only a knave must think that the shoe size will not vary as we get down to specific countries. Bhagwati, Erhard Lecture (2004).

23 Bhagwati (2005) mentions three fallacies, we think that the list should be augmented by the first one listed in the text.

- Freer trade would lower wages in rich countries and protection remains necessary. But as shown in the Appendix, this is a fallacy. Wage levels are always determined by the productivity, not by a trade policy of a country. What is needed for maintaining high level of wages is that labor moves to more productive uses each time a strong foreign competitor emerges. This is Bhagwati's "ladder of comparative advantage" which probably speeds up technological progress in leading economies. Losers from mature industries then will form interest groups to fight free trade, claiming to be fighting for "economic patriotism" but fighting for themselves, instead. Nor will immigrants succeed in lowering wages in rich countries, as they have never done this so far. In addition, growth in their own countries (as it started in India, China, Korea, etc) will hold them at home, but they will make a competitive pressure from there, also. This has only led to progress for all so far, with no reason for things to turn the other way around.
- That infant industries in poor countries will collapse unless protected is another fallacy, which remains vivid despite all examples proving that this is not the case. But autarkic trade barriers seem to make another big distortion, as they create an anti-export bias! As Yeats and Ng (1996) have shown, even when the rich-country markets are opened further, one's own trade barriers can prevent the penetration of these markets.
- That the rich countries have more trade barriers than the poor ones is another fallacy. The truth is exactly the opposite: poor countries have greater tariff protection on manufactured goods,. The poor countries enjoy Special and Differential Treatment in trade negotiations. As Bhagwati (2004) indicates, few poor countries have undertaken significant commitments on services, nor are developing countries obliged to sign the optional procurement code, which all rich nations have signed.
- Agricultural subsidies in the rich countries prevent the poor from becoming successful agricultural exporters, which unfortunately is also a fallacy driven by powerful interest groups, as described in previous paragraph.

Being trapped in a Prisoner's dilemma, the trade diplomats often say that "concessions" are granted in exchange for a trade opening somewhere else. Under the umbrella of the World Trade Organization, any concession to one trade partner is automatically extended to all members, which has helped the world enjoy decades of prosperity.

Figure 3.6 "Spaghetti bowl" of investment rules



Source: UNCTAD

But the future of this central principle of non-discrimination (the Most Favoured Nation principle) which enabled that each trade liberalisation automatically leads to overall trade liberalization has been virtually destroyed by a growing number of PTAs (preferential trade agreements), the number of which proliferated to close to 300. These agreements which the architects of the GATT thought would be minor exceptions have now swallowed up the trading system. All economists now recognise the resulting "spaghetti bowl" problem, as Bhagwati (2000) had christened it. It results in a chaotic crisscrossing of preferences, which apply different trade barriers to the same products depending on which countries they originate from. "*This is a fool's way of doing trade—not only does it destroy the efficient allocation of resources, but it flies in the face of the fact that today it is becoming almost impossible to* *define which product is whose… And evidently, the MFN tariff in the EU has now become the LFN, the least favored nation, tariff!* said Bhagwati his 2005 paper.

The way out of this jam is that the only way to "kill" the PTA-generated preferences (which are of course relative to the MFN tariff) is by curbing the MFN tariff itself down to negligible levels. The suggestion is that after concluding the Doha Round another multilateral trade negotiation should follow which will eventually get the MFN tariffs virtually down to zero. The good news here is that an important trading partner, United States, seem to be aspiring this idea.[24]

Another threat to the multilateral trading system arises from the ability of rich-country lobbies to capture the trade liberalisation process (through PTAs and S&Ds - special and differential treatment for developing countries) to pursue their own unrelated agendas, such as labour standards, which would then be implemented into trade agreements and institutions such as the WTO. This is nothing but abuse of the WTO, which is, unfortunately, driving things back from a freer trade perspective in which the EU administration is especially persistent.

But evidence shows that over the last half century, trade has dramatically reduced poverty, so dramatically that even the hardest anti-globalisers do not deny this fact. Growth proved to be the best antidote to poverty and trade proved to be an engine of growth of incomes and generator of new jobs in an economy.

It has to be born in mind, however, that as Adam Smith already said, this process needs time for people to fully comprehend and adopt new rules. But when it comes to free trade, as Adam Smith (1776) said, "*Not only the prejudices of the public, but what is much more unconquerable, the private interests of many individuals, irresistibly oppose it*[25]*"*.

24 The former US trade representative in the WTO, and the acting President of the World Bank Robert Zoellick, launched a plan of reduction of tariffs on non-agricultural products to a ceiling of 8% by 2010, and then progressively cut to zero by 2015.

25 *Wealth of Nations*, 1776.

Appendix

Not even the best trade policy can compensate for a lack of good leadership, unsound economic policies and major institutional defects (corruption, weak legal framework, poor enforcement of contracts, etc.) Thus the beneficial effects of free trade cannot always be traced from the angle of poor countries. The aim of this Appendix is to provide examples from developed countries and to show that their fears of free trade often seem to be very similar to the ones in poor countries, and that as in the case of poor countries, interest groups win and countries lose with protectionism.

A.1 Free trade and jobs lost: globalisation and outsourcing debate

Joseph Stiglitz, Nobel Prize laureate in economics, defines globalisation as follows: "*Globalization is the closer integration of the countries and peoples of the world … brought about by the enormous reduction of costs of transportation and communication, and the breaking down of artificial barriers to the flows of goods, services, capital, knowledge, and people across borders*." (from *Globalization and its Discontents*). This is a very complex process[26], essentially being the deepening of free trade, but yet and again, this phenomenon is not a very welcomed one. Many anti-globalisation movements across the globe claim that globalisation is just another word for a form of "Americanization", claiming that the United States could be one of

26 According to Bhagwati (2006), globalisation has at least five distinct aspects: trade, direct foreign investment (or what is sometimes simply called "multinationals"), short-term capita flows (which were at the heart of the Asian financial crisis in the 1990's), international flows of humanity, and technology transfer (which includes the problem of patents and generics which has central importance for the poor countries).

the few countries (if not the only one) to truly profit from globalisation. And within the US, media only too often record complaints about cheap Chinese imports that destroy American jobs. Hence the country accused of being the only winner of globalisation also experiences harsh competition through new types of trade, such as outsourcing.

A.2 Arguments against globalisation: what did Paul Samuelson really say?

According to worldwide media coverage from 2004, Paul Samuelson almost gave the final "coup" to advocates of globalisation and free trade, publicly confronting mainstream economic consensus on the long run benefits that the American economy will have with all forms of international trade, including the outsourcing of call centre and software programming jobs. That is ''*only an innuendo*,'' Mr. Samuelson writes. "*For it is dead wrong about necessary surplus of winnings over losings.*"

Although Samuelson did not explicitly mention outsourcing and globalisation, his article for the Journal of Economic Perspectives (2006) turned out to be a theoretical stick on which traditional doubters could lean on. However, what Samuelson really said was nothing of the kind. He only offered three cases of trade and showed that, theoretically, one of three possible outcomes is that trade might not bring long-run benefits of free trade for all participants. The three analysed cases wereas follows. In the case of the United States and China, the first case would be the classical Ricardo's case, where both countries have a comparative advantage in one good, with a well-known outcome where both nations gain from free trade. In the second case, China improves its productivity gain in its export good; both countries gain from free trade again, also improving the US terms of trade and bringing further benefits to the consumers in the United States. A third case (act two, as Samuelson put it) turns out to be problematic, and that is when China (through an innovation) improves productivity in its import-competing sector, and this improvement turns out to be "large enough to cut some US production of it". Only in that case, Chinese technological improvements would "blow away all of the United States' previous enjoyments from free trade." However, the fact remains that Samuelson's "Act II", although theoretically possible, remains highly improbable. Samuelson confirmed that himself in the New York Times, stating that so far, the gains to the United States had outweighed the losses from trade

As the first on the list of people that Samuelson criticised (with N.G. Mankiw, Alan Greenspan and Douglas Irwin being the other three), Jagdish Bhagwati acknowledged the results from the Samuelson's model. *"And in markets like information technology services, where America has a big advantage, it is true that if skills build up abroad, that narrows our competitive advantage and our exports will be hit."* But in his book "In Defense of Globalization" (2004), he doubts whether the Samuelson model applies broadly to the economy. *"Paul and I disagree only on the realistic aspects of this*," he said.

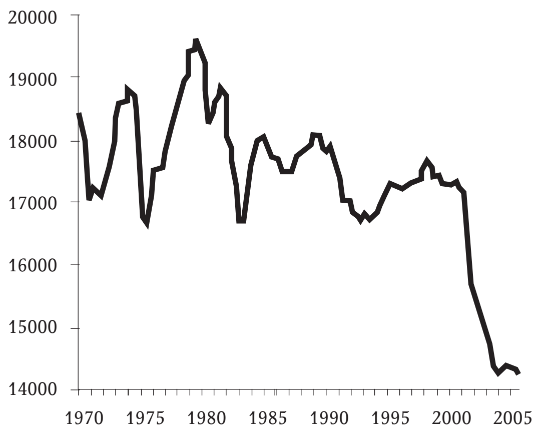
Samuelson further polished his findings in his paper form December 2006, where his conclusions were that trade and globalisation will likely benefit all regions, more to poor than to rich places, possibly exacerbating real income inequality between rich and poor, but certainly bringing more lifetime uncertainty along with augmenting material gains. Any slowdown in free trade, as economic history suggests, Samuelson repeated, would lead to "*weaker productivity advance, enhanced degree of monopoly, and to aggravated crony-capitalism and plutocratic lobbyist democracy*." However, Samuelson already said that in his paper from 2004[27], and few trade union leaders or protectionist lobbyists would have made a case for this at all, had it not been followed by his statement that "being able to purchase groceries 20 percent cheaper at Wal-Mart does not necessarily make up for the wage losses in the US". But it does make up, as shown in his own analysis from both recent articles.

27 "It does not follow from my corrections and emendations that nations should or should not introduce selective protectionisms. Even where genuine harm is dealt out by the roulette wheel of evolving comparative advantage in a world of free trade, what a democracy tries to do in self defense may often amount to gratuitously shooting itself in the foot." Samuelson (2004).

In a recent United Nations Conference on Trade and Development (UNCTAD) report, "Shift Towards Service", a prediction is given that almost 3.4 million service jobs are to be outsourced from the US till 2015. However, analysts claim that the situation is far from dramatic, since the same study estimates this figure as insignificant when compared to the average turnover of four million jobs in US every month. However, most American media cut this last sentence from their report.

Until it became clear in mid 2005 that it was the recession that kept the jobs rate at a low level, globalisation and outsourcing were the first on the list of accused for low employment rates in the US. The fears that China would take away most of manufacturing and that India would take away the jobs in high-technology services started to dominate, and politicians started building their careers on aiming to protect the US from harsh competition from the Far East. Graphs like Figure A.3.1 presented here predominated in the US media, showing that over 3.5 million people lost jobs in the manufacturing industry.

Figure A.3.1 U. S. Manufacturing employment (in thousands)



Source: U. S. Department of Labor

When observing a longer-run horizon, like we did in Table A.3.11 and in Figure A.3.2a, one can observe that aggregate employment in the US fell only in 2002, when two million jobs closed.

But if the principal causes of closing jobs in America were free foreign trade, imports from China and outsourcing, it would hardly be possible to have a net rise in employment of 1.7 million people only a year later (2003), and what more, that employment grew at a faster pace in 2005 and 2006 than it did in the pre-recession period.

Table A.1 Employment and Annual Increments in Jobs in the US

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Employed, 000	130726	133027	136559	137778	135701	137421	138471	140236	143099	145957
Annual change, 000	+2428	+2301	+3532	+1219	-2077	+1720	+1050	+1765	+2863	+2858

Source: U.S. Bureau of Labor Statistics

Employment in the manufacturing industry is still falling and those developments need further explanation. Raising productivity in the manufacturing industry indeed led to more layoffs than before.[28] Automation and computerisation have reduced the number of man-hours needed to produce a ton of steel. This raised productivity enormously, but low-skilled jobs were automated and the jobs that remained required more education and training.

Another factor remains for massive present and future layoffs in the steel industry, leading to a further expected decline to 13 percent over the 2004-14 period, primarily stemming from increasing consolidation in the industry as companies are bought by other companies in the industry and their operations merge. As larger companies create more efficient mills, the result will be fewer workers, but a more productive industry that will be better able to meet foreign competition.

28 Fastest job declines can be traced on the BLS web page http://www.bls.gov/emp/emptab4.htm.

Figure A.3.2 Employed and Unemployment Level in the US, 1970-2007. (Numbers in thousands, 16 years and over.)

Figure A.3.2a number of employees

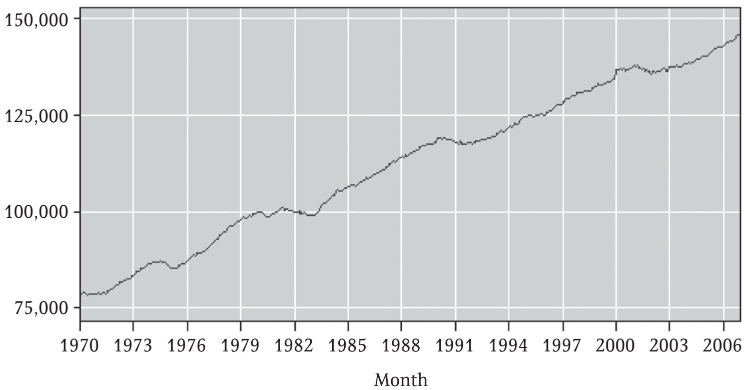
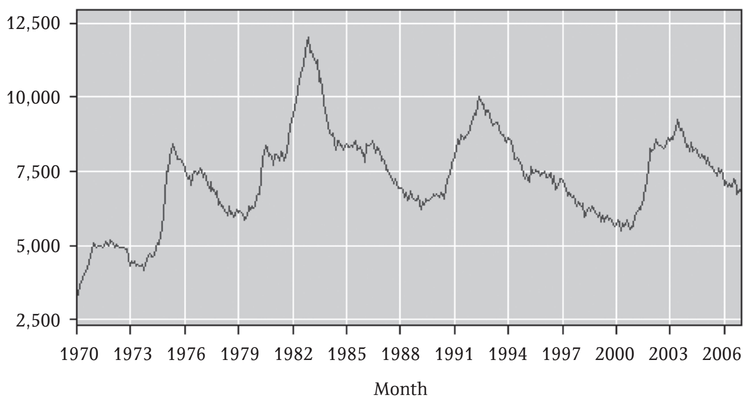


Figure A.3.2b: number of unemployed



If it ever became clear in public that automation and mergers, rather than the Chinese, were the principal cause of layoffs in US manufacturing, the case of outsourcing was not that clear at all. The call-answer services and the reading of x-ray charts by Indian radiologists brought about fears that the US would "lose services also!"

But nothing is less true. Bhagwati calls this process the "ladder of comparative advantage", where innovation capacity guarantees the rich countries to remain on the top of the ladder. In his famous book Free Trade Today, Bhagwati describes how poor countries, like Mauritius and Indonesia, started out entering foreign trade in exporting labor intensive goods, such as toys and clothing. More advanced businesses, such as consumer electronics and automobiles, were taken by countries like South Korea and Taiwan. And rich nations, like the US and Japan, keep businesses which operate at the frontier of technology, and continuously create new industries like wireless communications and biotechnology. Ant it is this very hierarchy of production that helps in reducing poverty in these poor nations. It is undeniably the fact that such a dramatic poverty reduction could not have taken place if countries like Thailand, Malaysia, and other Asian countries had not been able to export their products to the developed world.

Bhawgati (2002) argues that the United States should not even try to keep hold of low value businesses, such as insurance processing and telephone call centres, even if its workers could operate them more efficiently than their counterparts in developing countries. Instead, businesses like publishing and entertainment should be focused on, hence this is where the displaced workers find more productive employment. According to the US Bureau of Labor Statistics, the copyright business, film, music, books and IT businesses, account for about five per cent of the gross domestic product, which means it is the biggest sector in the economy, bigger even than the auto industry. Demand for jobs in US information technology constantly rises and the pay for these jobs is estimated to remain high and rise also. The US Bureau of Labour Statistics estimates that the demand for computer support specialists and software engineers will double between 2000 and 2010, while the demand for database administrators is expected to rise by three-fifths. Among the top score of jobs with the highest growth, half will need IT skills.

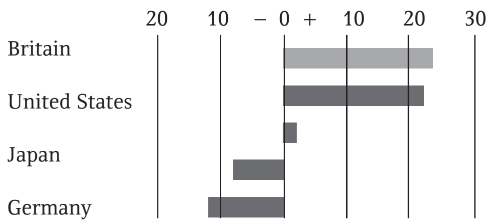
Still the fact remains that exports of services from the US vastly exceed their imports, which consists mainly of low-value services, while high-value services remain to be exportables. However, most American media do not frequently publish this fact, and the fear of losing jobs still remains vivid. According to Bhagwati in *Free Trade Today*, the reason lies in different weights that people give to these news, as *"…infinite weight" is accorded to jobs lost to foreign competition, and "zero weight" is accorded to jobs created by trade*".

BOX A.3.1
Where have we won?

"All I hear from Washington is that trade is a win-win proposition. Then I look at our growing trade deficit and think about the 3,400 good people in our good factories that we had to let go and I want someone to show me where we have won." John Emrich, chief executive of Guilford Mills in Greensboro, N.C. *The New York Times* quotation of the day, November 2nd 2004.
But estimates show that the society paid even $750,000 for every job saved in the steel industry. The author challenged protectionists with the following offer to redundant workers: *"we will give you severance pay of $750,000—not annually, but just once—in return for a promise never to seek work in a steel mill again. Can you imagine any worker turning the offer down? Is that not sufficient evidence that our present method of saving steelworkers' jobs is mad?"* Blinder (1987).

On the other hand, if one tries to impose restrictions to free trade, jobs might be saved, but the cost of saving jobs can be very high. As shown in Blinder (1987) job saving in the textile industry was tried by implementing import quotas on textile, but it succeeded only in raising consumers' annual costs by $42,000 per saved job, which greatly exceeded the average earnings of a textile worker. That same study showed that each saved job in the car industry costs $105,000, each job in TV manufacturing costed $420,000 and that the society paid even $750,000 for every job saved in the steel industry. The author challenged protectionists with the following offer to redundant workers: "we will give you severance pay of $750,000—not annually, but just once—in return for a promise never to seek work in a steel mill again. Can you imagine any worker turning the offer down? Is that not sufficient evidence that our present method of saving steelworkers' jobs is mad?" The author challenged protectionists with the following offer to redundant workers: "*we will give you severance pay of $750,000—not annually, but just once—in return for a promise never to seek work in a steel mill again. Can you imagine any worker* *turning the offer down? Is that not sufficient evidence that our present method of saving steelworkers' jobs is mad?"* Recent estimates lead to similar conclusions. Clyde and Wada (1999), show that US households would have to pay over $800,000 per year in order to save jobs for only 1,700 workers in the steel industry. The conclusion from all these studies is that by "draining" small amounts of money from many households, very few firms will be tremendously enriched.[29]

Figure A.3.3 Big businesses in Britain – trade balance in business services, 2006, $bn



Source: Advanced Institute of Management Research

Technological progress is known to have destroyed more jobs than free trade and no efficient means of protection from technical progress have ever been invented. In the example of steel quotas, the study shows that quotas could do little to achieve their announced goals of job saving. Due to rising productivity, output was constantly growing, but steel employment has been constantly falling as inefficient integrated mills were closed, whether or not steel quotas were imposed. Most of the "jackpot money" goes to lucky steel importers (windfall gains of $600 million) and efficient US steel firms (windfall gains of at least $200 million). In addition to being extremely costly, protection turns out to be no more than a short-run jobs saving policy. But at the same time, ideas

29 The study showed that US households pay $400,000 annually for every job saved by high tariffs on ceramic tiles, $500,000 annually for every job saved by dairy quotas, and $900,000 for every job saved by tariffs on luggage. Saving jobs by imposing trade barriers turns out to be a very costly way of doing it, the study shows.

Box A.3.2
Will Indian radiologists lose jobs over Indian competition?

"The scare for US-based radiologists (and extended to all medical professions almost instantly), created by radiologists in the Massachusetts General Hospital sending x-rays digitally to be read by a radiologist in India, turned out to be little more than a panicky one. Subsequent examination has shown that, to date, not one radiologist in the US has lost his job! Their earnings also remain extremely high, as does the demand for their services. Besides, the x-rays that now get read abroad typically go to India and Australia where the time zone difference enables these charts to be read by radiologists who work while the US-based radiologists sleep at night or rest over the weekend…"Indeed, even if jobs for radiologists were to decline, there would be new jobs coming up for obesity-treating doctors and related medical specialties and treatments (such as liposuction and diabetes) as the US experiences an obesity epidemic and for plastic surgeons as America also ages.", as Bhagwati (2004) argues.

and movements aimed at job protection have remained throughout history, from Ludist's movement to the anti-globalisation and anti-outsourcing movements of today.

A.4 Will freer[30] trade reduce wages in rich countries

Fears remain in rich countries, and theory confirms that following the factor-equalisation-theorem, that freer trade with the poor countries is bound to create more poor in the rich countries, since the real wages of unskilled workers would fall. But probe deeper and the fear vanishes, as Bhagwati says in his Ludvig

30 The word freer as distinct from the word free comes from Jagdish Bhagwati's work, highlighting his willingness to move outside the trade theory, and to enlarge analysis beyond direct comparison between autarky and totally free trade as extreme points of the spectrum, as distinct from seeing liberalisation "as the process of moving some way along this continuum." This consideration becomes highly relevant when moving from theoretical arguments towards empirical verification.

Box A.4.1
Will EU enlargement does not lower wages in Scotland

EU enlargement brought fears that lower skilled workers from new member states would make a pressure towards lowering of domestic wages in rich countries. Old member states take different positions on this matter, mainly keeping protectionism high. On the contrary, Scotland seems to reject this policy. As The Economist reports, East Europeans, especially Poles "*have flocked to the Highlands since May 2004 to do the low paid jobs Scots have turned their noses up at for years, in tourism, construction and food-processing.*" Employers are doing everything they can to welcome them: producing vocabulary leaflets, providing English classes at the factory, learning Polish themselves, even offering accommodation." … Experiences have been excellent so far, but employers fear that when more old EU members open their labour markets to workers from the new member states, that "the well of cheap, cheerful workers for Britain will dry up, since workers, with improved English, will head south for better-paid jobs." *The Economist*, December 13th 2006

Erhard lecture (2004). The prerequisite for this outcome would have to be the falling (relative) prices of labour intensive goods (such as textiles and shoes) in world trade. But evidence is that these prices constantly rise instead! This is so because a false general presumption was made – that over time more and more poor countries will enter in the trade of these goods, which will lower their prices. But this is not the case. Poor countries do not join trade simultaneously, but one by one, so that some already withdraw from labour intensive exports and only then new suppliers enter. When the famous Bhagwati's "ladder of comparative advantage" is called for again, one can see that China actually stepped into exports sectors that East Asian economies had already withdrawn from; and the same thing happened to these countries, who entered those markets in the 1970s, when Japan started to shift away from them.

As shown in the previous section, trade with poor countries cannot be accused for the downward pressure on rich-country wages in some sectors. Sapsford and Garikipati (2006) argue that when downward trend in sector wages is noticed, it already indicates a mature industry where technological changes will soon emerge, and that competition that comes from abroad at that moment actually moderates the fall provoked by technical change that continually reduces the need for unskilled workers.

Table A.4.1 The lure of multinationals – average wage paid by foreign affiliates and average domestic manufacturing wage by host country income, 1994

	All countries	High-income	Middle-income	Low-income
Average wage paid by affiliates, $'000	15.1	32.4	9.5	3.4
Average domestic manufacturing wage, $'000	9.9	22.6	5.4	1.7
Ratio	1.5	1.4	1.8	2.0

Source: Edward M. Graham, Institute for International Economics

According to the trade theory, free trade brings to the poor three principal benefits: (1) foreign investment raises the marginal product of labor, resulting in a rise in wages, health and safety standards in a poor country (evidence can be traced in Table A.4.1); (2) opening the country enables migration to richer countries, resulting also in a rise in wages and remittances; and (3) according to Stolper-Samuelson proposition, export activities lead to higher real wages in export sector, and Balassa-Samuelson effect ensures us that workers in other sectors would benefit through the inevitable process of wage equalisation within the country.[31] This in fact leads to the conclusion that pro-poor impact of trade will be emphasised, because the real wages of the unskilled workers will inevitably rise.

31 Numerous empirical studies appear to uphold the Stolper-Samuelson argument (e.g. Krueger, 1983; Beaulieu et al., 2001; Dollar and Kray, 2001, etc.)

4. Foreign Aid and Prosperity

"Dear Bono…

I am afraid that your energies have been misdirected when they are used to advance an aid agenda that is based on two obsolete and counter-productive premises: first, that aid for Africa must be spent in Africa rather than outside it and, second, that we must work to increase aid flows to a target of 0.7 per cent of gross national product…

In a recent interview, you said that you expected your music would endure forever but poverty would have ended in a hundred years. I wish you good luck on your music. But not even a hundred years would suffice to end poverty if you fail to correct your course."

A letter from Jagdish Bhagwati to Bono in the *Financial Times*, 27th February 2006

Introduction – basic categories

Foreign aid is a rather recent phenomenon. It generally appeared only after World War II in the completely new international order. The most brutal war in the world's history had just ended with horrible consequences to physical and human capital, new international institutions, such as the UN and international financial institutions were created, the decolonisation process started and the number of new, underdeveloped and poor countries increased day after day, while the Cold War started to divide the world into two blocs. It was an era when some thought that big problems should be resolved by big, decisive moves. Foreign aid was thought to be one of such moves.

The first relevant question is: what is foreign aid? It represents grants and all soft loans awarded under terms that are more favourable than those that would be obtained in the capital market. In other words, soft loans have a grant component, sometimes as part of the principal that is not to be repaid, and sometimes as an interest rate that is below the market rate. The loans having a grant component are accounted for as foreign aid only to the extent to which they contain grants. Commercially borrowed funds, like funds borrowed in the international private capital market, hence the funds borrowed under market terms, are not considered as foreign aid.

The largest part of foreign aid relates to aid provided by governments, or government agencies on behalf of those governments, as well as international financial institutions governed by those governments through their representatives. For that reason foreign aid is sometimes erroneously equated with Official Development Assistance (ODA). Nonetheless, apart from the government, aid is also provided by the private, non-profit or charity sector. Although there are significant differences in the ratio between government (official) aid and private foreign aid, in all donor countries the total amount of government aid is significantly higher than the amount of private aid.[1] Foreign aid recipients are mostly also governments of those countries designated as underdeveloped or poor. In the case of official, government aid, recipients of that aid are, as a rule, governments. In other words, the largest part of foreign aid does not present aid to poor people/households, but aid to poor countries and their governments. It is up to these governments how they will distribute the received aid, or whether it will be distributed at all. And this is where the first danger lies hidden – that foreign aid is not received by those who need it, but by those who

1 Comparative analysis of aid structure for the 19 largest donor countries shows that, in 1998, the largest share of private foreign aid provided was recorded by the USA, in which government aid was 3.29 times the amount of private aid, while in the case of France private aid virtually does not exist at all. With government aid that is almost 80 times the amount of private aid, Finland is the country with the largest ratio of that kind.

do not need it at all, since the poor are not the only ones living in poor countries.

Why foreign aid?

Why do donors provide foreign aid? What motivates rich countries and other donors to do such a thing? The answer to this question has two components: 1) positive (value-neutral), which means the answers to the questions of why donors really provide aid and what their actual motives are; and 2) normative, which explains how donors justify provision of that aid, or what the donors state as the purpose of that aid.

Normative analysis of foreign aid: poverty traps

Let us begin with the normative aspect. One of the basic arguments used in favour of aid to underdeveloped or poor countries by the supporters of foreign aid is the one regarding the existence of poverty traps. The poverty trap mechanism is such that, according to this theoretical concept, a country cannot get out of that trap (vicious circle). A typical example of that kind is low or zero savings. The trap mechanism functions approximately in the following way: poverty, or low income level, leads to small or virtually zero propensity to save (the entire income is spent on satisfying the most basic needs), which means that there is no investment (since there is nothing it can be financed from), and without investment there is no economic growth, which means that poverty is perpetuated, which, by the already described mechanism, leads to absence of investments and economic growth. In such circumstances, the country is doomed to poverty; the steady state of its economy will be zero growth rate.[2]

If this is really so, the only cure for economic growth establishment is a "big push", by which the mentioned trap and its mechanism will be broken and the country will take the path of economic

2 Savings trap is but one of the traps appearing in literature. Another is the trap of technology, or low productivity. Poor technology generates low productivity, whereby investments are prevented by which the technology could be improved, or the productivity increased.

 growth. As soon as the trap is broken, or as soon as a specific rate of economic growth is reached, that growth will be sustainable by its very definition. The "big push" philosophy is very popular in the literature on development theory and its popularity has endured the test of time, regardless of whether it has endured the test of evidence. One of the seminal contributions on the subject of economic growth/development (Rosenstein-Rodan, 1943) proposed breaking the underdevelopment of Southeastern Europe by a big push; some twenty years later, Rostow (1960) described the need for underdeveloped countries to reach the *takeoff* phase, since after that the economic growth would be self-sustainable, while some sixty years later Sachs (2005) emphasized that the World can solve the poverty problem permanently by a new, this time final, big push.

Naturally, the big push cannot come from a poor country itself, since it is trapped, but it is necessary to materialise that big push by a massive inflow of financial funds from those that have them at their disposal. In other words, there is no "big push" without (large) foreign aid. Therefore, both Sachs (2005) and the initiated MDG (*Millennium Development Goals*) program speak about the need for doubling foreign aid to underdeveloped countries. The summit of the leaders of G8 countries held in Scotland (*Gleneagles*) in 2005, led to their decision for the most developed and richest countries of the world to double the aid to Africa (Easterly, 2006).

Also pointing out the necessity of foreign aid as a precondition for economic growth initiation and materialisation are the two-gap economic growth models, which were very popular during the 1960s and 1970s. These models are based on the finding, or rather assumption, that poor countries must overcome two gaps in order for their economies to start growing or reach the steady state of growth. These two gaps consist of, on the one hand, domestic savings, by which investments should be financed, and, on the other, foreign (hard) currency funds, by which investors from poor countries can purchase capital equipment on the world market. While the first mechanism is similar to the mechanism of poverty trap based on zero savings, the second mechanism, or gap, is based on the assumption about the lack of export receipts, or non-convertibility of domestic currency, so that foreign (hard) currency funds are necessary in order to provide capital equipment through imports.

All mentioned findings are based on another implicit assumption, the one about imperfection of the international capital market. Namely, regardless of how low the savings in poor countries are, the necessary investments could be financed by loans obtained on the international capital market, i.e. by loans from commercial creditors. Since the needs of poor countries are very large, quite a large number of very profitable investment projects, whose internal profitability rate can sustain very high interest rates or cost of capital, should be expected to appear. Although savings are low or nonexistent, investments could be financed if there were capital flows on the commercial basis. The assumption about the international capital market imperfection (hence the funds will not flow to the countries where they are mostly needed) creates a basis for foreign aid as a "magical solution", regardless of whether there is a demand for such funds, particularly demand from the private sector. Namely, the thesis about the international capital market imperfection simply precludes any discussion on the subject of the demand for funds or the answer to the question of how high the investment rate would be in the conditions of a perfect international capital market.

This described causation is very elegant and solves a large number of conceptual problems. On the analytical level, the existence of poverty traps and the big push as a mechanism for breaking those traps, offers a simple and consistent theoretical explanation of the poverty phenomenon. There is no need to waste time on researching different, complex and fairly complementary factors of poverty, or lack of prosperity – all is clear. Also, there is no need for the theory to continue dealing with the problem of economic growth sustainability – growth is self-sustainable as soon as the country gets out of the poverty trap. Finally, such an approach gives very clear guidelines with regard to policies that should be applied. The more foreign aid, albeit provided that the recipient country ensures that it will not be wasted, but completely directed to investments, the greater the possibility of breaking the poverty trap, and then the prosperity will be inevitable. There is no need to discuss any alternative, often complex and painful policies, which are hard to implement due to the existence of strong opposition of those whose interests those policies disrupt, or conduct complex research on aid effects. All this suggests that massive foreign aid is one of the favourite choices of politicians of rich countries as well as those in the countries receiving such aid. It is easily applied, visible in the public, so political points are easily and simultaneously scored on both sides.

The problems arise, however, if the basic precondition is not fulfilled – the one relating to the existence and mechanism of poverty traps. Poverty traps based on low savings, or low level of technology used in economic activities, were taken for granted for a long time. However, the latest theoretical and empirical research (Kraay and Raddatz, 2007) demonstrated that these two types of poverty traps practically do not exist. It was demonstrated that the preconditions for these traps to exist were far from the actual values existing in developing countries. For example, in order for a poverty trap based on low or zero savings to exist in different countries, it is necessary for the level of minimum basic spending between these countries to be significantly different. Such an assumption is obviously not realistic, since the level of minimum/subsistence expenditures cannot be determined by the factors that differ from country to country. In order for the poverty trap mechanism to work, everyone in all countries should, by their spending, be very close to the level of subsistence expenditure.

The basic problem of the trap related to low or zero savings level lies in the fact that it is assumed that income is so low that it is fully used for subsistence. The phenomenon of economic inequalities is completely disregarded by this. Namely, it is certain that, in addition to many households living at the subsistence level, there is also a certain number of wealthy households that are far above that level of income or expenditure. It is estimated that in developing countries, 20% of households account for about 50% of total income. Therefore, the key question is whether, and to what extent, rich households save and what the destination of their savings is. It is obvious that large differences between the rates of savings and investments within developing countries can be explained by differences in the behaviour of those whose income is such that it makes it possible for them to save. While some invest (directly or indirectly, through the capital market) directly in their own country, or do so through local financial intermediaries, others decide to move those savings out of the country.

Although an overview of the literature on the topic of poverty traps (Araziadis and Stachurski, 2005) presents some possibilities of a new type of poverty traps, it turned out that the basic two types, those relating to low savings and low productivity, simply do not correspond to the facts. New poverty traps are found in the institutional framework and the quality of governance in a country. The models with multiple equilibriums have demonstrated that a country with a poor institutional framework that leads to such incentives to use the resources in redistribution, and not in value creation, may slip into an equilibrium in which an even greater part of resources will be allocated to redistribution. If a country gets into such equilibrium or into such an institutional poverty trap, foreign aid cannot help at all and, as will be seen later in this chapter, it may also push the country towards such a poverty trap.

Thus, the basic "disease" that foreign aid should allegedly cure does not exist at all. This does not mean that there are no developing countries that are characterised by low investment rates, usually followed by low efficiency of those investments as well, but only that the reasons for such a state of affairs are rather far from the mechanism specified by the poverty trap theory. In other words, poverty exists and persists for some other reasons and not for the reasons specified in the poverty trap theory.

However, the rationale for foreign aid can go this way: foreign aid can increase investments, regardless of the cause for such a low level of investment in developing countries, and hence lead to economic growth. Hence, it is irrelevant whether poverty traps exist or not. There are three basic problems related to this way of thinking. First, how will foreign aid, by which investments will be funded, solve the problem (low investment rate) for which we do not know even how the problem appeared? Second, is there any guarantee that the foreign aid will be used exclusive/predominantly for increasing investments? Research has shown that a large part of foreign aid not only failed to be directed or indirectly toward investments, but it even left the recipient country. Third, how will foreign aid increase investment efficiency? While the goal is the provision of economic growth and prosperity, investments are merely the means of realising that goal and not the goal in themselves. Therefore, the key issue is the one of investment management in the recipient country, and that is directly connected with its absorption capacity, i.e., the capacity to "process" the aid, enable it to pour into investments and enable those investments to be efficient. Without convincing answers to all these questions, foreign aid is not at all credible as a mechanism by which economic growth and prosperity of the poorest countries can be ensured.

This brief normative analysis of the foreign aid demonstrates that the basic rationale for foreign aid is not very convincing, and it should be expected that foreign aid fails to generate immense positive effects to economic growth. Accordingly, the relations between foreign aid and economic growth should be analysed very carefully to determine whether there are effects of that kind at all.

Positive analysis of foreign aid: factors of supply and demand

Irrespective of the ostensible rationale for foreign aid, it is necessary to consider the factors that have an impact on the amount of aid granted to poor countries. This analysis should identify both factors on the supply and demand side of the foreign aid. A comprehensive analysis of these factors (Alesina and Dollar, 2000) demonstrated that the decisive factors of foreign aid lie primarily on the supply side of that aid, in political and strategic considerations of donor countries, and far less on the demand side, observed, for example, in terms of economic needs for foreign aid (high incidence of poverty, for example, or low level of investment rates) or performance of public policies or governance of foreign recipient countries.

As to the factors on the supply side, former colonial powers send the largest portion of their aid to the countries that used to be their colonies and with which they maintain close political and cultural ties. As an illustration, 57% of French aid in the period from 1970 until 1994 went to former French colonies. Furthermore, aid is directed to the countries with which a political strategic partnership and joint action have been established, such as, for example, identical voting in international institutions.[3] It is also

3 Kuzienko and Werker (2006) demonstrated that US government aid statistically significant increases if the receiving country is a member of the UN Security Council. It is obvious that provision of such a type of aid represents a mechanism by which favourable, from the viewpoint of American global policy, outcomes of voting in the Security Council are ensured. A seat in the Security Council, according to the findings of this work, brings a 59% increase in total American government aid (economic and military aid in aggregate).

noticed that the democratisation of a country leads to an increase in the foreign aid that country receives, although such an increase is most frequently a one-time increase, immediately following the democratisation, but it does not appear that donors react to changes of government/public policies – a finding identical to the one reached by Brunside and Dollar (2000). The first part of the last finding demonstrates that there are nevertheless some elements on the demand side of foreign aid that have an impact on the volume of that aid.[4]

Very significant from the aspect of understanding donor behaviour is the research on the relation between foreign aid and corruption carried out by Alesina and Wader (2002), who started from the question whether corrupt governments (countries) receive less foreign aid. It turned out that there was neither a theoretical basis nor an empirical claim that corrupt countries receive less foreign aid – it was confirmed that foreign aid is conditional upon some factors that are not indicative of the performance of the recipient country. Nevertheless, it turned out that some donors, primarily Scandinavian countries, take into account the corruption level of the government of the recipient country, so less corrupt countries receive larger Scandinavian aid.

On the demand side of foreign aid, a voracity effect was identified in the literature (Tornell and Lane, 1999), which shows that an increase in foreign aid supply, which is then distributed by contest of interest groups, leads to an increase in spending of the interest groups and to an increase in their rational expectations. Additionally, this leads to an increase in the pressure on the government to ask for more aid, and thus to an increase in demand for foreign aid, which may lead to a further increase in supply or volume of that aid, but clearly with unfavourable effects on growth and economic efficiency.[5] In other words, an increase in the volume of

4 A country's strategic position may decisively affect the level of foreign aid to that country. A typical example of that kind is Israel. However, in today's world, there is a relatively small number of developing countries that have a strategic position. Most of them ate in the Middle East.

5 Taking into account usually strong political and cultural relations between donor and recipient countries (former colonies, for example), it could be expected that there are strong lobby groups in the donor country (diaspora of the recipient country, for example) that provides pressure for more aid to recipient country.

 foreign aid creates incentives that lead to further increase in that aid. Corruption in the foreign aid recipient country can be a sort of multiplier of that relation. An increase in foreign aid leads to an increase in resources or rents which different interest groups seek, which leads to an increase in corruption and, thus, multiplies voracity effect, i.e., increases demand for foreign aid funds.

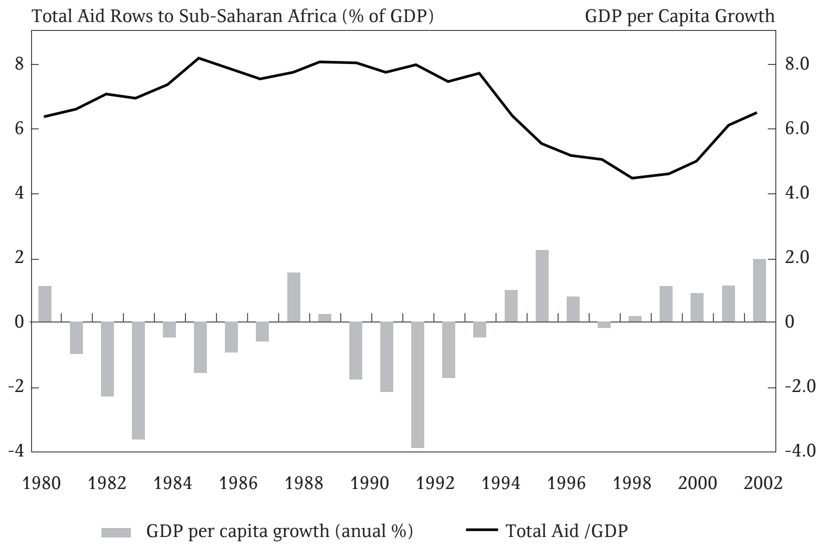
Foreign aid and economic growth

Normative analysis demonstrated that poverty traps, the basic rationale for the foreign aid, do not exist. Positive analysis of foreign aid demonstrated that the motives for granting aid do not have much in common with the economic growth of a country or with the reduction and elimination of poverty in that country. In other words, supply of foreign aid depends on factors that are very weakly tied to the aid recipient. On the demand side for aid, it turns out that it is not strictly determined by the situation in the country (poverty level and prevalence) and character of governance, but very often connected with the rent seeking activities directed towards income/wealth redistribution. A question arises whether a connection between foreign aid and economic growth or prosperity may be established at all at the empirical level. If it may be established, does foreign aid support economic growth at all?

Already the fact itself that, in the last five decades, the developed countries have transferred USD 2,300 billion as aid to underdeveloped and poor countries, but that the level of poverty expansion in the world is still such that a substantial part of the planet's population lives in poverty (Chapter I), gives us the basic idea about the efficiency of this type of aid. It is easy to conclude that it is highly improbable that foreign aid supports economic growth at all if we take a look at the chart that shows foreign aid compared with growth rates in sub-Saharan Africa.

However, before considering in detail the effects of foreign aid and its efficiency in terms of initiating and promoting economic growth and prosperity, it is necessary to answer one essential question regarding mechanism by which foreign aid can or should boost economic growth in developing countries.

Figure 4.1 Aid and Economic Growth in Sub-Saharan Africa



Sources: World Bank, World Development Indicators Online available at www.worldbank.org/data; Organisation for Economic Co-operation and Development, International Development Statistics available at http://www.oecd/50/17/5037721.htm

Types and mechanisms of foreign aid

One type of foreign aid is direct financing of a specific investment project in the recipient country. In that regard, if there is a good supervision mechanism, it is certain that these funds will go to investment and not to spending, thus increasing the investment rate in the recipient country. The higher the investment rate, the higher the growth rate that can be expected. Nonetheless, the implicit assumption on which this prediction is made is the one about constant marginal productivity of investments, i.e., that aid funded investments are equally efficient comparing with the other investments.

However, there is substantial evidence that the marginal productivity of an investment funded by foreign aid is lower than other, privately funded investments. In the case of investment funded by foreign aid, investment projects are not selected according to the market criteria. Hence it is not evident that project it is really necessary, i.e. its internal rate or return need not to be higher comparing with the cost of capital on the market. In other words, instead of evaluating the investment project to market criteria, on the basis of which entrepreneurs would compare the expected rate of investment return and capital cost and bear all the consequences of their investment decision (both good and bad), that decision is made by donors and domestic authorities. Donors make that decision without being accountable in any way to the public of the recipient countries, while domestic authorities are often accountable solely to powerful interest groups interested in rent distribution and not in efficient investments or economic growth. Taking all that into account, it is reasonable to assume that marginal productivity of investment funded by foreign aid is lower comparing with the investments funded by private capital, and thus overall economic efficiency is decreased. Foreign aid that is channelled strictly to investments increases investment rate, but decreased economic efficiency of investments and effects on economic growth are ambiguous.

The other type of aid is budgetary support to the recipient country: funds that can effectively be used in any manner, but primarily for (public) consumption/expenditures. Nonetheless, the rationale of budgetary support is to channel these funds into consumption and to enable the recipient country to keep the tax burden low, enabling the increase of private investments and investment rate in the economy. If budgetary support works in this way, it will provide an increase of private investment and solve the problem of adverse selection of investment funded directly by the foreign aid. Nonetheless, a necessary condition for that is that public expenditures remain the same, i.e., that budgetary support provided by foreign aid does not increase the level of public expenditures and enable the government to lower the tax burden without producing a budgetary deficit. If this precondition is not fulfilled, the mechanism will not create an increase of investment rate because the same tax burden will generate increased public expenditure.

Even if the investment rate is not increased and the growth rate of the country is not affected, foreign aid that is disbursed as budgetary support increases wealth, at least in a short-term and unsustainable way, due to transfers from rich to poor countries. Nonetheless, the problem in this case is whether such spending/

expenditures will be in accordance with the priorities of the recipient country. Will it, for example, be directed for the benefit of a small group of rich people in power and those close to the government, or will it be directed to poor households? There is no unambiguous answer how foreign aid disbursed as budgetary support will affect the country's public finance, whether the tax burden will decrease, and what public spending will be financed, but there are strong incentives for public consumption to increase, for the tax burden to be the same (or bigger), and for the increased public expenditures to be focused to rich people.

However, regardless of the type of foreign aid (investments or budgetary support), it inevitably leads to distortions on the market (both products' and factors' market) of the country that is the recipient of that aid. For example, prices of some products or production factors decrease or prices of others increase, and then this spreads to other market segments and leads to global distortion which reduces economic and investment efficiency. Accordingly, there is a decrease in the efficiency of all investments in that country (and not only those financed by foreign aid funds), and that decreases the rate of economic growth for the given investment level/rate. Even if foreign aid leads to an increase in investment level/rate, this does not necessarily offset the inevitable decrease in economic efficiency which arises due to all the analysed distortions. That leaves room for the possibility that foreign aid has no effects on growth or even decreases the growth rate of the recipient country. In other words, there is a possibility that a country would do better in the area of economic growth without foreign aid.

Models of behaviour of recipient country government

Taking into account the options regarding the effect of the foreign aid, the crucial questions are: what would be the outcome of the foreign aid and which factors influence the outcome? It is reasonable to assume that the majority of these factors are on the side of the recipient country.

Theoretically speaking, following Boone (1996), there are three models of government that may be used for explaining the different behaviour of the government of recipient country. *Elitist government* takes care of itself and the political elite, and of the interest groups supporting it, which means that the received foreign aid is directly (via budgetary support) and indirectly (via funding investment projects that benefit a small number of people) transferred to the already rich political elite of the recipient country. This is followed by competition of the interest groups in rent seeking, i.e., in having access to the government which makes redistribution decisions. *Egalitarian government* takes care of the widest strata of the population, and foreign aid is distributed so as to also increase the well-being of the poorest people. Nonetheless, it is implicitly assumed that this type of government increases public expenditures as a consequence of foreign aid and that the tax rate, i.e., tax burden, stays the same after budgetary support is introduced. Finally, the *government oriented towards the free market* uses foreign aid as budgetary support to reduce the tax burden and its distortional effect, which leads to a higher level of available income, higher savings and more investment, and to economic growth as well. It is only in this case of government that incentives for economic growth are created. Empirical research has demonstrated that the behaviour of government in the majority of developing countries can be best described by the model of elitist government – foreign aid is channelled towards the expenditure of the rich in power and those that are close to the government.[6]

In conclusion, foreign aid not only fails to promote growth, but it predominantly goes to spending, without reducing the tax burden, and not to the help the poor. The governments that are recipients of foreign aid redirect that aid to budgetary support, and in such a manner that the foreign aid benefits most of the country's political elite, which is one of the richer strata in that country. In other words, foreign aid not only fails to provide economic development, and thereby help the poor, but it also does not increase the spending/

6 It turned out (Boone, 1996) that the marginal propensity to consume foreign aid actually equals one (statistically, it is not significantly different from 1), and marginal propensity to invest equals zero, which means that spending is predominant in the use of foreign aid. Foreign aid does not lead to significant tax decrease or to abandonment of distortional economic policies. However, foreign aid increases public spending, so public spending constitutes about three fourths of the total foreign aid received, and that public spending is not directed towards the poor, since it is directed towards improving the well-being of the rich elite that is close to the government.

consumption of the poor in the short term either – the poor have no benefits from such a foreign aid.[7] Although foreign aid is very often called aid to the poor, effectively is not. Aid does not come to poor people/households, but to the governments of poor countries. And governments as the intermediary in that aid have their own political priorities – eradication of poverty is definitely not one of them.

Empirical findings on foreign aid and growth

Taking all that into account, it is somewhat surprising that early empirical contributions on the subject of relations between foreign aid and economic growth during the 1950s and 1960s seemed to find some positive correlation between foreign aid and economic growth rate. However, those papers did not engage in detailed research of the causation between these two phenomena, and particularly not of the question whether and for what reason foreign aid leads to economic growth in some countries, while in others it does not, or even leads more to the opposite effect. Furthermore, the first serious research in econometric terms of these two phenomena (Papanek, 1973 and Papanek, 1982) found numerous methodological weaknesses in this early research, leading to serious questions of the reliability of their results. Moreover, the early research was quite limited, since it did not provide for the basic picture of what happens with foreign aid when it arrives in the recipient country, or what all the effects that foreign aid have been.

One of the first empirical conclusions that foreign aid has no effect on economic growth is related precisely to the already given explanations, since foreign aid is redistributed to spending as it is disbursed as budgetary support and since the distortions in the operation of the private sector decrease the overall economy efficiency and marginal investment productivity.[8] Furthermore, dis-

7 Such a manner of using and distributing foreign aid leads to an increase in economic inequality in poor countries. It is unlikely that it was the explicit goal of donors, which they could defend before their own constituency. Fortunately for donors, their constituency is not too interested in the results of the aid their countries grant to the poorest countries of the world.

8 Mosley *et al*. (1987) show, on different samples of underdeveloped countries, by using different specifications and methods of econometric assessment, that foreign aid generally does not affect the rates of economic growth of the countries that receive it.

 bursement of foreign aid to budgetary support creates the classical case for rent seeking, which means that the resources are used in the struggle to redistribute as much foreign aid as possible for personal benefit. Instead of being used for value creation, resources that have their opportunity costs are wasted on its redistribution.

However, an interesting question is whether there are some specific conditions in which foreign aid may contribute to acceleration of economic growth. In other words, are there perhaps special cases in which there is a beneficial effect of that aid?

More recent works theoretically explain and empirically show that economic growth occurs under conditions of good economic policies and stable institutions that create good incentives for economic agents. Such policies and institutions create incentives for all economic agents to increase economic efficiency and promote economic growth. Households save if their savings deposits are safe from expropriation, either through inflation or arbitrary government decisions, or by plundering actions of economic agents from the private sector. Entrepreneurs invest if their property rights are protected and if there is a low risk of government intervention that will deprive them of the already acquired rights. Producers produce efficiently if there is unrestricted competition on the market that increases pressure on all producers and provides incentives to control their own costs. All this leads to an increase in economic activity level, economic efficiency and economic growth.

The first of the "third generation" research (Boone, 1996), which was based on these questions, demonstrated that foreign aid does not lead to an increase in investments, or improvement of poor people's circumstances, measured by means of the usual human development indicators, but that it leads to an increase in the size of government, measured by the relative volume of public spending (measured in relation to gross domestic product). Furthermore, it turned out that there is no difference in the effects of aid in cases of liberal-democratic and repressive regimes – the same effects appeared in both cases. Obviously, the already explained mechanisms work in both types of political regimes.

In accordance with all this, the key question is: how do we get to good economic policies, or how do we create good, effective institutions that create good incentives? For the purpose of discussion in this chapter, what is the relationship between good economic policies and institutions, on the one hand, and foreign aid, on the other. Two questions are fundamental. First, what effect does foreign aid have if the recipient country conducts good economic policies and has good institutions? Second, can foreign aid lead to good economic policies and institutions, or at least to their improvement? The second question will be addressed in the following chapter.

As to the first question, in one of the most influential works on that subject, Brunside and Dollar (2000) demonstrated that foreign aid leads to economic growth in countries that have good economic policies.[9] It turned out that, if there are good economic policies, foreign aid may promote economic growth and that an increase in foreign aid leads to an increase in the economic growth rate. However, foreign aid cannot do it independently, but only together with good economic policies.

The model specification itself shows that the independent action of good economic policies is of crucial importance for economic growth, regardless of the amount of foreign aid. Therefore, foreign aid can lead to economic growth acceleration only if there is a solid basis for that, embodied in good economic policies. Since good economic policies already, in themselves, provide the dynamics of economies of the poorest countries, in such conditions, foreign aid can lead to additional economic growth acceleration. In other words, in the conditions of poor economic policies, foreign aid cannot do anything in economic growth. The countries having poor economic policies are doomed to stagnation and poverty, regardless of foreign aid or its amount.

The mentioned empirical finding and its interpretation have been the subject of intensive discussion in the last few years. Additional research has shown that the mentioned empirical findings were not robust.[10] At the same time, however, not one study has shown the existence of any statistically significant connection between foreign aid and economic development irrespective of the

9 Three components of good economic policy are identified: good montary policy (monetary stability, or low inflation), good fiscal policy (balanced budget) and good foreign trade policy (low import and export barriers).

10 Result robustness is tested by changing some parameters of empirical research only. For example, changes are introduced in the sample size and scope, model specification, indicators by which a loose variable is represented.

 country's economic policies, but many have shown that foreign aid does not have any impact on economic growth, not even in the cases of countries with good economic policies. In other words, the pessimism regarding the connection between foreign aid and economic growth has not been disputed. It turns out, however, that in some cases not even good economic policy can cause foreign aid to have a positive effect on economic growth, and that foreign aid cannot help at all to countries with poor economic policies.

Character of the returns to foreign aid: the Laffer curve[11]

Even if foreign aid has positive effects on economic growth, a question arises regarding the character of these returns. It may be assumed that there are decreasing returns (an increase in foreign aid causes a decline in the growth rate increase), but there is a quite real possibility for the decreasing returns to turn into negative returns, i.e., that the increase in foreign aid causes a decrease in the growth rate of the country receiving that aid. In other words, perhaps it can be assumed that there is a special case of the Laffer curve of foreign aid – at a low level of foreign aid, an increase in aid causes an increase in the rate of economic growth, while at a high level of foreign aid its increase leads to decreasing and even negative returns in terms of the rate of economic growth.

Exploring the character of the returns of foreign aid to economic growth is very important for the normative analysis of foreign aid. If there are increasing returns of foreign aid to economic growth in all the conceivable levels of foreign aid then an appeal of Sachs (2005) to dramatically increase foreign aid is well founded. Such an increase will produce over-proportional results in economic growth and poverty reduction/elimination. However, if the Laffer curve exists, the aid will decrease the growth rate, eventually leading to the zero or even negative growth rate.

11 The Laffer curve is used to illustrate the concept of taxable income elasticity, the idea that government can maximise tax revenue by setting tax rates at an optimum point. Beyond that point the increase of tax rates (burden) decreases tax revenue. Accordingly, Laffer curve describes the character of the returns to the tax rate. The curve was popularised by American economist Arthur Laffer and that is the origin of the name.

What are the factors that cause decreasing returns of foreign aid to economic growth, or even negative returns? The first one may be the change in the character of the national economy that is caused by an increase in foreign aid. As mentioned by Bauer (1991), since foreign aid in most cases comes to the government of a poor country, intensive foreign aid almost inevitably leads to a statist economy and politisation of economic life, strengthening the government's role and its interventionism based on arbitrary decisions. Instead of engaging in the provision of basic public goods (the rule of law and creation of preconditions to private investors and entrepreneurs for business activities), the government deals more and more with redistribution based on foreign aid, which leads to expanded rent seeking, with all of the negative effects of that activity.

Even if one assumes that governments of developing countries are benevolent and not engaged in redistribution and rent seeking, there is a problem of the absorption capacity of developing countries and their governments to "process" foreign aid. Even if all the funds of foreign aid are channelled in investments, underdeveloped countries do not have enough administrative capacities to manage all those investments well, which inevitably lead to a decrease in the marginal productivity of investments. The distortions foreign aid leads to, particularly if the increase in foreign aid leads to distortions in overall resource allocation and economic efficiency, may lead to negative effects and returns of that aid. An increase in foreign aid leads to a decrease in the growth rate.

Another factor that can lead to decreasing or negative returns of foreign aid is called "donor fragmentation" in foreign aid literature (Knack and Rahman, 2007). Namely, it is reasonable to assume, and it was empirically verified that the number of donors themselves increases with the increase in the amount of foreign aid to a country. Each donor performs the whole aid implementation work by itself, and therefore it needs significant administrative capacities in the country receiving the foreign aid. These administrative capacities are created by employing the best local workforce to perform these tasks, the workforce that would be engaged in the domestic private sector or in the local government administration. In other words, these resources are crowded out of the incumbent purposes and reallocated to the foreign, donor sector. By that very fact, the administrative capacity of local government and the productivity of the domestic private sector are weakened, thereby weakening the overall economic efficiency and overall positive effects of foreign aid as well. Moreover, the wage policy in the foreign donor sector is determined in a centralised manner, regardless of the circumstances in the local labour market. It is usual for the wages in that sector to be far above the competitive wages in the domestic private and public sectors. This leads not only to the already noted drain of quality personnel to the donor sector, and to a further decrease in the absorption capacity of the recipient country, but also to huge distortions in the local labour market, or to an increase in equilibrium wage, and *ipso facto* to an increase in unemployment as well, and to a decrease in value creating activities. The higher the donor fragmentation, usually occurring with an increase in the amount of foreign aid, the more pronounced the mentioned problems in the labour market. This decreases the economic efficiency and the economic growth rate, and the returns of foreign aid as well.

Donor fragmentation leads to another problem that further decreases aid returns. Namely, there is no strict division of labour or full specialisation among donors. Although there is a certain level of donor specialisation (e.g. between the IMF and the World Bank), in most cases it is a matter of competition between donors. The key question is whether that competition is desirable and whether it increases the efficiency of foreign aid. It is highly unlikely. In this case it is not a matter of competition in the market in which success criteria and the costs of failure are clear and understandable. Consequently, competition pressure to donors virtually does not exist at all, so it cannot have any beneficial effect on the increase in economic efficiency. Therefore, there is more and more talk about donor coordination or coordination of foreign aid operations in a country in order to avoid the "duplication" of efforts of various donors and to reach effect maximisation for the given level of aid. The problem lies in the fact that the results of that coordination are not encouraging either. Although it is indisputable that there are some results in some cases, the coordination process is such that it does not include a credible threat to non-cooperative parties.

Namely, there is virtually no sanction if one of the parties that have concluded a coordination agreement breaches or abuses that agreement. Thereby the problem of foreign aid management and coordination returns to the problem of coordination in central planning that has never been solved for one simple reason – the incentives to the agents are such that it can never be solved. Increase in foreign aid and increase in the number of donors exacerbates the insoluble problem of mutual coordination, so foreign aid is wasted and its returns decrease.

Empirical research and tests of the hypothesis about the existence of the foreign aid Laffer curve failed to produce distinctive results in the case of foreign aid (Lesnik and White, 2001 and Nkusu, 2004). Although some empirical findings were obtained supporting the thesis about the existence of decreasing or negative foreign aid returns, it turned out that those results were not econometrically robust, and that the statistical significance of obtained results is lost with a change in the sample, model specification, indicators applied or the manner of economic assessment. Although it is clear that there is a convincing theoretical explanation for the existence of the Laffer curve in case of foreign aid, it is obvious that additional empirical research is needed in order to find out more about this phenomenon and the character of the returns of foreign aid to economic growth.

Foreign aid and institutions

However, regardless of all mentioned problems regarding foreign aid, it is indisputable that good economic policies and good institutions enable and promote economic growth. Therefore, it is reasonable to ask the following question: can foreign aid have an impact on public, especially economic, policies and institutions of the recipient country? Can foreign aid, for example, have an impact on the quality of governance in the recipient country? If foreign aid enabled and fostered the formulation and enforcement of good economic policies, or the creation of appropriate economic institutions and good governance, then a huge part of the work regarding prosperity would be done. Good economic policies and good institutions would by themselves create incentives to the private sector to bring the country to the path of rapid economic growth with its own investments. Then the issue of foreign aid would not be raised any more – it would definitely help economic growth and prosperity. To answer these questions, it is necessary to consider the potential benefits that foreign aid offers to the formulation and enforcement of good public policies or the building of good institutions, the pitfalls arising in this, as well as incentives to use possible advantages.

As suggested by Coviello and Islam (2006), there are three basic potential advantages of foreign aid regarding building the institutions of recipient countries: (1) providing resources necessary for institution building; (2) increasing, transferring and expanding appropriate knowledge for policy formulation and institution building, and informing the public about that; and (3) creating incentives to governments to implement reforms and build institutions.

On the first potential advantage, it is certain that many poor countries do not have sufficient funds available in their budgets for financing institution building. The additional tax burden would either endanger economic activities or, due to the weakness of tax administration, would not lead to any increase in tax revenue at all. In that regard, this really may be a potential advantage; however, it turns out that additional inflows into the budget that originate from foreign aid often go to expenditures, and the expenditures of those who are close to the government – the political elite of poor countries. Furthermore, if foreign aid finances institution building, then the governments are accountable for their activities in that area to foreign donors and not to their own constituency, or at least not to domestic interest groups. The motives of donors are questioned, whether they are essentially interested in building institutions and whether they are in a position to effectively punish those that failed in that respect. This will be discussed in more detail later when discussing the donors' policies of conditionality.

The second potential advantage relates to increasing, transferring and expanding appropriate knowledge, and informing the public regarding good policies and institution building. This advantage is indisputable; more knowledge and information can only be useful in the attempt to reach prosperity from poverty, regardless of to what extent the lack of knowledge really is an obstacle to the creation of good economic policies and good institutions. However, there are two important constraints to this advantage. First, there are few donors in a position to offer systematised, appropriate knowledge in this sphere – these are, above all, international financial institutions and their research institutes. Second, some donors that can play the role of informing the public of the recipient country often disregard that very public and limit themselves to the transactions they carry out with the government of the recipient country. In this way, donors become special "hostages" of the government, with no developed positions in the civil society in the recipient country.

The third advantage is the most controversial. Can foreign aid create incentives for the governments of poor countries to reform their policies and institutions? This question virtually boils down to the issue of aid conditionality as a driver of reform. And two questions arise here. The first regards the motives of donors: why would a donor condition foreign aid upon reforms in the country? The second relates to the efficiency of conditionality: does such conditionality have any effect on the reforms in a recipient country?

As regards donors' motives, making aid conditional on reforms is not a priority. Far more popular are the other two types of conditionality. The first is political, in which a country is explicitly or implicitly required to implement a specific policy, for example, support to the donor country in actions that have nothing in common with the recipient country. The motives for this type of conditionality lie in strategic considerations of the donor countries and maximisation of strategic political benefit that may be obtained by foreign aid placement and conditionality. The second is the conditionality that part of the aid must be received in kind, and from the sources of the donor country at that. In case of technical assistance, for example, it is a matter of engaging consulting companies from the donor countries, which most frequently spread ideas that are predominant precisely in that country. The motives for such conditionality are in the still widespread Keynesian philosophy of government that it is necessary to increase the demand by public spending and thus increase domestic production and employment.

 Making aid conditional upon reforms thus virtually boils down to conditionality by international financial institutions – only they may have some motives of this kind.[12] Only these institutions still believe in certain economic policies, like the "Washington consensus", or reductions of costs of doing business. Furthermore, international financial institutions, in addition to aid in the form of funds, also provide technical assistance and transfer of knowledge in reforms, both economic policy reforms and institutional reforms. However, is making aid conditional upon reforms effective? If there are no domestic incentives for reforms of economic policies and institutional reforms, can these incentives be successfully substituted by the policy of conditionality?

It turns out that the reform conditionality is effective when it is practically unnecessary – in the situations in which there are reformist governments and in which they are strongly devoted to reforms. Then the foreign aid conditionality may be useful with regard to the tactics that will be applied or the manner in which the reformist governments will oppose anti-reformist groups and their activities. From the aspect of political tactics, it is sometimes worthwhile to shift the responsibility for particular moves in the public to international financial institutions. Also, if there is a short-term "reform fatigue", the conditionality may lead to overcoming the problem. However, that can lead only to short-term progress. If, in the long run, there is a lack of reformist potential, it cannot be substituted by conditionality. Then the domestic government will only look for a way to evade that conditionality (see Box 4.1.).

Except in a small number of already mentioned cases, reform conditionality is not effective for the adoption of specific economic policy, particularly the one which creates incentives for economic growth, such as monetary stability, balanced budget and free foreign trade. The point is that these economic policies create numerous losers, so it is of key importance to achieve strong and wide political support at home for such policies.

12 This naturally does not mean that the countries having a large number of votes in international financial institutions cannot abuse voting in the Board of Directors of these institutions for their political or strategic purposes.

Box 4.1
Selling reform

In 15 years, the government of Kenya "sold" agricultural reform to the World Bank four times in a row. Each time the Bank made the release of funds conditional upon appropriate changes in legislation or government policies in agriculture. Each time, following the disbursement of funds and following the realisation of the foreign aid, the Kenyan government annulled the reform that had been the condition for the disbursement of funds (Collier, 1997). It is obvious that the one who is not determined to implement reform can always find a way of evading the conditionality of foreign aid upon reforms.

Another reason for the ineffectiveness of reform conditionality is that the personnel of international financial institutions, the only donors that are actually in the position to make aid conditional upon reforms, become special "hostages" of the recipient country's government. Without cooperation with that government there are no new projects, while the personnel, for example, of the World Bank are rewarded only if a project has been approved. It is irrelevant whether that project is sustainable and what its effects are, the only important thing is that the project has been approved (Shirley, 2004). Foreign aid is measured by transfer of funds and not by the results achieved. For that reason, the personnel will be lenient towards the government that is not quite effective in the implementation of reform policies.[13]

As regards institution building through foreign aid, the problems are even more complex. Institutions, generally observed, emerge in two ways. One way is that which comes from below, on the basis of competition of different institutions (North, 1990), in which superior institutions replace the inferior ones. This is a slow, piecemeal and long-term process based on decentralised initiatives and the trial-and-error method, while the whole process

13 That could be the explanation of the recent empirical research (Dreher and Rupprecht, 2007) that demonstrated that net reform effect of the IMF programs is negative.

 is conducted by specific institutional entrepreneurs. Foreign aid conditionality cannot improve or accelerate this process, since it is, by its own definition, endogenous.

The other way of institution building is their transplantation or transfer from one environment to another. Although, at first sight, transplantation is associated with failure, or a small possibility of success, transplantation can be a substantial part of successful institution building. It cannot substitute the mentioned bottom up institution building; however, institutions created in foreign countries may simply enter the competition for a selection of the most efficient institutions. In that regard, making institution building conditional upon the establishment of specific kind of institutions may also be of some benefit only if it is accepted that those institutions are only an option in the institution building and that they should, together with other alternative institutions, endure the test of time and/or competition. If that does not happen, then the countries on which a particular institutional arrangement has been imposed will accept that arrangement only formally and pass particular legislation, but then that legislation will simply not be implemented.

This section has argued for which foreign aid may lead to an improvement of economic policies, but also the factors that weaken or even annul that effect. If it were only for these factors, foreign aid would certainly have a beneficial effect on government policies and institutions, only there would be a question of magnitude of that effect. However, there may be factors by which foreign aid leads to a deterioration of economic policies or economic and political institutions in recipient countries. If so, there is an open question of the character and direction of foreign aid impact on economic policies and the quality of institutions of the recipient country. Namely, there is an ambiguous answer to the question as to which of the mentioned factors prevails, so it is not known what the final outcome of their action will be. In other words, it is quite possible for foreign aid to lead to a deterioration of public policies and institutions in the recipient country.

Knack (2001) suggested that the dependence on foreign aid has two effects. First, it undermines the quality of governance and public sector institutions in a country by reducing the responsibility or accountability of those who make key decisions on that governance (politicians and government officers) and increasing the intensity of rent seeking and other redistribution activities, including corruption, intensifying the fight for control over incoming foreign aid funds. Second, dependence on foreign aid leads to the reallocation of scarce resources, primarily talented and educated people, towards wrong purposes, taking them out of the domestic private sector and domestic government service. The quality of resources allocated to both of these decreases, which weakens domestic government institutions, which also reduces political and other pressures to reform domestic government policies and institutions that would lead to higher economic efficiency and to economic growth. If a larger part of public expenditures is financed from foreign sources, then those who make decisions on the distribution of those funds are not accountable to their voters and taxpayers and do not react to the pressure they create, as their power base is located outside the country.[14]

An increase in foreign aid leads to intensified rent seeking and corresponding efforts by politicians to stay in power and please the interest groups that keep them in power. In such circumstances, they have no incentive to create institutions related to the rule of law and protection of private property rights. On the contrary, the violation of private property rights of all people except the privileged ones represents a goal of the ruling elite and the mechanism for their political survival.

There are more and more findings that demonstrated a direct connection between foreign aid and corruption. The theoretical model of foreign aid as a corruption factor was established by Svensson (2000), who proceeded from the finding that foreign aid, from the aspect of the economic performance of recipient countries, is, to say the least, disappointing. The explanation of this failure offered by Svensson is that foreign aid generates rent seeking and, consequently, corruption. The results of the model are

14 Moreover, foreign donors focus on the resources that are relatively easy to provide, and not on the creation of incentives for the normal performance of the activity. Although funds are granted for textbooks and wages of teachers in elementary schools in poor countries, the problem of the lack of teachers is not solved, those who collect their wage and then fail to come to classes: the system of incentives or accountability is not created, so economic efficiency is not established.

 interesting. First, under specific conditions, an increase in public/budget revenues of the government due to foreign aid leads to a decrease, and not an increase, in the supply of public goods. These conditions are connected with the number and organisation of interest groups that participate in rent seeking. If these groups do not cooperate among themselves at all, then an increase in foreign aid will lead to a decrease in the supply of public goods, an increase in the redistribution of those funds towards the interest groups, as well as a commitment of resources for obtaining those funds, or an increase in rent dissipation and thus an increase in economic inefficiency as well. Empirical research conducted on the findings of this model demonstrated the existence of a statistically significant parameter estimate of foreign aid as a corruption factor – the higher the amount of foreign aid, the more widespread the corruption. This was confirmed by other empirical research (Ali and Isse, 2003) that also demonstrated the existence of a statistically significant connection between foreign aid and corruption. In this, an increase in foreign aid leads to an increase in corruption. The interaction term between the foreign aid and the size of government stands for the marginal effect of an increase in corruption when the government size increases along with an increase in foreign aid.

Furthermore, it turns out that foreign aid leads to a reduction of economic liberties. However, it remains unclear what mechanism leads to such causation. One possibility is that conditionality goes in such a direction that foreign donors insist on such economic policies by which economic liberties are reduced. There is no empirical confirmation of such a thesis. The other possibility is that foreign aid reduces incentives to the domestic government to undertake reforms that will increase economic liberties. Simply put, if a large part of the budgetary revenues are based on foreign aid, the government is not accountable to the domestic public in whose interest economic liberalisation, increased economic efficiency and accelerated economic growth would be. Therefore, the policy of structural adjustment financing, which has been popular for a long time in international financial institutions, may also have negative effects on economic reform and deregulation. Designed as transfers to government and disbursed as budgetary support, by which the government could compensate for those suffering losses due to such a reform, this type of aid may eliminate every incentive to the government to undertake any kind of economic reform or deregulation.

The mentioned phenomena indicate the existence of the Samaritan's dilemma. The greatest success for a Samaritan is if the aid recipient reacts to this aid by investing its maximum efforts to turn that aid into a benefit for its entire country. The greatest success for the aid recipient is if the aid arrives, while he invests the smallest effort possible. It is worth noting that the actual aid recipient is a politician or a government officer who wishes to minimise their efforts. Therefore, very often only a *status quo* appears instead of the expected reform.

Foreign aid also has negative effects on a country's democratisation. Namely, the curse of natural resources may be compared with the curse of aid (Djankov *et al.*, 2006) – large revenues pour into the budget, thus creating incentives to ensure domination over those funds by heavy political struggle, and not only by political fighting. Demands for democracy and free elections are rejected since the ruling elite, enjoying the advantages of foreign aid, is afraid that the improvement of the political representation of the poor could lead to the redistribution of that aid in their favour. Sometimes, as happened in Somalia, foreign humanitarian aid (aid in food) was one of the reasons for the outbreak of civil war, since that fight was, *inter alia*, a struggle for control over that aid and its distribution.[15]

Moreover, there exists the pressure of interest groups amidst strong foreign aid (Svensson, 2000), which leads to a change in the structure of public spending. Direct transfers become increasingly large under the pressure of powerful interest groups that are interested in redistribution, and less and less funds remain for the provision of public goods or local public goods. In the conditions of a relatively small budget, without foreign aid, the costs of collective action of interest groups are often prohibitively high, and so there is no pressure on the government either. Namely, it is profitable to interest groups to get organised only after the chances

15 See more details about this in: Maren (1997). The one who has food supply at his disposal in a country that is, like Somalia, reduced to mere subsistence can, by distributing that food, gain very much in the sphere of recruiting political followers.

 for appropriation of the funds from the budget become high, and that is made possible precisely by foreign aid, which, regardless of the original budget revenues, increases the expenditure side of the budget. Foreign aid enables that to happen.

Macroeconomic aspect of foreign aid: Dutch Disease

"Dutch Disease" stands for a paradoxical outcome of a windfall in an economy, be it energy discovery, abundant foreign aid, remittances or any other form of increases in the wealth of domestic residents. A good fortune eventually turns out to be a curse, bringing a negative net effect to a country.

Box 4.2
What really happened in Holland?

In 1959 the Netherlands experienced a windfall from natural gas which, in the following twenty years, brought earnings of over $2 billion and savings in imports of at least $3.5 billion. But in the meantime investment declined by 15% and employment in manufacturing fell by 16%, with the unemployment rate rising from 1.1% to 5.1%. Profits also fell from 16.8% of GDP in the 1960s to 3.5% in the first half of the 1970s.* Thus the Netherlands' situation was far worse than most countries hit by the oil crisis.

De-industrialisation of the manufacturing sector came as a consequence of the pressure that the energy discovery put on the national currency and wages, and was then named the Dutch Disease. Later on this term widened considerably, now standing for any situation in which a country's economic fortune ultimately proves to have a negative net effect.

*Data from: Rajan and Subramanian (2006)

The mechanism of macroeconomic decay is as follows. Large windfalls raise demand in the non-traded sector,[16] from construction to education and medical services, etc, which ironically leads to shifting resources away from "traditional" industries, followed by massive plant closures and unemployment of workers. In case of natural windfalls, these workers can eventually be absorbed in the new exporting sector (like in case of discoveries of gas in Holland, or discoveries of oil in the UK in 1970s), but in case of aid, no new exporting sector emerges, hence only the non-traded sector experiences a rise in demand and a rise in prices, which ultimately raises the real exchange rate. If aid does not lead to a substantial increase in the supply of non-traded goods (which is highly improbable), the country's real exchange rate could remain permanently higher, leading to a long-run loss of competitiveness. The final outcome is that, as aid pours in, recipient countries lose competitiveness, followed by a consequent shrinkage of the manufacturing sector.

Since aid is considered a strong instrument in the fight against poverty, this result needs further attention. This is particularly the case since large aid flows come in form of ODA, official development assistance, and the money goes directly to the public sector. Through its increased spending associated with aid, the governments crowd out the private sector. A rise in interest rates, fall in private investments and appreciation immediately follows. Reducing growth may then come also from this side, not connected directly to the Dutch disease.

Various countries' experiences indicate, however, that Dutch disease is not easy to isolate in complex country-specific circumstances. In addition to foreign aid, other events in a country, including economic policies countries implement, matter a lot.[17] Adenauer and Vagassky (1998) find evidence of appreciation in four CFA frank countries—Burkina Faso, Côte d'Ivoire (Ivory

16 Comprising goods and services that cannot be imported. Technological progress made this list much shorter, but still comprises large portion of services, construction and all sectors where transport cost are insurmountable obstacle to trade.

17 In some countries, like in the case of Tanzania, even an adverse outcome was recorded, with depreciation, instead of appreciation of the real exchange rate, which repeatedly emerged during periods of intensive foreign aid inflows.

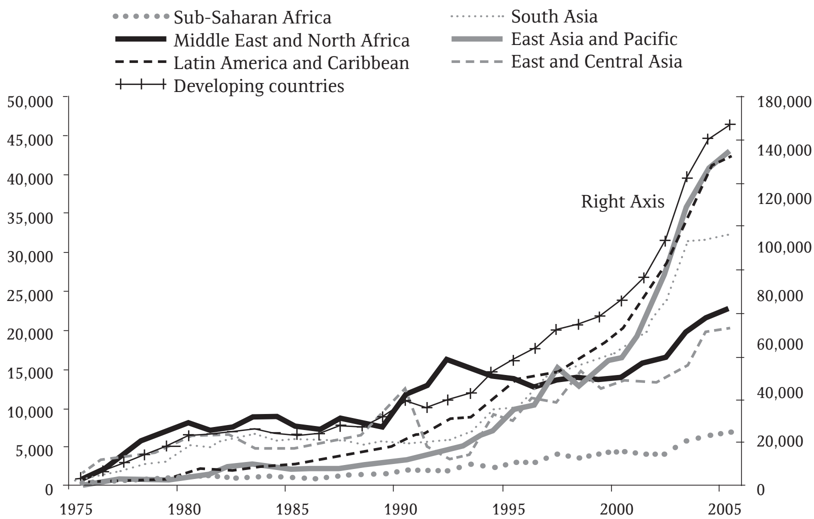
 Coast), Senegal, and Togo—during a period of large aid flows, accompanied by government deficits, high wage bills and a widening trade deficit. At the same time, however, the world prices of their primary exports fell and the French franc appreciated against the dollar, which leaves the question of isolating Dutch disease unsolved, since trade balances might have been driven more by declining world prices than by domestic appreciation, which was not of any help, of course.

In classical cases of Dutch disease, empirical analysis confirmed that even in some cases countries experienced no dramatic harm from windfalls in resources. Nkusu (2002) demonstrated that Botswana's windfall gains from diamond exports could not be associated with the Dutch disease, since no appreciation occurred. But the same study indicates that an analysis of the macroeconomic impact of aid in Nicaragua demonstrated that aid is weakly but negatively correlated with export volumes, with an odd detail that stronger effects were recorded during moderate inflows in the 1970s, rather than during large aid inflows from the 1980s and 1990s.

The case of Ghana, on the other hand, gives a promising picture. The results are that the increase in official development assistance, from 3 to 6 percent of GDP (from 1981–83 to 1984–87), induced macroeconomic problems associated with high inflation, appreciated real exchange rate and tightening credits to the non-banking private sector, which bolsters the case for Dutch disease. On the other hand, FDIs inflow was intense at the same period, and Ghana demonstrated remarkable results when compared with the average for low income countries in the sub-Saharan Africa region on many indicators, including growth of total and sectoral GDP, exports, and gross domestic investment. Nkusu (2002) indicates that the Ghanaian government's response to aid inflows was a combination of foreign exchange accumulation, provision of credit to the banking sector, and increased public spending, especially on development projects.

Since remittances present just another form of unrequited transfers to poor households, the Dutch disease might occur. This is of particular importance since remittances amount to twice the sum of official assistance that developing countries received, and moreover, evidences are that such flows are underreported, e.g.,

Figure 4.2 Remitances to Developing Countries by Region, 1975–2005 (Millions of US dollars)



Source: *IMF Balance of Payment Yearbook*, 2005, World Bank staff estimates

World Bank (2006) indicates at least 50 percent to the globally recorded flows. But being a private flow, remittances remain on a self-correcting path, because when a currency becomes overvalued remittances deter, hence neutralising Dutch disease (Rajan and Subramanian, 2005). The cynical conclusion that "remittances are pro-cyclical, rather than altruistic" actually turn out to be correct, but non-altruistic behaviour turns out to be quite patriotic, since it shifts national currency away from its appreciated level. As for Latin America (Amuedo-Dorantes and Pozo, 2004) and Cape Verde (Bourdet and Falck, 2006) evidences of Dutch disease effects are found on the competitiveness of the tradeable sector in those countries. Hence the conclusion is that in countries with a large inflow of remittances, and where supply constraints exist in the nontradeables sector, policymakers should always be aware about the possibility of a Dutch disease phenomenon.

How to improve foreign aid? One of the first topics mentioned is the ratio between grants and loans. Which of these two mechanisms should be insisted on? Naturally, the answer to this question depends on the particular project that is to be financed. As for investments, generally speaking, loans are better since they do have a mechanism that may discipline the aid recipient (debtor) and impose a greater responsibility for the project on him. Loans may be used primarily for financing investments. The problem is, however, that loans increase the country's debt, and that very often leads to debt forgiveness, whereby loans are effectively turned into grants.

From the aspect of the possibility for fund raising, it is certain that more loans than grants may appear on the supply side. However, it is hard to adopt a general position about the superiority of one or another form of foreign aid, since it all depends on the country and character of the projects for which it is assessed and should be financed.

Foreign aid should be directed towards poor people, and not poor countries. However, the key question is whether the government should be avoided in this. On the one hand, does alternative mechanism of transferring funds exists? In many situations it does. Directly channelled private aid (like remittances, or mediation through nongovernmental or non-profit organisations) often may create a very efficient network for aid transfer and realisation. On the other hand, a complete exclusion of government from foreign aid flows may lead to large problems regarding not only the absence of cooperation, but also hostile attacks on foreign aid. Since the government is not involved in foreign aid, it cannot capitalise on any success before their constituency or interest groups, so they have an incentive to channel a portion of the aid by attacks and blackmail. Thus, although it is quite wise to avoid the government in all situations in which it is possible, it is necessary to ensure that a small piece of the cake passes through the government's hands so that its minimum cooperation is ensured and so that it would not pose an obstacle to the realisation of foreign aid that goes through other channels.

The foreign aid directly or indirectly provided by the for-profit sector is also significant. Namely, corporations take care of the profitability of their projects, so the sustainability and results of aid projects are of key importance. In other words, corporations have an incentive to encourage economically efficient behaviour. One of the key goals of corporations is market expansion or an increase in demand for their products. In other words, the interest of corporations is the wealth of individuals who will spend their income, *inter alia*, on the products of these corporations as well. The selfish interest of private companies and capital owners may lead to efficient and sustainable aid to the poor.

Box 4.3
Private hygiene

The HLL Company, a branch of the Unilever multinational corporation, initiated a campaign against diarrhoea - the disease of dirty hands - in India. The problem the campaign was focused on were the hygiene practices of the poor who washed their hands only when they were visibly dirty. By spreading the knowledge about the connection between dirty hands and diarrhoea, primarily through educational campaigns aimed at school children, two goals were attained: by increasing the level of personal hygiene, the incidence and frequency of diarrhoea were reduced and the demand for soap, the main product of the HLL Company, increased, thus increasing the profit of that company. This demonstrates the possibility of establishing a strong bond between improving the well-being of the poor and increasing the profits of the corporate sector. See more details about this in Prahalad (2005).

Foreign aid, particularly the aid from international financial institutions, may be linked with investments of international capital, i.e., the precondition for realisation of these investments may be the realisation of foreign aid. A project financed by foreign aid may "set the stage" for the realisation of foreign direct investments. A typical example of this kind can be investments in infrastructure.

Box 4.4
Dinking water

One of the most successful foreign direct investments in water supply is the one realised in the city of Conakry (Guinea). The investment of a private French water supply company led to a drastic improvement in the water supply, with the poor being the ones who most profited. The technical assistance project implemented by the World Bank presented the necessary condition by which the existing water supply system and institutional framework were prepared for the arrival of foreign capital. Without those preparations there would be no foreign direct investment or water supply improvement at all.

It is certain that there are many different ways of foreign aid placement. Foreign aid was initiated as a big solution to a big problem, in a way that Easterly (2006) calls “The Planner Way”. Donors thought that their aid would eliminate all problems and all evils of poor countries and that it would turn those countries into prosperous countries of rich citizens. Similar ideas, those that will mark the “end” of poverty, emerge today as well, around the MDG Project. The future of foreign aid, however, lies in the abundance of different forms of that aid aimed not at global goals but at small projects by which the situation of the poor will be improved, primarily by creating preconditions for sustainable economic growth and prosperity.

Appendix: Aid donors have shown microfinance can work

After the Nobel Prize for 2006 was awarded to Muhammad Yunus for his role in promoting financial services for the poor, more attention has been given to microfinancing institutions as a means for resolving the problem of poverty. His Grameen bank has become a sizeable institution, with 6.7 million customers, most of them women and all of them poor. By its own reckoning, professor Yunus distributed $6 billion in loans, each averaging less than $200. And the awarded Grameen bank of professor Yunus is only one among some 10,000 microfinance institutions lending an average of less than $300 to 40 million poor borrowers worldwide. Actually, loans to the poor have existed for thousands of years, almost as long as poverty itself.

The overall effect of microfinance on alleviating poverty still remains questionable. According to *The Economist*, the few studies that have been done suggest that small loans are beneficial, "but not dramatically so". Unlike other professionals, economists strongly argue against IFIs providing soft lending schemes to the poor. Instead, microfinance really is a good source of money for parts of the economy that are starved of capital, but only provided that IFIs and donors leave the best credit risks to profit-seeking lenders and to concentrate instead on the poor who are still stuck outside the system.

Although this may seem ungrateful to IFIs and donors who provided not only grants, but also loans and training to untested microcredit institutions, it turns out that IFIs, may also be an impediment to the further evolution of microcredits. Since microfinance has become profitable, economists claim that the time has come for top-tier microlenders to replace IFIs or philanthropists in this field, which also can crowd out for-profit money. The reason is that after becoming profitable, microcredits have the potential to become self-sustaining, rather than relying on the charitable instincts of others. And this is because charitable instincts grow at a much slower pace than the poor would need. What microfinance needs is a strong and fast growing network, and no institutions but for-profit institutions can provide such an environment for alleviating poverty.

5. The Rule of Law, Economic Growth and Prosperity

If there is any consensus in modern economic science, it is probably the need for the protection of private property rights as a prerequisite for economic growth. Even Dani Rodrik, the man who relativises all the usual generalisations in this field, perhaps more than any other growth theoretician, does not deny that the protection of property rights constitutes a necessary condition for economic growth. The key question from the standpoint of economic growth is whether the investor will receive the returns he expects, i.e., whether he will recover the amount of his investment and earn target profits on top of that amount, or whether his full returns, together with the total value, will be seized. If property rights are protected, i.e., if the investor can expect target returns on his investment, it is possible to expect economic growth – otherwise, there is no investment, no growth, and so poverty persists.

The rule of law provides such protection. From the standpoint of investors, entrepreneurs and all economic agents, the rule of law is manifested as an efficient protection of private property rights,[1] as well as an efficient control of contract performance (the fulfilment of contractual obligations), and/or efficient contract enforcement, if need be. The rule of law has long been known

1 The term "property rights" in this text is understood to mean property and all other protected purely ownership rights, such as: other rights in reality, intellectual property rights, industrial property rights, etc. Such understanding of property rights is close to the concept of property in Anglo-Saxon law.

 to be a prerequisite for economic efficiency and economic growth, ever since Adam Smith (1776).2 It is precisely the rule of law that enables the employment of selfish human interests and their activities aimed at accomplishing these interests, for the purpose of maximising social welfare. This finding has not been contested for more than two centuries by any serious economist or scholar from another relevant field. The main argument corroborating this thesis was presented at the very beginning of this paper. Bearing in mind that people behave rationally and respond to incentives, a particular action will be taken only if it brings benefits, i.e., people will invest (in the broadest sense of the word) only if they can enjoy the fruits of their investment.

Specifically speaking, property and contractual rights can be threatened and/or denied in two manners: they can be expropriated by the state, which disposes of force by its very definition, or by other individuals of equal status, but better equipped for such denial – they are more efficient in applying physical force (violence) or fraud. Let us first examine the latter case. If there is no protection of property rights, a society will enter a state of anarchy: a Hobbesian world of a war of all against all, where there is no legal order at all, and where the redistribution, or misappropriation of resources takes place through violence or fraud. The one who is the most efficient in using violence, or the credible threat of violence will be in a superior position; his well-being will improve, while the wealth and welfare of society will decrease. Furthermore, the one in the superior position from the standpoint of violent redistribution has no incentive whatsoever to provide, or at least enhance, the protection of private property rights, since that would only make his task of redistributing these rights through violence, or a credible threat of violence, more difficult. Under such conditions, the one who becomes the ruler is nothing else but what Olson (2000) has termed the roving bandit, an economic agent who has an incentive only to plunder and destroy, without any incentive to create value or to provide a public good such as a minimum of the rule of law.

Such a state of affairs in the human community prevents the creation of any value whatsoever. No one will have any incentive to

2 Smith (1776), North (1981), Olson (1982), De Sotto (2002), Easterly (2002) and many others.

invest in any kind of value creation. Why should anyone invest in anything and possess any wealth if they will not be able to keep and enjoy it, as it will be taken away from them as soon as tomorrow? Rational economic agents decide to join the activities that distribute the existing, already created value; incentives drive them towards seeing the maximisation of their own welfare precisely in the redistribution of value and/or wealth. All rational individuals take such decisions and they will all be included in the redistribution of value, irrespective of whether they take part in the plundering and/or fraud, or invest their resources in the prevention of that plundering and/or fraud, in order to protect their possessions. In such a society, the basic feeling is mutual distrust among people, and credible threats to which each individual is exposed, where man becomes a predator to man in the true sense of the word.

Box 5.1
Eastern Congo – Heart of Darkness

During many years of the civil war in East Zaire (nowadays DR Congo), with the ample involvement of regular and less regular armies of neighbouring countries, the unfortunate people who lived in that area faced a state of anarchy. Not even a small investment in agriculture (purchase of a goat that can feed the family) could pay off, since marauders were taking everything. The only activity that yielded returns, though only occasionally, was guarding one's own life. Under such conditions, nobody had any incentive to opt for those activities which bring economic growth and prosperity. Starvation and threatened human existence were inevitable consequences of such incentives.

The Economist, 27th March 2003: "Peace, they say, but killings go on"

The main problem with such a state of the human community is that it is not sustainable. Since there is no public good in terms of protection of private property rights, no one has any incentive to invest resources in the creation of value/wealth. In other words, the equilibrium is such that all the resources are engaged in the activities of redistribution and destruction, which means that no value is created, hence in time there will be ever less value/wealth for redistribution. In the end, there will be nothing left. This is the reason why those engaged in redistribution and destruction develop a need to become roving bandits – when the possibilities for plunder in one area are completely exhausted, they move on to another area where there still is some wealth which can be plundered and redistributed/destroyed.

In such circumstances of all-out anarchy, the establishment of a dictatorship is an important step forward. That implies the transformation of the roving bandit into a "stationary" one. As Mc Guire and Olson (1996) and Olson (2000) have shown, such a transformation results in incentives that the bandit now has to provide a public good in terms of legal order, i.e., a minimum of the rule of law, which will enable a certain (though not high) level of protection of private property rights. Such protection creates incentives to generate value/wealth, while the equilibrium in the system is such that, irrespective of the partial expropriation by the dictator, "Stationary Bandit", at least some returns are left for other economic agents on their investments. The bandit turns from roving to stationary, since there are no more incentives to roam – by moving to the stationary state he cuts back his costs and increases his returns. In such a manner, the roving bandit becomes the one who initiates the creation of the first, rudimentary form of the rule of law.

Olson's theory about the transformation from a roving into a stationary bandit has two very important components. First, it shows to which extent the protection of private property rights, elevated to the level of the rule of law, is vital to economic efficiency and growth. As long as these rights are threatened, there will be no incentives for either of the two, and there will be no prosperity. Even the most feeble protection of private property rights gives results in terms of higher investment in value creation. Second, Olson's theory shows that institutional changes which result in the rule of law are not a consequence of good will on the part of the strongest (in the broadest sense of the word) individuals, not even of their ideological beliefs (if there are any). Instead, they are exclusively a consequence of incentives to decision-makers. Appropriate decisions will be taken only after decision-makers have assessed whether that it is beneficial to them. The protection of private property rights will be provided only if that is necessary to increase the value which could be redistributed, naturally, in favour of those who are introducing that protection.

It has already been mentioned that the rule of law implies efficient protection of property rights, including efficient control of contract enforcement. There are two basic ways in which the rule of law protects private property rights and contractual rights. One is deterrence, which boils down to the creation of incentives to all economic agents not to violate other people's private property rights and to meet their contractual obligations as they are stipulated. The rule of law in this sense can be perceived as a public good, perhaps the most important public good that the state can provide. Two main characteristics are typical of any public good, including the rule of law. First, there is no rivalry between the "beneficiaries" of the rule of law in the sense of deterrence: the fact that one economic agent enjoys the protection of his property rights does not result in any other economic agent being deprived of that protection. Second, there is no real possibility to exclude the beneficiary who has not paid for the service of the rule of law in the sense of deterrence – in economic jargon, the costs of excluding any beneficiary of a public good are prohibitively high. In other words, the rule of law in the sense of deterrence is a public good enjoyed by all economic agents (natural and legal persons) located in the territory of a particular state. From the standpoint of economic growth, i.e., prosperity, that is precisely the key public good which a state should provide.

In addition to the rule of law in the sense of deterrence, the other way to protect private property and contractual rights is litigation, a civil action brought by an interested party. A judgment in favour of the party whose property rights have been violated implies the obligation for the other party to stop violating property rights and to at least provide full compensation for the damage inflicted by that violation. Litigation provides *ex post* protection of property rights, unlike deterrence, which provides that protection *ex ante*. Moreover, litigations in which property rights were successfully protected demonstrate the operation of the rule of law in practice and generate high preventive effects. It is reasonable to assume that deterrence as a form of the rule of law cannot be achieved without them. All the above show that there also is a certain complementary effect on the rule of law, generated by deterrence and litigation. The rule of law cannot be achieved solely by means of deterrence, or solely by means of litigation.

If the state fails to provide the rule of law and the protection of private property rights through good laws and their efficient enforcement, then alternative methods for the provision of such protection will develop. Simply, those who possess something have an incentive to protect it, so they look for a substitute for the protection of their own property rights, which the state is not providing. The most well-known private institution/organisation engaged in the provision of that protection is the Mafia,[3] which is nothing else but a criminal organisation that protects private property rights on a commercial basis. Such protection, however, is not efficient, among other, because this same private organisation, by its very nature, with violent technology at its disposal, can very efficiently violate other people's property rights. This brings us to an unanswered question of: "Who will guard us against our guardians?"[4]

The examples above related primarily to the violation of private property rights by individuals. However, economic history has demonstrated that very often the greatest danger from the violation of private property rights comes from the state, which is very well equipped for that, since it has at its disposal the monopoly of force and coercion. Just as it is used for protection, state coercion may also be used to trample on private property rights. Instead of the rule of law, the state may create an environment of state-sponsored looting and full legal uncertainty, in the same manner in which private marauders create that legal uncertainty. These conditions are, as regards their effects, very

3 Gambetta (1993) examines the case of the traditional, Sicilian Italian mafia, and shows that the reasons for its emergence can be found in the withdrawal of the state from Sicily at the time of the implosion of feudalism and the creation of a new ownership structure. New owners of land could not rely on the state to guarantee their property rights, hence demand for such protection was generated, to which the private sector responded by generating a matching supply.

4 One of the main activities of the mafia is extortion, i.e., the provision of and charging for protection services, irrespective of the fact that there is no freely expressed will of the other party to enter into such a contract. The contract on the basis of which such services are provided is a contract concluded under duress.

close to the anarchy described above, with the only difference being the appearance of the state, rather than private bandits[5], as the looter.

Therefore, the protection of property rights that are violated by the state is the key element of the rule of law, and it is precisely the rule of law which should restrain the state from violating private property rights. In that sense, two basic components of the rule of law can be identified. The first one is related to the procedural aspect of that rule – the intervention of the government must not be arbitrary and subject to government officials' discretion; arbitrariness and discretion should be reduced to the lowest possible level. The higher the arbitrariness of government intervention, the higher the risk of violating private property rights and the higher the uncertainty faced by economic agents, which adversely affects the growth rate.

Another component of the rule of law for the protection of private property rights against violations by the state is related to the substantive component of that rule: which are the rules that should be implemented without arbitrariness and discretion? Are those rules the ones that threaten economic freedoms of economic agents and their private property rights such as increasing the extent of their abuse by means of government intervention? For instance, taxation at high tax rates is a violation of private property rights, such as the right to enjoy proceeds from assets. In the same manner, general business regulations constrain assets' owners in their actions, i.e. their right to use these assets.[6] In that regard, public policies, although not based on arbitrariness and discretion, may result in dramatic violation of private property rights. The protection against government arbitrariness

5 The plundering, that is, cleptocratic state is not such a rare phenomenon as it is often thought. Baumol (1995) argues that the authorities that care about the welfare of their subjects and whose arbitrary and violent actions are restrained by the rule of law may be assessed as interesting exceptions to the rule, which have emerged only recently and can be seen only in a very limited part of our planet.

6 These two restrictions imposed by the state are not necessarily equal in intensity. For instance, Scandinavian countries are countries with high tax burdens (measured by the marginal tax rate), but with great economic freedoms in terms of general business regulation. Conversely, many developing countries, in particular African ones, do not have high tax burdens, but nevertheless have all-permeating strong general business regulation.

 and discretion lies in the development of the mechanisms for controlling the state and its intervention, i.e., for accountability of government officials for the discharge of their public functions. Public policies based on economic freedoms constitute the protection against violations of individual property rights, such as violation through a high tax burden and strong regulation.

In that sense, economic freedoms and the protection of private property rights inseparable concepts.[7] As it turns out, economic freedoms not only constitute a mechanism by means of which the protection of private property rights is achieved (in the cases where they are violated by the state), but economic freedoms also cannot be exercised if there is no protection of private property rights. Namely, the freedom to trade will not be exercised since no one has an incentive to trade, and that incentive cannot exist if one's own private property rights are not protected in such an exchange.[8]

There is an interesting question of whether the protection of private property rights against violations by private individuals and violation by the state is an alternative to each other.[9] In other words, will the expansion of government mechanisms for the protection of private property rights, inevitably lead to a situation

7 Empirical research shows a correlation between the level of economic freedoms and growth. However, that correlation is not direct. As demonstrated by Haan and Stuem (2000), countries with higher degrees of economic freedoms will faster reach the steady state of growth, but the growth rate in that steady state will not depend on the degree of economic freedoms. This empirical finding certainly merits further research which might be able to shed some more light on the relationships between the protection of private property rights, economic freedoms and economic growth.

8 Gwaerteny and Lawson (2006) who have formulated, on behalf of the Fraser Institute, an index of economic freedoms in the world use the protection of property rights as one of the indicators of economic freedoms. That refers in particular to the protection of the rights arising from contracts, that is, the certainty that contractual obligations will be honoured as stipulated in the contract.

9 Djankov *et al*. (2003) have considered different possibilities for the protection of private property rights, while taking into account first and foremost violations of those rights by private individuals. More specifically, they have identified four possibilities for the protection of private property rights, starting from private mechanisms (a market without any regulation), litigation within the system of common law, economic regulation, which they associate with continental law where the judiciary is not a source of law. According to their opinion, moving from one to the other extreme unavoidably leads to the risk of moving from private expropriation toward government expropriation.

where the state itself will begin to infringe on private property rights? Such a danger definitely exists, but such an infringement is not inevitable. In addition to the already mentioned procedural restrictions, there are also other ways to eliminate that danger – ways that are related to the contents of government operations. In that sense, the state should focus on the provision of public goods, such as the legal order, rather than on redistribution programs by means of which those property rights are (legally) threatened by the state. More specifically, redistribution programs should be considered as to include all those programs that have considerable redistributive consequences, irrespective of whether such redistribution was a motive for their introduction or not.[10]

Contemporary papers dealing with this subject (Benabou and Ok, 2001 and Alesina and La Ferrara, 2005) have shown that demand for redistribution declines with a rise in the degree of protection of private property rights as a public good. When individuals believe that they have equal opportunities just like anybody else, and when they believe in themselves and the possibility to increase their welfare through their own endeavours, they then expect to be rich, and are therefore opposed to redistribution in the future, since income/wealth will be taken from them. Others, those who do not believe in their own success (regardless of who they blame for that expected failure), are positively disposed to redistribution in the future, since in such a manner other people can compensate for their failure and they can only gain by redistribution. An increase in the level of a public good cannot ameliorate the lack of somebody's inherent self-confidence, or a possible lack of entrepreneurial talent, but it can certainly produce a different, optimistic assessment of chances for success. This results in a further cut in redistribution in the future, since demand for it declines.

Nevertheless, no matter how the rule of law is defined and what can be done to improve it, it is beyond a doubt that there are

10 For instance, a program for controlling the entry of new competitors in a branch may be motivated by consumer protection, i.e., by the maintenance of the quality of supply (entry control for practicing law). However, that results in a non-competitive structure of the industry and the generation of rents, which are appropriated by those who are already in the branch, while part of those rents is the redistributed consumer surplus. Hence, the direction of redistribution is from consumers to producers that are already in the branch.

 very big differences today among countries all over the world. An interesting question is why the rule of law exists in some countries, while in others it does not.[11] Is there a plausible way to explain such differences? Why are some countries successful in establishing the rule of law, and consequently in achieving economic growth, i.e., prosperity, while others are not? An answer to this question enables us to better understand the basic incentives that underlie economic growth.

Box 5.2
Differences in the Rule of Law or *Costs of Doing Business*

It turns out that countries differ considerably with respect to the terms on which contractual obligations are enforced. The differences exist also with respect to the number of days that are necessary for something like that (the lowest score is 109 days in New Zealand, the highest as many as 1,642 days in Afghanistan), the costs measured as a share in claims (with the lowest score being 5.5% in Korea, the highest as much as 227.3% in Sierra Leone) and the number of procedures (14 in Iceland, 69 in Timor). All in all, the Scandinavian countries, measured by the composite index, are the best in the enforcement of contractual obligations, while the most unfavorable situation is in Afghanistan. Other indicators and indices, which are used for expressing differences in the rule of law, evidence significant differences among countries.

Another possibility for explaining such differences lies in different legal systems that countries have inherited. There is a very limited number of legal systems in the world (in respect of company/commercial law, only five: common law, the French, the German, the Scandinavian and the socialist systems). Djankov *et al.* (2003) have demonstrated, by using the example of an eviction of a tenant who failed to pay the rent, and the passing of a bad check, that these systems differ with regard to the protection of

11 This question can be reformulated along the notion of rule of law as a continuous variable. Then the relevant question would be: why are different countries endowed with different degrees (levels) of the rule of law.

private property rights. Among them, the Anglo-Saxon system is the most efficient, while the protection of private property rights is the weakest in the French system. Irrespective of the methodology that was used, this finding has only two important constraints. First, within the same legal system there are considerable differences among various countries – the system is not producing uniform results. Obviously, law is not applied in the same manner. The effective protection of property rights differs, since the application of a given legal system, i.e., the effective legal system in place, differs widely from the normative one, and therefore considerable variations exist in that respect. Second, from the standpoint of the possibilities to pursue policies, the scope for the introduction of a different legal system is fairly limited – it is not possible to dramatically change the legal system, except in the case of major reform undertakings, caused by tectonic political changes.

Why, then, should there be different levels of protection of private property rights, even in countries sharing the same legal origin? A simple answer could read: because different institutions exist in different countries.[12] But then the question follows of why that is so. Why do different institutions exist in different countries? Acemoglu *et al.* (2002) demonstrated that European settlers in those colonies where they came to live in more sizeable groups and in those colonies where the mortality rate among settlers was low, created institutions that universally protected property rights – precisely the property rights of colonists. Conversely, in the countries where mortality among settlers was high, European settlers confined themselves to the plunder of local resources, so a far-reaching protection of private property rights was not only of no use to them, but it also constituted a barrier to their plundering. The key differences are related to the manner in which European settlers organised their life in colonies and to the choice of their objectives. The incentives of that kind were, in fact, the most important for institution-building, rather than the culture and dominant institutions from their countries of origin.

12 The Nobel Prize winner, North (1981), defines institutions as a set of rules and/or norms that have been created in order to put constraints on the behaviour of individuals geared to maximising the wealth/welfare.

Box 5.3
Korea – A Natural Experiment

North and South Korea are countries with different institutions, and at the very beginning of the history of that country's division, that was the only thing by which they could be differentiated. It is the same people, the same language, the same culture and even, as suggested by Acemoglu *et al.* (2005), the completely same level of development at the beginning of the division of the north and south. In the north, under the ideological influence of communists, institutions were created that did not provide protection of private property; on the contrary, those institutions enabled the pursuance of such ideological objectives as the subversion of private property. On the other hand, in the south, institutions that provided strict protection of private property rights were established very early. Therefore, today's South Korea, after several decades of dynamic economic growth, is a country of economic prosperity, while today's North Korea is a country of poverty and want. The difference is, hence, to the great extent in institutions, since they create incentives for the protection of private property rights, thus also creating incentives. for economic growth.

Bearing in mind that the rule of law is a precondition for economic growth, the question is raised of how to achieve the rule of law. From the procedural standpoint, what is required for the rule of law are institutional arrangements that would enforce law, which implies a competent, efficient, independent and impartial judiciary. How to develop such a judiciary? In particular, because it very often happens that the executive and the legislative branches undermine the independence of the judiciary (and through wrong policies, very often its efficiency as well), parties to litigation bribe judicial officials, and interest groups threaten and blackmail them. All this can be forestalled only if there is strong political will, a commitment to create and maintain an independent and strong judiciary. That political will is not exogenous, but it depends, as shown by Stephenson (2003), on the factors that are part of the political process in a country: the degree of political competition, political stability, risk-aversion on the part of the political elite and a time horizon in which politicians take decisions. Although it is certain that democracy may ensure the fulfilment of the mentioned preconditions, it remains as an open question whether it is the necessary and sufficient condition for that.

The rule of law, however, in addition to its procedural aspect (how certain rules are implemented), has its substantive aspect (what kind of rules are implemented). Under the already accepted definition of the rule of law, its contents include all those rules that enable the protection of private property rights. In other words, these are the rules public policies from which these rules arise, that lead to the enhancement of economic freedoms.

Box 5.4

The Role of Lawyers in Economic Growth: the Rule of Law or Redistribution?

In the early 1990s, an interesting debate developed in the US about the role of lawyers in economic growth. For a group of authors, the number of lawyers was an indicator of the prevalence of rent seeking, i.e., of redistributive activities. The second group of authors was of the opinion that caution should be exercised not to jump to conclusions, since lawyers may be engaged in the activities/jobs that create value, rather than just redistribute it. The debate was also supported by empirical research. However, unclear main theoretical concepts, unreliable indicators and problems related to the measurement of phenomena have rendered the findings of this research disputable, to say the least. Still, an interesting hypothesis has been formulated about the existence of an optimum number of lawyers in an economy. Further research into this topic could yield both interesting and relevant results.

In that respect, general business regulation is aimed at limiting economic freedoms, that is, imposing restrictions on economic agents in their use. Such general business regulation is related to starting a business, obtaining necessary licenses, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business (exit from the industry).[13] Of course, the higher the restrictions on economic freedoms, the lower the incentives for investing resources in value creating activities for which reason economic efficiency and growth suffer. Empirical papers that show the existence of a strong correlation between economic freedoms and the economic growth rate are numerous. For instance, the latest paper dealing with this subject (Djankov *et al.*, 2006) has demonstrated a statistically significant correlation through which a reduction in the level of general business regulation results in higher growth rates. By using data from a World Bank report (*Doing Business 2006*), the authors have demonstrated that the effect of a change that would move a country from the quartile which includes the countries with the most widespread regulation up quartile including the countries with the highest degree of economic freedoms would be an increase in the economic growth rate by 2.3 percentage points. It is obvious that deregulation, as a method to increase economic freedoms, and thus more consistently safeguard property rights, certainly pays, since it contributes to the pace/dynamics of economic growth and to the accelerated achievement of prosperity.

If there is no dispute over the fact that the rule of law constitutes a necessary condition for accelerated economic growth and prosperity, it is interesting to raise the question of the relationship between democracy and economic growth. Namely, it has already been demonstrated that the chances to establish the rule of law in the procedural sense are higher in the case of a democracy. This further gives rise to the question of relationships between the rule of law and democracy. Are democracy and its establishment a prerequisite for the establishment of the rule of law?

The relationship between the rule of law and democracy is fairly complex, and so far a clear and unambiguous link between these two phenomena has not been established. Empirical research into this subject (Barro, 1997, Glaeser *et al.*, 2004) has shown that the

13 For years now, the World Bank has been monitoring developments related to these restrictions, i.e., the level of and changes in general business regulation of economic activity by country. Data on this is available on the website www.doingbusiness.org .

extent to which these two variables are linked (measured by the correlation coefficient), i.e., the statistical significance of that link, varies considerably depending on the democracy indicators that are used. In other words, the results of empirical analysis are not robust. Consequently, it is possible to assume that, besides positive effects of democracy on the independence of the judiciary and the constraint of the ruler's arbitrariness, hence on the rule of law, there are also some negative effects related to public policies that curtail economic freedoms. It turns out that democracy opens up the opportunity for redistribution requests, i.e., for those who request redistribution to have political representation in democracy, in which manner their interests and demand for redistribution will gain in importance. For this reason, economic policies in democracies may also be oriented toward redistribution more than toward strict protection of private property rights.[14] So, what is gained through democratisation in the field of an independent judiciary can be lost in the field of government. Economic policies can be more oriented towards redistribution, in which manner private property rights are violated.

In that sense, protection of private property rights is of key relevance to economic growth. That is precisely what prompted some authors (Glaeser *et al.*, 2004) to assert that political institutions are not of relevance to growth, but rather public policies. In this context, the authors perceive the rule of law as a public policy, rather than an institutional constraint. That is why the possibility of high economic growth rates being recorded in dictatorships, where the policy of strict protection of private property rights is pursued, is absolutely acceptable at the analytical level. That explains substantial part of the difference between the two Koreas before the establishment of democracy in South Korea – both states were dictatorships, there was no mechanism for constraining the exec-

14 Although no one is disputing the theoretical grounds for this hypothesis, i.e., its plausibility, the hitherto empirical studies, such as Persson (2002) and Mulligan *et al*. (2004), did not offer results that might corroborate this hypothesis, since it turned out that in most of the cases there is no statistically significant difference between democratic and non-democratic regimes. Moreover, Mulligan et al. (2004) have demonstrated that in those cases where it did, after all, turn out that there is a difference, it ran contrary to the theoretical expectations – democracies have lower distribution based on the income tax, since the progressivity of the tax rate is lower.

 utive government, and only the dictators in South Korea, unlike in its northern neighbour, applied a government policy of strict protection of private property rights.

Box 5.5
Ukraine – Resources or Institutions?

There are very few countries that are as rich in resources as Ukraine. It is a country with a highly educated labour force, ample natural resources (from fertile soil to mineral resources and energy) and fairly good infrastructure. Nevertheless, Ukraine has recorded virtually no economic growth – it lacks appropriate institutions that will provide the rule of law and enable the activation of all the above resources. The problem is that key economic institutions are the legacy from the Soviet Union era, and they are not capable of ensuring the rule of law. As argued by Tiffin (2006), Ukraine's economic growth can materialise only if the present government implements its program of comprehensive institutional reform. And even after that has been done, it will take a lot of time to see results. After the grass has been planted, the lawn still needs cutting and watering, cutting and watering, cutting and watering...

Yet, without getting into a terminological debate, it is reasonable to question whether one can predict the likelihood of the probability that dictators would opt for those public policies which protect private property and contractual rights and boost economic growth. In other words, it is an open question whether there is a higher probability that dictators would opt for a policy of strict protection of private property rights, or if this probability is higher in the case of democratically elected authorities. As shown by Wintrobe (1998), dictators can be very vulnerable to pressures of interest groups, and strict protection of private property rights is not in the interest of cleptocratic interest groups, whose interest is to appropriate high amounts of rents. Furthermore, there are no guarantees that dictators, who may have opted for the policy of strict protection of private property rights at one point, would remain committed to that policy. The problem of commitment to a certain policy is the biggest problem in political life, since there is no authority to adjudicate that someone has failed to deliver on their promises. Still, it is certain that democracy would increase the probability of the government authorities delivering on their promises. Although that probability is not high, it is nevertheless higher than in dictatorships, where the dictators do not face the problem of re-election. This is the best answer one can get to the question of whether rulers would keep a promise they made.

Box 5.6
Protection of property rights is not for rich only

Hernando de Soto's main point is that people in developing countries lack an integrated formal property system, leading to only informal ownership of land and goods. Accordingly, their property rights are not protected. The lack of such an integrated system of property rights in today's developing nations makes it impossible for the poor, for example, to leverage their now informal ownerships into capital (as collateral for credit), which de Soto claims would form the basis for entrepreneurship. Hence farmers in much of the developing world remain trapped in subsistence agriculture. As such, he argues that this informal ownership should be made formal, for example by giving squatters in shanty towns land titles to the land they now live on.

As *The Economist* pointed out "Mr de Soto is not one of those economists who thinks that the key to capitalism's success is to protect existing, legally established property rights, come what may. On the contrary, he argues that capitalism will thrive, and overcome threats such as terrorism, only if legal systems change, so that most of the people feel that the law is on their side. Creating this sense of inclusion requires many things, including marketing the idea aggressively to the poor. But one of the best symbols of change is a mass programme of giving full legal protection to the de facto property rights that are observed informally by the (typically poor) people now living beyond the formal law."

The Economist, 30th March 2003: "The economist versus the terrorist"

On the other hand, it is certain that both among democracies and among dictatorships there are countries with very different economic policies. There are free market democracies, with relatively low tax burdens on taxpayers and a low degree of general business regulation. Contrary to that, there are democracies with high tax burdens, welfare states and regulatory states, in brief, democracies where there is widely prevalent government intervention. Differences also exist among dictatorships, that is, non-democratic regimes. In addition to those such as Singapore (a non-democratic regime beyond doubt), which has managed to become one of the most efficient and dynamic economies in the world through strict protection of private property rights, there are many cleptocratic dictatorships, particularly in sub-Saharan Africa, where there has been neither economic growth nor prosperity for decades now.

Persson and Tabelini (2006) point to the problem of reformers, before whom there are needs to change economic policies toward their liberalisation. Priority should be given to economic liberalisation, particularly to the policy of strict protection of private property rights. It was empirically demonstrated that such policy will very quickly yield results. It is a different matter whether these results will be sustainable. Moreover, such political decision does not mean that a policy should be pursued of deliberately constraining democracy, or postponing democratisation. At the end of the day, something like that would not be possible in the long run. Empirical research into the sources of growth of democracy (Barro, 1997) has shown that economic growth inevitably produces progress in democracy. This confirms the thesis that prosperity creates a situation where people peacefully and without violence settle their disputes. The causality goes from economic growth toward democracy. That is how the establishment of the rule of law, through a high rate of economic growth, results in democratisation, since rising prosperity creates political pressures toward democratisation. Democracy is not a prerequisite for economic prosperity, but it is its virtually unavoidable consequence. By putting restrictions on government behaviour, democracy enables the sustainability of the rule of law and economic prosperity. Maybe democracy can be a constraint on economic growth when it is necessary to take brave decisions by the authorities, but it seems that it becomes its ally when it is necessary to halt their foolish decisions.

Still, one might ask why the authorities of a country should introduce the rule of law when there obviously are good reasons for which they were violated in the first place. In answering this question, one should always bear in mind that the rule of law in a country is provided by its authorities. They have a monopoly over that job and nobody else can perform the job instead of them. With this finding in mind, why would the authorities of a country, where there is no rule of law, initiate and implement activities geared to its introduction? This question can be posed at an even higher level of generalisation: why would the authorities of a country proceed with any reform? What are the motives of the government authorities to make such a move? By following basic principles of economically rational behaviour, it could be said that the authorities would proceed with something of the kind provided that the benefits for them from the pursuance of such a policy are higher than its costs. Under which conditions could something like that be expected? When would the introduction of the rule of law bring more benefits than costs?

It seems that there are at least two basic explanations on the basis of which it is possible to answer the mentioned questions. The first is associated with the theory of public interest. Under the standard theory of public interest, the government embarks upon reform, in this case the introduction of the rule of law, because it is in the public interest. The provision of the rule of law results in economic growth, and that is in the interest of the (almost) entire population. The main problem with this theory, even on the assumption that economic growth will produce Pareto improvement (increase in welfare of some, without anybody else's welfare being reduced), lies in the fact that a mechanism that motivates politicians to embark upon such reform is not explained in its conceptual framework. Therefore, the following question has to be answered: what are the incentives to politicians to embark upon the introduction of the rule of law?

One such incentive could be a higher probability of re-election and remaining in power. Irrespective of how plausible this explanation is, it implies that in a country where there is no rule of law, there is a functioning democracy, and that is not such a frequent case. In most of the cases that are relevant for this discussion, there is neither the rule of law nor democracy. And even if there is democracy, the question of time is raised. Can the rule of law be established in one election cycle and will that rule of law produce economic growth and prosperity before new elections? In other words, will the authorities be able to harvest the fruit of their reform in elections? The likelihood of something like that happening is low for at least two reasons. The first is that the mentioned processes take time, so even if the reform is successful, in all probability only the next government will enjoy the fruit of that reform, while the one that carried it out, in part also due to the costs of that reform, will be removed from power. The second reason is low public awareness of the link between the rule of law, on the one hand, and economic growth and prosperity enjoyed on that account by all the citizens of a country, on the other.

The second explanation of the motives of politicians/authorities, to embark upon reform is in the influence of interest groups on public policies formulated by the government (legislative and executive). The articulation of private interests and their imposition as public ones, i.e., those protected by the state authorities, essentially is the subject of the analysis of public choice theory, although it is often associated with the economic theory of regulation as well. Pursuant to the findings of that theory, interest groups will manage to capture the regulator/state, if they have strong incentives to do so and low costs of collective action in Olson's (1965) sense. Applied to the field of property right protection, it means that the government of a country will introduce the rule of law if it is captured by those interest groups who have an interest in protection of private property rights. Who are those interest groups, and who are their members? They are producers who are exposed to the violation of their property rights and who are economically superior, so they appropriate private rents – their opportunity costs are lower than revenue, provided that there is a free market. Such producers are in fact the most vulnerable ones, since the rents appropriated by them on a free market, through their economic superiority, are bait for all those engaged in the business of redistribution. The more powerful the attacks on their property rights, the stronger the incentives to capture the state and to impose a private interest to combat the violation of private property rights effectively as a public interest. The lower the number of those affected by the violation of private property rights, the lower the costs of collective action, and it is possible to expect the appropriate public policies for establishing the rule of law.

Yet, the state is captured by those interest groups whose relative power is greater than that of another interest group, or groups, with different interests (Becker, 1983). It is reasonable to ask about the relative power of interest groups that are interested in violating property rights, those engaged in the business of redistribution and rent seeking. Becker's model has shown that there is hope after all, hidden in this mechanism of competing for state capture. If one interest group wants to impose its private interest that is close to the public interest, there is a higher probability that its relative power will be greater, which will enable the imposition of precisely that private interest.

Nonetheless, it is necessary for the public to accept the idea, that strict protection of all private property rights is in the interest of that public. The problem is often in the fact that everybody will be interested in the protection of his property rights and may be indifferent to the protection of the property rights of others. This is possible particularly under the conditions of high economic inequality. The poor, who do not have much property that needs protection and who are embittered on account of their poverty very often have nothing against violations of property rights of the rich. Although such an emotional response is understandable, it can hardly be justified and must not be a basis for any public policy. It is necessary to raise public awareness about the fact that good protection of private property rights will result in economic growth that will bring benefits to all.

Under the conditions of good protection of private property rights, the greedy rich will selfishly want to increase their wealth. Nothing noble, let alone altruistic, should be sought in that, and besides, the rich do not have a monopoly on greed. However, as a result of free functioning of the market and its invisible hand, an increase in the wealth of the rich brings about economic growth, a rise in prosperity of society as a whole, reduction of poverty, and a rich society is a society of rich individuals. The awareness of the fact that the wealth of the rich is good for society as a whole, will make the job more difficult for populists, who want to build their political careers on demagoguery and promises of redistribution in favour of their own voters.

The existence of strong public pressure on the authorities to provide protection of private property rights facilitates the job for interest groups whose private interest is the rule of law. These interest groups have the goal to capture the state, in order to force it, irrespective of the existence of the public interest, to establish the rule of law. In the circumstances of strong public pressure, part of the job has already been done, since political returns for the authorities are higher if the rule of law is established, hence the costs of persuasion are lower – and that can be achieved in a much easier way if there is strong public pressure.

A role in creating incentives for the authorities to establish the rule of law can also be played by the international community, especially international organisations such as international financial institutions. Governments of many countries where there is no rule of law or economic growth face high budget and external deficits. In many of these countries, famine and contagious diseases have not yet been eradicated. These countries, just like many other developing countries want to maintain good relations with international financial institutions in order to at least narrow, if not close, the public and external deficits through grants and concessional loans, whose interest rates are far lower than the market ones. This gives an opportunity to international financial institutions, above all to the World Bank, to create incentives to the authorities of a country, through appropriate conditionality built in financial arrangements (mostly concessional loans), to design and implement the improvement of their own rule, primarily with respect to the establishment of the protection of private property rights.

In doing so, one has to be cautious regarding the effectiveness of this type of incentive coming from abroad. There are several constraints on such incentives. First, in the circumstances of evident asymmetry of information, domestic political entrepreneurs can play the card of manipulation and, instead of being honestly engaged in the protection of property rights and bearing the costs of that struggle, they can just pay lip service to it, hoping that this will formally satisfy foreign actors. Second, the question is raised of whether international actors would really embark upon something like that. Namely, in the previous chapter, it was demonstrated that the motivation of international actors can vary considerably, more specifically, that strategic interests in cooperating with a country may be dominant, regardless of the level of corruption in it. The realisation of their strategic importance for the authorities of a strategically important country also means a signal that people will cooperate with them irrespective of their results in combating corruption or any other results. Therefore, even possible conditionality attached to cooperation, and to the provision of aid, related to the fight against corruption, does not create effective incentives to engage in such a fight. Finally, the priorities of the international community, hence of its actors as well, which predominantly include international institutions, are changeable, which raises the question of the sustainability of incentives for the establishment of good governance and the rule of law as part of it.

Pursuant to all the above, in the long run, incentives to reform created by the international community are not a good substitute for domestic, indigenous incentives, but in the short run they can serve only as the second best solution. The good side of the engagement of the international community in the field of the introduction of the rule of law is that it can have effects on the creation of domestic incentives, first and foremost by putting the issue of protection of private property rights on the political agenda of a country. If there are domestic, autochthonous incentives to the authorities to embark upon institutional reform, incentives from the outside can increase the power of those domestic incentives, thus strengthening the effects on the establishment of protection of private property rights.

The main precondition for successful institutional reform is the existence of strong and sustainable incentives to the authorities for that. That implies resolve on the part of the authorities to do that and there can be no such will without “political pressure”. However, it turns out that this cannot be any political pressure. It is of key importance that such political pressure is effective, powerful, sustainable and endogenous, which means that such pressure has been created through the collective action of a large number of actors on the domestic political scene, who are vitally interested in the protection of private property rights in their own country and who have managed to organise themselves properly and to overcome the free rider problem. Something like that requires a clear and widespread perception that without the rule of law high economic growth rates will not happen.

6. Public Finance and Growth

Introduction

Economic growth is, as we have seen in the previous chapters of this study, a result of numerous factors, including the public finance system. A system which often turns over even more than half of a country's GDP, which finances important functions such as infrastructure, education, health care, public order or judiciary, which collects large financial resources by means of different taxes and social security contributions, which often makes considerable deficits and public debt and manipulates it in domestic and foreign financial markets – certainly has an impact on the economic growth rate and trend of many other economic and social variables.

This chapter will argue the following: there are needs, or public goods, which must be provided and financed at the government level (security, education, public lighting, etc.). If their provision and financing are performed in an efficient manner, the fiscal system can certainly provide a positive contribution to economic development. However, there are additional costs (additional to taxes) that make the calculation of total effects not only complex but, in general, uncertain as well. Namely, additional costs arise on both the expenditure and revenue side: in expenditures there is often unnecessary expansion of budgetary financing to goods that may be satisfied more efficiently through private channels, as well as uneconomical provision of necessary public goods; while in revenues there are distortions resulting in economic inefficiency, as well as the costs of tax collection both in government administration and taxpayers. Thus, the ultimate effect of the fiscal system on economic growth/development depends on the specificity of the main characteristics of systems and policies in particular countries.

The government commonly performs four economic functions: regulation, stabilisation, redistribution and allocation.

Regulation: Legislative and similar activities set boundaries to economic freedoms and private economic initiative, with the aim of increasing business efficiency, reducing risk, properly regulating mutual relations between participants and similar. The question is obviously where to put the boundaries of government regulation, but it will be left for another chapter.

Allocation: Government provides its citizens more efficiently with particular goods or services than the private sector, so it must decide what, how and how much of these goods it will produce and how it will finance them.

Redistribution: Certain citizens and regions are less endowed with resources than others or are underdeveloped for historical and other reasons, so the government works on equalising their position, to the extent and when considered appropriate. Redistribution will be discussed in more detail in the chapter on social welfare.

Stabilization: Care about the macroeconomic soundness of the economy, e.g., the fight against economic cycles (for full employment), inflation, balance of payments deficits, is economic policy in the narrower sense.

While the first, regulatory role is not directly connected with public finance, the other three certainly are, and they will be the focus of our attention.

Public expenditure

The basic role of government is to provide its citizens and the entire private sector with public goods. These are goods that the private market would provide to an insufficient extent or would not provide at all, e.g., defence, police, legal system, basic government administration, monetary system, parts of infrastructure, health care, education, clean environment. However, a question remains whether it is reasonable or not to produce and finance all these and other similar functions at the government level. In other words, what should government take upon itself and what should it leave to the private sector?

Public goods

In order to try to answer that question, it is useful to apply the concept of public goods. Public goods are those goods that possess three properties that make them essentially different from usual private goods: non-exclusivity, non-rival consumption and existence of external effects.

Non-exclusivity means that those who do not pay for a good or service may not be excluded from its utilisation. A classic example is street lighting: it is impossible or prohibitively expensive to prevent a passer-by from using a lighting system paid for by somebody else. Since it is so, then everybody will try to use, free of charge, the good or service paid for by somebody else (the well-known free rider). A shortage of the good or service will automatically appear in relation to the demand or the needs because the producer of the good or service will not agree to such an unprofitable arrangement in which it bears all expenses, while everyone enjoys benefits. The problem of coordination in the private system is clearly perceived here: everyone would benefit from a street lighting system, but it does not exist because the issue of fair distribution of cost financing has not been solved.

Non-rival consumption is the second aspect of public goods. It designates such a property of a good or service where it is practically impossible to terminate someone's consumption of a good without simultaneously terminating it to everyone, or where the additional cost for a new user is nonexistent, or equals zero. The example of a street lighting system may be mentioned here as well: it may be the same and it may cost the same, whether ten or a hundred passers-by walk along the street per hour. Or, the example of defence: it is impossible to defend only some people from an external aggressor, i.e., those who paid for it, and exclude the others who failed to do so.

External effects are, in this case, positive effects which public goods demonstrate beyond the boundaries of their direct utilisation or costs of their production. For example, inoculation against contagious diseases brings benefit not only to the person who was inoculated, but also to those that come into contact with the inoculated person.

Therefore, if a good possesses the three mentioned properties – non-rival consumption, impossibility of exclusion and external effects – then completely private provision of this good is uneconomical, or economically inefficient. The supply will be too small or there will be no supply at all, since nobody has a motive to produce something which can neither be charged for nor whose utilisation cannot be controlled.

The classic answer to this problem has been sought and usually found in the involvement of government, just as in other real or alleged market imperfections. It was believed, and it is believed even now to a somewhat lesser extent, that the government is the cure for many social and economic weaknesses and that it represents an incarnation of Hegel's absolute spirit. European continental tradition, not only German but also French, is responsible for the spreading of the idea that a strong government can resolve economic and social problems if it takes the matters into its own hands and organises production of public goods financed by compulsory taxation. Two assumptions of that all-inclusive statism were crucial: that the government is omnipotent and well-intentioned. We shall see later that neither of those claims is quite correct.

While Great Britain became liberalised during the first half of the 19th century, Germany replaced the former cameralist system, based on wide governmental control over economic flows, with a more modern one, but also with a pronounced role of government. Mandatory state social security, protectionist industrial policy and similar were created there. And they were followed by France, which also relied on the idea of a strong centralised government. During the 20th century, partly in connection with the two world wars, the concept of a great state spread to all continents. Particularly in the underdeveloped part of the world, there was also emulation of the methods applied in the socialist countries, where economic and social life was completely subject to the will of the state and party.

Fiscal share in GDP in the more developed part of the world has grown from around ten percent at the beginning of the 20th century to 50 percent, and as much as 60 percent in several countries, during the 1970s and 1980s. Indeed, the government did all sorts of things: it produced goods and services in its economic and financial enterprises; treated people in its hospitals; educated the children and the young in its schools and universities; took care of children and old people, employed and unemployed persons, women and mothers, families and individuals, the poor and the disabled; built roads and libraries, gas and water supply systems, telecommunications and telephone networks, post offices and airports. It did everything for which the private sector had no interest in given conditions, or, more often, what the government wanted to keep for itself.

Involvement of government certainly solves, to the highest extent, the problem of the free rider who refuses to pay for the benefits he likes to receive. However, a new non-trivial problem arises at the same time: the political process of deciding on optimum level of public goods provision is never based on good methodology because there is no such methodology. We can not ascertain here how much the individuals are prepared to sacrifice in order to obtain a public good; the politicians are not able to estimate the urgency of the need for satisfying that need either, since the budget money is always in great demand. The public good supply under government arrangement will usually be wrong: either too small or too large.

The problem with this concept lies also in the fact that only a few public goods are pure in the necessary theoretical sense, so that it may be unambiguously said that the government must take them upon itself. Let us consider several examples. National defence is taken as an indisputable example of public good and it certainly is that. It is truly hard to imagine a private air force. However, there are some alternative, contractual solutions here as well:

- First, a country may place itself under the protection of another country and thus free itself from the necessity of having its own defence forces. Of course, that must be paid somehow, politically or otherwise; thus, numerous countries have joined NATO and provided themselves with efficient defence, while in return accepting an obligation to send some infantry to peacekeeping missions.

- Second, if an air force cannot be private, many other defence activities can. Thus, for example, Great Britain has left numerous military-related activities to the private sector, so privatisation has spread, more or less, over many sectors: airports, shipyards, army bases, engagement and training of personnel (including pilots), provision of equipment (for example, leasing of heavy trucks for tank transport), equipment maintenance, creation of military internet, military satellites, transport (air force transport), etc. It seems that even the air force is not immune from privatisation any more!

Or, inoculation of the population against contagious diseases really belongs to pure public goods, due to external effects consisting of benefits to others as well, and not only to those inoculated. However, health care also includes many other components that could be organised in a different manner than by government provision: for example, dental medicine is very suitable for privatisation.

Two facts are crucial here: 1) pure public goods are almost non-existent and 2) in addition to government provision, there are also other technologies of providing these goods.

There is no doubt that the goods are hard to classify into pure public and private. In fact, it is a matter of a continuum, with numerous transitional, mixed forms, for which it is hard to say whether they are more public or more private. By this very fact, easy determination of government functions is not possible either, which is a fundamental fact that hinders proper organisation of governments in the modern world. Be that as it may, the fact is that the number of pure public goods is very limited[1] and that for many others it is questionable whether they will be provided more efficiently by the government or by the private sector.

Fortunately, production of public goods under government arrangement, together with taxation, is not the only possible manner of their production. There are also other social arrange-

1 There is a well-known quarrel between two Nobel award winners, Samuelson and Coase, about whether sea lighthouses are public goods. Indeed, everyone would claim, together with the great theorist Samuelson, that private financing of lighthouses is not possible, because ship owners will certainly not pay any tax to the lighthouse keepers, but Coase showed that, during the previous centuries, British lighthouses had been privately organised and financed by nearby ports for the purpose of increasing the safety of navigation and traffic in those ports.

ments that provide or encourage production of public goods. Let us take a look as some of them.

The first is the production of goods or services in the private sector for governmental needs, with the government determining the quantity of a public good and provides financing. The difference in relation to the full state-owned production is partial, but also essential: a more efficient production is ensured because, in principle, the production in the private sector is more efficient than in the state-owned sector.

The second is cooperation with the non-profit “tertiary” sector, where non-profit organisations try to interest financiers in their public good production projects, in which they certainly often succeed. While there may be some lucrative motives in the non-profit sector, there are none of them in financiers, except for tax savings and honours that public benefactors receive.

The third manner is the application of ordinary market mechanisms, but by connecting in some manner the consumption of public good with private products. Operating in that manner is the internet, that large network with no owner, which provides services – knowledge and information – that are a public good, and is financed by advertisements of private firms, with the users usually getting an advertisement together with what they are looking for.

The fourth is purely private, based on voluntary change of ownership, according to Coase. For example, if there are several owners of a lake, each of them will try to be a free rider in cleaning the lake, leaving the payment of the bill to others. Nevertheless, the government is not the only solution: the first method may be a joint cleaning action, and the second, if the first fails, may be the purchase of the lake by one owner, who will subsequently clean and collect a higher fee from all lake users (fishermen, swimmers, boatmen, etc.).

For conclusion, much of what is usually considered a public good is not a pure public good at all, but a mixed good, with more or less of private elements, so it is possible to provide it through private arrangements as well. Additionally, on numerous occasions pure public goods may also be provided without relying solely on the government, sometimes in a completely private arrangement. Such a perception leads to a change in the opinion about the extent of government participation in the production of goods and services, which is the subject of the following section.

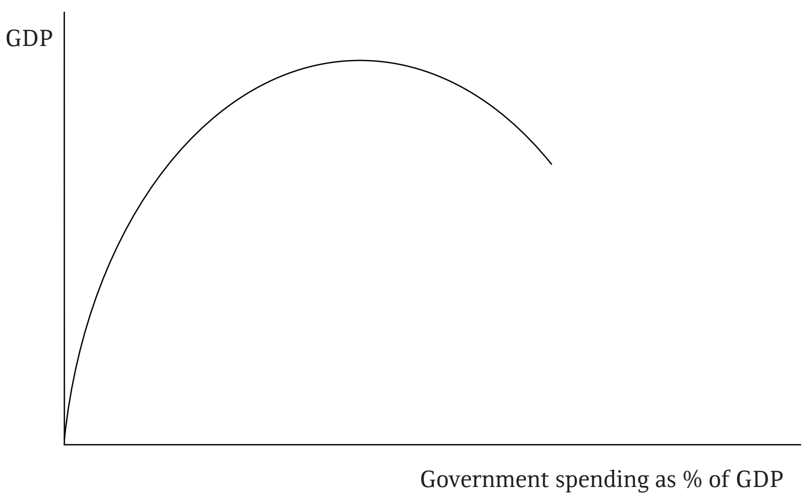
Public Finance and Growth

The discussions from the previous section introduced us to the greatest dilemma of modern public finance: how large should the government be, and which portion of gross domestic product should be entrusted to it for the purpose of performing its functions?

There is no doubt that economic activity and GDP in a country would be very low without the government and its services, just as it was at the dawn of civilisation. Then there would be no protection of public security, so there would be widespread pillaging by plunderers and other thugs, and life would be reduced to struggle for bare survival. Similarly, no one would ensure the observance of contracts or protect private property, so no one would try to create any property and conclude business with unknown persons; economic life would be reduced to hunting and gathering, without any wider division of labour and striving for larger-scale production, just as it was at the dawn of civilisation. This position is shown in the left-hand part of the following diagram: when the government share in GDP equals zero, GDP is low.

With the appearance of government and its performance of classic government functions, also appearing is the government

Figure 6.1 Government spending and GDP



that needs money. These basic government functions include the provision of external and internal security (military and police) and judiciary, which should provide proper dispensation of justice. With these three functions, we get a "night watchman" government corresponding to the classical liberal idea, while all other activities are performed in a private manner. Some larger infrastructures, according to the great liberal and founder of modern economic thought Adam Smith (1776), may also be created under government arrangement. Inclusion of these functions and their financing lead to an increase in government share in GDP, as well as to a rapid increase in economic activity, because the individual is personally safe now, and his property is, in principle, safe from robbery or usurpation. Now he completely devotes himself to economic activities, trying to increase his consumption and enlarge his property. The country's GDP grows fast, which is inevitably followed by poverty level reduction.

In addition to these most classic government functions, it is commonly believed that there is work for government in other activities as well, for example in education, health care and infrastructure.

In education, the guiding idea is the conviction that all children should be provided with a minimum of education that will not only bring them good civilisation knowledge, but also create chances for success. The majority of parents are not the problem here, because they would provide necessary education to their children even without the government, but a small number of those parents who would not, and whose children would remain handicapped compared to the former. Admittedly, it is not only a matter of society's humanity towards children here, but also of the necessary education of the workforce, which is also beneficial for business. Since the government thus introduces mandatory education, then it would be proper for the government to provide it by itself, which it usually does through the state school system.

In health care, there are two problems with private provision. First, what should be done with the poor, i.e. those unable to pay for their treatment, since it is considered unacceptable in the civilised countries for someone to die just because he/she has no money for treatment. Second, there is a so-called information asymmetry in health care, i.e. doctors know much more about diseases and treatment than patients, so when they are private doctors, they know how to take advantage of that and can perform unnecessary actions and therefore charge the frightened patient for more than is necessary. There are also some other problems in private health insurance, such as negative selection[2] and moral hazard,[3] which question the efficiency of market solutions. So it is no wonder that, since the end of the 20th century, state health care systems have been developed, including state doctors and insurance, which take over the population health care from the private sector.

There is room for government in infrastructure services as well. We have already mentioned the street lighting system, and we may add many more activities similar to that: construction and maintenance of roads, bridges in the city, irrigation systems, flight control and similar. Indeed, modern countries invest huge amounts of money in the construction and maintenance of various infrastructure projects, which contribute significantly to the rise of economic activity.

Guided by such reasoning, many countries, not only former Communist countries, completely nationalised their systems of education, health care and infrastructure activities. The government took more and more competences upon itself, because to many people it seemed capable of solving daily difficulties in the most efficient manner.

In that process of government utilisation, the pendulum went to the other direction: instead of specific activities in health care, education or infrastructure, private initiative was completely stifled and in many countries the government took the entire activities upon itself – the entire health care system, the entire education system (including universities), infrastructure (electric power industry, telecommunications, railway system, roads, even airlines, local utilities, etc.), as well as the activities in the social sphere, such as pension insurance, social care in the narrower sense (child and family care, care for unemployed and poor persons, etc.). It

2 In this case, the people who need health care services opt for insurance to a greater extent than those who do not, and therefore insurance costs for individuals are high, which discourages them from taking insurance.

3 In this case, the insured take less care of their health than they would if they were not insured, which also raises questions about the calculation of insurance companies.

seemed that there was almost no economic or social activity that could not be performed under government arrangement. Many people even thought that this would be good.

In the developing countries there was another incentive for increasing the size of the government: development theory and development polices that were accepted in the first three post-World War II decades were obsessed with increasing national saving for accumulating capital assets and the first precondition of economic growth. The increases of government spending in the GDP and the overall size of the government was widely considered as the best way for creating conditions for economic growth. Although this result follows the findings of the neoclassical model of economic growth,[4] the basic rationale was somewhat different: it was believed that increasing taxation was an inevitable substitute for a poorly developed capital market and financial mediation in developing countries, hence the government should take the leading role in providing capital finances for economic development.5 That very concept of government that provides an increase in capital investments in developing countries was faced with problems in the early 1970s, when it became obvious that large and active government ends up in budgetary deficits and inflation with lower growth rates than previously.

Government size reduction

The confidence in the government was based on two important assumptions: that it is competent and that it is well-intentioned. Both proved wrong.

The assumption about capability means the conviction that the government can conduct the activities entrusted to it in an efficient manner, whether these be railway system and hospitals or pension insurance and family care. However, it soon turned out that it was not quite so: state hospitals were dirtier and the treatment there was poorer than in private hospitals; state railway companies recorded poor performance in terms of timetable

4 For example a simple Phelps-Shell model of economic growth demonstrates that increase of public investments funded from increased taxation results in the increase of capital ratio to labour and GDP *per capita*.

5 That is basically the position of Nurske (1953).

 observance and employed many more people than private railway companies, often according to party membership; state pension insurance systems, in contrast to private ones, promised too much and often posted deficits, while support to families often presented paternalism and encouraged parasitism. Observed globally, with the expansion of government functions to those that should not or would not have to be such, it turned out that the government costs more than it provides, i.e. that the money entrusted to it is spent uneconomically.

Indeed, is it really necessary for every railway and every train to be state-owned? Why could a local water supply system not be privately owned, which is, as a rule, more efficient? Why could a hospital not be private as well? Must power plants and the local gas network really be in government hands? Why should there not be private universities as well; does dental medicine really have to be state-owned?

State ownership is not efficient, either in commercial activities or in others as well. Simply put, when performing an entrepreneurial or managerial role, whether in an airline or an elementary school, a civil servant does not face an equally stimulating environment as a private entrepreneur or manager. Thus, in his work, a civil servant faces:

- *unclear target*: While the target in a private firm is profit maximisation, the targets in a state-owned institution are always complex; they include both social and political incentives and cannot easily be translated into a clear work program, even with the best intentions.
- *inefficient supervision*: In private firms there are shareholders, represented by the board of directors, who supervise the manager and replace him when he does not perform well, and who have the best motive for this (their own assets); on the other hand, the politicians' supervision over the servant is always inadequate and inefficient because they themselves have neither a strong motive nor the knowledge to ensure efficient operation of a given institution.
- *unclear system of individual incentives*: The wage system is always less stimulating in government administration than in private firms, i.e., a fixed wage is usually earned, which is not attractive enough for greater efforts, or for the engagement

of higher-quality managers; certain hope for a subsequent reward may be brought by possible advancement in a political career, but this kind of promotion depends to a certain extent on the civil servant himself and, to a much higher extent, on the political circumstances.

Usually, the final result is low efficiency or inefficiency. That implies a greater or smaller waste of constantly scant resources to a greater or lesser extent, which is not good from the viewpoint of economic progress.

The assumption that the government and its servants are well-intentioned also proved to be wrong because the idea about politicians as real saints who fight solely for the welfare of the people is quite unrealistic. Politicians are human just like everyone else, quite selfish and inclined to pursuing their own interests.[6] Their basic goal is their election or re-election, and not the welfare of the people. An earlier belief that elections are the mechanism which forces politicians to work in the people's interest is not convincing any more, as it turned out that marketing communicativeness or even plain demagogy are usually considerably more important for the success in elections than great results or at least reasonable action programs. All politicians know very well that the voters' memories are short and are inclined to make impressive rather than smart moves.

With the appearance of this more realistic theory of politics, it has turned out that it is not sufficient any more to justify state interventionism with the fact that the market is not perfect in some segment of economic or social life, i.e., with the existence of so-called market failure. Now when the government is known not to be perfect either, we must make a decision on its possible interference through answering the question – whose failure is greater: that of the government or of the market? Of course, by this we have gained realism, but paid for it in complexity, because it is not easy to give this answer.

All in all, during the 20th century the government did not perform very well as an institution that spends its taxpayers' money in a reasonable way. It took too many competencies upon itself

6 This is convincingly presented by the public choice theory of the Nobel award winner James Buchanan. See, for example: Buchanan and Tullock (1962).

and failed to execute them well. In the states with the widest functions, those in Western and Northern Europe, it was probably in the right-hand part of the previous diagram, i.e., where negative effects of further expansion of government competencies are. In other words, the government created more costs than benefits, with costs including not only direct financial costs, but also the damage that may be created by its poor actions; for example, if foreign trade, or the financial system, or taxi service in a city, or health insurance are overregulated or badly regulated. Then even the direct cost of carrying out a policy may be low or moderate, but the potentially negative effects on the economy and society (economic growth, population health, etc.) may be far greater.

Simply put, increasing government consumption has its opportunity cost. It means that something in the private sector must be reduced, perhaps investments or personal consumption. This leaves hard choice to be made as to what is more important and better.

Furthermore, there is an empirical support to these findings. Easterly and Rebelo (1994) have demonstrated, using data for 100 developing countries from 1960 to 1988, that positive effects on economic growth had only two factors from the public finances sector: public investments in transportation and telecommunication and budgetary surplus.

Since the 1980s, the pendulum started to move in the opposite direction. The time of liberalisation and privatisation began. Great Britain was the first to make a radical break with omnipotent government, which in the previous period had brought the British economy to the bottom of the list of European countries and which had been rightfully called sclerotic. Then the USA and many other counties followed suit, particularly the former Socialist countries, whose transition was truly radical and which abandoned the system of central economic planning in favour of the market system. Also, many developing countries, such as India, used to adhere to statist solutions, emulating to a considerable extent the allegedly successful Communist countries, but later they also oriented themselves towards capitalist economy and the decreasing role of government.

The last important bastion of statism in developed world is Europe, particularly Western and Northern Europe. While Ireland and Great Britain have dismantled their state to a considerable extent and reached the top place on the continent by economic performance, it is persistently maintained in many other countries in the region. The last attempt at reform, initiated at the European Union level, is represented by the so-called 2000 Lisbon Agenda, when the Union countries agreed on essential reforms that would enable it to become the most competitive economy in the world by 2010. However, this has failed. The European social model is already deeply rooted in the value system and views of many people and it is not possible to reform it without major (political) resistance. The northern variant is interesting: these countries combine economies organised in an exceptionally liberal manner with a very extensive social care system. Therefore, one part of the old welfare state has been abandoned – the one that led to over-regulation of economic flows by the state, so these countries hold the top place by all indices of economic freedoms – but the other part has been preserved, the one regarding extensive social benefits. The welfare state has thereby moved from the production sphere to the pure consumption sphere, which at least presents clear progress from an economic viewpoint.

A more recent experience has clearly shown that many public goods may be provided without being funded and produced by the government in the standard manner. For example:

- natural monopolies do not have to be state-owned, and can also be privately-owned, with the regulation of that private monopoly having a key role to prevent consumer exploitation by the private monopolist
- the problem of externalities, i.e. discrepancy between private and social costs and benefits (example: pollution) does not have to be resolved by nationalisation, but by a combination of taxes and subsidies
- private production with financing from government sources is possible for many goods and services (education, health care, telecommunications, infrastructure, etc.)

A government expenditure improvement program in developing countries, with the desire to improve government efficiency and contribution to economic development, could do as follows:[7]

7 According to IMF (2006).

- eliminate unproductive or low-priority services, since the opportunity cost of financing these needs is very high (unfavourable);
- privatise the activities that may and should be performed in the private sector, which are always plentiful in statist economies;
- introduce more commercial approaches to the remaining activities in the public sector, including competitive tendering and leaving contracts to the private sector, since the inclusion of the private sector usually brings significant efficiency gains and saves budgetary funds;
- simulate market discipline in the public sector, for example through competitive procurement from state-owned companies;[8]
- strengthen management, for example through lowering the decision-making levels or through performance-linked management remuneration, in order to create working conditions in government administration which at least resemble those in the private sector.

Public revenues

Increase in public expenditure would not be a particularly negative event if it did not have to be financed in some way, usually from the public revenues of the same government. Alternative methods may be considered; though in the long run, they are either impossible or undesirable. Therefore, government borrowing in developing countries in the domestic financial market is unfavourable from the aspect of exhausting domestic investments or loans in the private sector, which decreases the economic growth rate. Alternatively, borrowing in the foreign financial market over a longer period of time jeopardises the country's credibility and worsens the conditions of new borrowing, with unfavourable consequences. And borrowing from the central bank leads to direct

8 A well-known example is efficiency in the production of military airplanes on the basis of competition between state-owned factories in the communist USSR.

inflation due to money printing, as demonstrated by the experience of numerous developing countries.

The only apparently good manner of covering government costs is from foreign donations,[9] which is partly done in the poorest countries of the world. Nevertheless, that method of financing does not provide sufficient revenues, nor can it be considered sound in the long term because it encourages parasitic impulses instead of aspiration for one's own progress.

Public revenues (taxes, contributions and similar) still remain the basic manner of collecting government funds for poor countries as well. The problem with them is that their total costs to the economy are higher than what is collected for the treasury. There are three additional costs, on the top of the collected revenue.

First is the loss of allocative efficiency. This is caused practically by every tax, because tax burden inevitably changes the behaviour of taxpayers and they try to reduce the tax burden by different moves. For example, when a tax on apple consumption is introduced, an individual will at least partly reorient itself towards consumption of another fruit in order to avoid the tax burden. However, that change in the structure of his consumption will inevitably mean loss of his well-being because he likes apples but consumes them less now due to the tax. Similar efficiency reduction also occurs with other taxes, such as personal income, sales in general, profit, property, etc. This loss is called *excess burden*.

It is usually thought, on the basis of calculations, that the excess burden is lower in consumption tax and wage tax and higher in profit tax or capital tax. According to this criterion, tax policy should be oriented towards consumption and wage taxes, while capital and profit taxes should be avoided, because efficiency losses created by taxes would be reduced in that manner. However, this tax orientation would be difficult to defend from the aspect of fairness, because it would obviously[10] favour richer classes, since sales taxes are mostly regressive. They affect the poor more than the rich because consumption share in income is higher in the case of the former than in the case of the latter. Nevertheless, it is certainly better for economic growth that the taxation be based

9 Donations are equal to borrowing that is eventually forgiven.

10 At least in the partial equilibrium analysis.

 on consumption than on income because consumption taxation leaves savings untaxed, which represent an important factor of investments and economic growth.

The issue of the ideal tax structure is very complex, and virtually insoluble. The findings of the related theoretical discipline (theory of optimum taxation) are very impractical for public policy purpose.

In developing countries there is an additional problem: their tax administration is less capable of collecting tax revenues than the tax administrations in developed countries. Accordingly, due to a poor collection rate, developing countries have turned to foreign aid, loans and even an extremely high tax burden of the tax basis and the taxpayer who can be taxed at all. According to the IMF (1995), African countries have significant potential for raising tax receipts by broadening the tax base, improving tax administration, and rationalising the tax system.

The principle of the 17th century French statesman Jean-Baptiste Colbert, "The art of taxation is the art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing", used to be taken as the basic principle of a good tax system. In the meantime we have made some progress in relation to Colbert's cynicism. Adam Smith suggested some principles of a good tax system, including:

1. **Fairness**:
- *horizontal equality*, where the equal should be treated equally, for example those having equal income or property should pay equal tax;
- *vertical equality*, where the unequal should pay unequal tax, and those having more should pay more.

2. **Efficiency**:
- *minimising excess burden*, which has already been discussed;
- *fiscal neutrality*, which says that tax policy should affect business decisions of firms and individuals as little as possible, i.e., that there should be as few reliefs, exemptions, exceptions, tax credits, etc. as possible. The ideal is a combination of extensive, all-inclusive tax base and low tax rate, which still provides considerable revenue;
- *adjustment of externalities*, where the undesired difference between private and general costs in some activities is taxed

for the purpose of encouraging its decrease and disappearance and where the positive difference between general and private benefit is encouraged by government subsidies.

3. **Low costs** of taxation:

- direct costs of tax collection by tax administration, since they may be very different – from less than 1% per monetary unit of collected income to several tens of percent;[11]
- indirect costs, or costs borne by taxpayer; these include not only administrative costs of preparing and keeping documentation in the firm and similar, but also the costs of tax consulting and lawyers assisting in litigations and similar; the latter costs may exceed the former.

Undoubtedly the best tax system for economic growth is the system that rests on:

- reasonable tax burden, which means a tax share in GDP from 20% to 30% instead of 50% or 60%, leaving more to the private sector for investments;
- simple tax rules, which will not complicate the life of an individual or business operation of firms, inducing them to perform gymnastics for the purpose of reducing their tax burden, but tax all income equally, without numerous relieves and impediments;
- fair and efficient tax administration, which will perform its work properly, collecting public revenues in a high percentage, in an inexpensive manner and without being lenient toward anybody.

Macroeconomic stability

Macroeconomic stability, which refers to reasonable internal and external economic balance, presents the basis of sound economic growth, in both developed (rich) and developing (poor) countries. In times when inflation is high, when government debt is high,

11 Agricultural income tax is not collected in Serbia today because the inflation from the last decade and a half has impaired the tax base (cadastre revenue), and so the postal expenses would be higher than the total revenue. The solution is, of course, adjustment of the base, but the politicians are somehow reluctant to get on the wrong side of farmers.

 when interest rates are high, when aggregate demand changes incrementally, when uncertainty about the flows of economic life is high and reversals are frequent, economic actors are not able to make decisions in a rational manner. This may reduce investments, lead to capital export from the country and in other ways cause a decrease in GDP growth rate or even a GDP decrease.

Inflation may be a result of poor fiscal policy, when public expenditure over a longer period is higher than public revenues, and especially when the deficit, created from that difference, is financed from monetary issuance (or money printing). Such inflation may reach great proportions, even become hyperinflation, which, as shown by numerous episodes from the economic history of the world, inevitably leads to a significant decrease in economic activity. It is also possible for moderate inflation to be created even without monetary issuance, when fiscal policy increases aggregate demand beyond the necessary extent and leads to an overheating of economic activity.

Fiscal policy may also be an important instrument of fighting inflation through several channels. It affects aggregate demand directly through the purchase of goods and services from the budget, but also indirectly through taxes and transfers to households, which affect the level of private demand. Alternatively, fiscal policy may reduce or eliminate its own deficits and thereby enable a reduction of monetary issuance for the purpose of eliminating this inflation channel. And fiscal policy may affect inflation through its effects on the demand for money, particularly through its impact on interest rates, confidence in the financial system and inflationary expectations.

Decrease in investments may be one of the consequences of poor fiscal policy and its deficits. When a government borrows funds in the financial market to cover its deficits and increasing public debt, its demand for money decreases available funds for investments and has an impact on increasing the interest rates, which again leads to a decrease in private investments. And investments are certainly an important determinant of economic growth.

Naturally, fiscal consolidation, with current deficit reduction, may have rapid effects on investment increases through a reduction of government demand for money in the financial market, as well as through interest rate reduction created not only through the mentioned government demand reduction but also through risk premium reduction. A credible fiscal adjustment also brings business optimism, which has a favourable effect on investments in the private sector and on the overall economic activity.

Public debt is an important component of overall macroeconomic stability. It is created when in a certain period government spending is above the amount of its revenues. Large consumption would not be a big problem if it did not have to be financed in some way. Admittedly, sometimes when a state is very poor or devastated (after major conflicts), the rich world shows readiness to help and grants financial and other aid that facilitates financing public needs without creating public, national debt. The series of budget deficits is then not accumulated in public debt; instead, the bill is settled by rich countries or multilateral agencies. However, even such a financing is not quite free of charge in the political and other sense. According to the old Serbian proverb, "What comes free of charge is the most expensive thing".

Macroeconomic stability is closely related to long-term sustainability of public debt, which depends on its level and the ability of the government to service it without endangering regular functioning of other government segments. Debtor crisis is a common companion of the poor part of the world and of many underdeveloped countries when they are unable to meet their obligations due to accrued debt and/or lower than expected public revenues.

In addition to real factors of sustainability, an important element in public debts is market expectations. Even when real factors suggest sustainability, market expectations may, for various reasons, take some other, unfavourable course and estimate future prospects of debt servicing as unfavourable. Appearance of a significant risk premium may make regular servicing an unattainable goal, so an incorrect forecast may become a self-fulfilling prophecy.

An increased risk of public debt servicing may also be caused by other institutions that may increase this debt: subnational levels of government structure (provinces, regions, municipalities, but also federal units), then extrabudgetary funds and public enterprises. For all of them there is usually a formal or informal, but moral, guarantee of payment by the government level if they fail to pay their debts towards domestic and foreign creditors. A rare example is Germany, which at one time did not rush to help one of its federal states and let it formally go bankrupt.

The anticyclic role of fiscal policy is one of its more important roles. Business cycles, or temporary decreases and increases in economic activity, are a common phenomenon and may result from different causes. However, one of the possible instruments of anticyclic policy is fiscal policy. It may increase or decrease aggregate demand as needed. When the aggregate demand is high, fiscal policy may cause its decrease, for example, by decreasing purchases or transfers to households by the government or by increasing tax burden. When the demand is low, the government may increase it by actions in opposite direction.

Half a century ago, an excessive ability of solving all economic difficulties used to be attributed to anticyclic fiscal policy. However, during the 1980s the pendulum went the opposite way, with the theory of real economic cycles from the arsenal of neoclassical macroeconomy, according to which fiscal policy is totally incompetent and unnecessary. In practical life, a moderate position is usually assumed, according to which there is a certain place for fiscal policy as well as for monetary policy, but more for fine-tuning of economic conditions and inflation and less for large, capital undertakings.

Political economy

Decisions of highest significance to public finance or the fiscal system are made through a political process, whether the political system is democratic or not. It is unrealistic to expect the decisions to be quite reasonable and in accordance with the best criteria of economic science. Quite the contrary, it is obvious that there is no great designer of a fiscal system who would wisely plan and realise the project; instead, these systems are usually full of conceptual inconsistencies, poor technical solutions, in disharmony with the environment, often with wrong timing and similar. Experiences of some countries are rarely used in others, so the fiscal systems of modern states are very different from each other: the levels of expenditure or revenue share in GDP, and the ratio between public consumption and transfers, and public consumption programs, and revenue structure and categories, and the appearance of deficits… Even in the European Union there is no attempt to harmonize fiscal systems and tax policies.

Public policy usually must find a balance among the voters' interests. When it comes to a relatively simple issue, one that can be presented in one dimension, then the *median voter theorem* is a very suitable analytical instrument. In redistributive programs, such as those in the area of social care, it is possible to proceed from voters' preferences and a solution may be derived from them that will prevail at the end of the political process; in these issues the views of majority of citizens are usually in the middle of the scale, while extremes are fewer in number. In democracies, all politicians strive to win the trust of those median, moderate voters, trying to express their views and interests and asking for their votes in return.

The adoption of a redistributive program that is based on transferring income from the richer to the poorer depends on how it financially concerns the middle class and what the value system of that middle class is. However, since more than half of the population has an income lower than the average, it is no wonder that redistribution was expanding in virtually all developed countries during the last century.

The politics in modern democracies is rather far from the idealistic idea about the median voter and a true representation of his/her interests. A more important role in parliamentary and, generally, political life is assumed by the struggle for *special interests*, where one group tries to impose its own interests as common interests and to "push" them through political process.

The central privilege from the struggle for special interests is the following: the benefit of success is concentrated on a small number of participants and it is very significant and stimulating for each of them. The cost is usually dispersed over the entire population (all taxpayers) and is, therefore, very small for each individual, who for that reason has no big motive to oppose the group that promotes its special interest. Special groups get easily politically and financially organised, while the general public, which will bear the costs, remains unorganised.

The best-known model from this group is lobbying, where one interest group tries to influence the outcome of the political process by winning the support of certain politicians, by various privileges that could be reduced to a contribution to their future election campaign. Lobbying is considered an unattractive, though probably inevitable, other side of democratic policy.

There is no doubt that the satisfaction of special interests is, by its essence, counterproductive, and very probably also negative from the viewpoint of society's economic prosperity. The ever limited resources are not used in the best manner, but in an inferior manner, to the benefit of someone who had the opportunity to influence the political process.

7. Social Assistance

On social assistance fundamentals

What is social assistance?

The term *social assistance* encompasses different types of budget-financed programmes targeted at the most destitute segments of the population. This definition contains two important elements that make it possible to differentiate social assistance from other governmental social protection programmes. The first one is that social assistance is always targeted towards the poor according to clearly defined criteria. The second refers to budget financing of social assistance programmes and points to the fact that beneficiaries do not have to pay insurance against specific types of risks in order to receive benefits.

In most cases, the notion of social assistance implies the payment/distribution of benefits, in cash or in kind. In kind benefits include distribution of goods (most often food), as well as programmes which provide the poorest with free or subsidized access to social welfare services, e.g. accommodation in homes for the elderly, day care institutions for persons with disabilities, kindergartens, social housing, different types of employment training courses, health care and education, and the like.

Social assistance is part of social protection. Most systems differentiate between social assistance programmes and social insurance programmes, which are two integral elements of social protection. The protection of the poor is also provided through universal benefits to families with children or persons with disabilities and universal access to education, employment programmes and interventions on the labour market, which, just like social insurance, do not target only the poor and can be preventive in character.

One of the most important differences between individual social assistance models arises from the role played by this protection instrument in different systems. In some systems social assistance constitutes the main and dominant instrument for protecting the poor. In other systems social assistance is an instrument that is activated only after all other protective mechanisms have failed in securing a sustained minimum standard of living.

Also, social assistance can be an instrument that provides only a minimum standard of living to beneficiaries, but also an instrument that should enable more equal income distribution, inequality reduction and a higher degree of social cohesion/inclusion. As an instrument of social inclusion, social assistance can also be used for achieving objectives in other segments of the social sector, such as in education or health.

In recent years, another objective has been added to social assistance programmes – that it should enable those beneficiaries who are able to work to re-enter the labour market. Models of social assistance can now be differentiated by the degree to which they are linked to employment initiatives and activation of beneficiaries: «Jobs for those who can work, protection for those who cannot»[1]. A requirement for able-bodied beneficiaries to work in order to receive benefits is a fundamental change in modelling social assistance. (Lodemel and Trickey, 2000, p. 2; Adema, 2006 p. 14).

There are also differences among social assistance models related to the level of centralization or decentralization of a system. Depending on whether national legislation regulates rules, or whether local levels are autonomous in decision-making, hence in the financing of this protection instrument. In most OECD countries, the amounts of benefits and criteria according to which benefits are distributed are centralized, although there are also mixed

1 The United Kingdom's Green Paper on Social Reform, quoted in Aust and Ariba (2004, p. 12).

systems, as well as highly decentralized systems (OECD, 1998, annex p.12-14; Neubourg et al., 2006, p.18). Even in those countries where "all the rules" are defined at the central level, administration and implementation are left to the local level[2].

How to help?

There are several types of social assistance programmes:

- Social assistance in cash, aimed at securing minimum income
- Child allowances, cash benefits targeted to poorer families
- Subsidising subsistence goods, such as food, housing, electricity and such
- Assistance in food, such as soup and school kitchens
- Free access to services for the poor
- Public works, one of the goals of which is to give the poor a chance to earn income
- Loans and other benefits aimed at encouraging self-employment, etc

In developing countries, assistance to the poor is mostly irregular and in the form of food distribution (direct distribution of food or food vouchers, free meals for children in schools, nutrition programmes for pregnant women and the sick...). Recently there has been an increase in the number of programmes that not only provide benefits but also have other pro-poor development objectives. Such programmes create incentives for children to go to school or, for example, improve the local infrastructure in the poorest communities (social investment funds[3]) through public works that secure food for the poor (instead of wages in cash). In countries where regular cash transfers do exist, benefits are targeted at specific groups – the elderly, war veterans, the chronically ill, orphans, widows, the HIV/AIDS affected, etc. (Subbaro, 2003; Tabor 2002; Lindert *et al.*, 2006).

2 On the other hand, in Switzerland, for instance, where social assistance falls within the competences of municipalities, there are no major differences among individual schemes, since most local authorities observe expert guidelines distributed from the central level. (Adema, 2006, p.16)

3 Social investment funds finance small-scale projects mostly of an infrastructure nature (local roads, school reconstructions) that are selected with the participation of the local population.

In developing countries, particularly in the poorest ones, informal and non-governmental types of assistance for the poor are still very important. Among them, one of the prevailing forms is support provided by family members. The non-governmental support also includes assistance from the church, local communities and neighbours, humanitarian organizations and such.

Both in more developed countries and in countries in transition, the basic role in providing social assistance has been taken on by the government, through regular support for the poor, by providing a considerable portion of benefits in cash (Tabor, 2002). Programmes of social assistance in cash imply, first and foremost, transfers aimed at securing minimum income, with special benefits for poor families with children, as well as transfers targeted towards the elderly with low-income. In those countries where disability allowances are not part of social insurance, persons with disabilities often receive cash benefits, which can also be directed only to the poor (Adema, 2006).

In kind programmes that do not involve cash transfers are also very well developed, even dominant, in particular countries[4]. These programmes include distribution of food vouchers, subsidies for rents, energy, and accommodation in homes for the elderly. Instead of cash benefits, the government can distribute coupons for food to poor families, or “reduce” their electricity bills or rents, by paying for the differential from the budget. In kind programmes also refer to budget financed health care of uninsured poor individuals or other social services for the poor elderly or persons with disabilities. In addition to compelling the poor to spend assistance on concrete goods and services, in kind allowances can be politically supported for other reasons, too. The government-subsidised construction of apartments for the poor can be strongly supported, for instance, by the construction lobby, food coupon programmes by the agricultural lobby, etc.

4 In the U.S., for instance, more than 70% of social assistance programmes do not involve cash. Half of the social assistance expenditure covers the costs of MEDICAID, a programme which provides free health care to poor families. (Stiglitz, 2004, p. 404)

The fact that the poor need to be assisted has become a practically universally accepted principle of state politics in a large number of countries. However, different motives and rationales for accepting this universal principle could be considered.

Rights based approach. One of the elements of a rights-based approach to development is non-discrimination and attention to vulnerable groups. This approach is based on a view that development is a fundamental human right and entails that the poor are entitled to certain social and economic rights, when they are not in the position to provide for themselves and their families. This is sometimes referred to as distributive justice and prescribes a certain just distribution of income that every society must adhere to. It could be argued that the principle is unfair since there is no such thing as the right of one person to another person's money in a market economy, nor does the government have the unambiguous right to take from one and give to another.

Humanitarian discourse. Many people feel that it is kind and compassionate to help the poor and that it is necessary to give to those that do not have sufficient means for survival, especially to vulnerable categories such as persons with disability and children from poor families. This standpoint is humane and founded on principals adopted by all civilisations in the contemporary world. It is highly unacceptable to watch people starve to death, but there is the question of who is expected to help them. Should it be the government, using its tax power, or better-off citizens, voluntarily? Voluntarism, however, may have several drawbacks: this type of assistance to the poor would probably be insufficient in a poor country, and then there are the questions on how this assistance would be distributed and whether all those in need would receive the assistance.

Child based approach. This approach is based on the argument that children are innocent and that they are entitled to a good starting position in their lives, regardless of the fact that they have been born into families where the parents are poor. Assistance should be targeted towards children in poor families in order to end the "vicious circle of poverty" and prevents these children from becoming poor adults. This approach also builds on the need to invest in human capital, one of the crucial elements for development.

Political rationale. Some governments/parties consider it politically profitable to defend the interests of specific vulnerable categories, for instance poor families with children, in the case when such a group represents a sizable amount of the population/electorate.

Winning over "losers" in the transition process. This approach is important in order to secure support for further reforms. Transition processes, such as transition from socialism to a free market system, usually result in increased poverty since many individuals cannot adjust quickly to the new circumstances. Providing assistance to these "transitional" poor can be beneficial both economically and socially, since it is expected that this category will need assistance only temporarily. This support would enable them to survive the "transition shock" and would offset potential resistance to further reforms necessary to complete the process of transition.

Government assistance programmes for the poor can be perceived twofold: as a form of redistribution and as a kind of "insurance". Redistribution consists of regular money transfers, primarily to the long-term (chronic) and non-able bodied poor who are unable to provide sufficient income for themselves and their families.

The second component, "insurance", could be perceived as a government-organized insurance against poverty. All citizens through taxes pay an "insurance premium" to the state that they can "draw on" in case they fall into poverty. In other words, this component is practically an "insurance" against the uncertainty and unfavourable consequences present in a market economy. This component pertains to short-term (temporary) and transitional poverty, and represents the consequence of the non-existence of efficient private insurance against poverty.

From the economic point of view, assistance to the poor can have both negative and positive effects. The negative are: 1) money that is spent for assistance could have been spent in a more productive manner (investments, repayment of debts etc.), 2) assistance can bring moral hazard, such as can decreasing the motivation of social assistance beneficiaries to find a job and independently earn an income for themselves and their families. The positive effects of a social assistance system should be: 1) preventing the decrease in human capital (education, health), 2) preventing crime, and 3) providing political support for economic reforms during transition.

Influence of politics?

Every social assistance programme inevitably has a political aspect that should not be overlooked. Elements of political nature have to be taken into consideration because the government, quite naturally, seeks to maximise its chances at the next elections.

From the political point of view, governments usually prefer providing social transfers to a large a number of citizens instead of targeting only a limited number of truly poor beneficiaries (the middle voter theorem). Thus, instead of immediate cash support to poor people, widespread politics of subsidising basic products and services that is beneficial to the entire population might be preferred. The problems with this strategy, otherwise possibly correct from the point of view of government rating, lie in the negative effects on economic efficiency, fiscal insustainability and insufficient support for the poor for whom, ostensibly, the programme was brought into being.

Apart from wide targeting and subsidies, it is good for government rating, as world experience proves, to lean on self-targeting and on assistance in kind instead of cash. Self-targeting enables the exclusion of political and other influences on the choice of users of governmental assistance because the users themselves do so. In kind assistance, especially in countries where the income is high, and thus assistance for the poor is high as well, is more popular because, in this manner, the objection that poor people buy alcohol, cigarettes and so forth from governmental assistance is avoided.

The government is usually under pressure from the loudest, and not the poorest. Therefore the strategic question is whether it will succeed in defence against the pressure of the louder, better organized groups or whether it will succumb to them, at least partially sacrificing the poorest, because the poor are usually not very well organized and therefore neither loud nor politically influential. Favouring those who are politically more powerful and louder over those more in need of assistance is common practice, but it leads to greater costs and inefficiency.

In most of countries social assistance spending is not high and it is considerably lower than the spending on social insurance. At the level of broader regions, the share of social assistance spending is not higher than 2.5% of GDP (World Bank, 2006, p.149).

The most widely accepted typology in the literature is the one that differentiates among three models of social protection in developed countries: liberal, conservative-corporatist and social democratic[5]. From the standpoint of the role played by social assistance in these models relative to other benefits, their main characteristics could be succinctly expressed by the following description:

1. The liberal model, which is mainly based on targeted benefits, heavily relying on social assistance instruments, with low levels of social insurance and universal benefits. This model is applied in Anglo-Saxon countries.
2. The conservative-corporatist model, that relies predominantly on social insurance, while social assistance has only a residual role. Typical representatives of this model are Germany, Italy, Belgium, Austria and France.
3. The social democratic model - based mainly on universal benefits, with social assistance playing a minor role in the social protection system – is primarily intended to be a short-term solution in crisis situations. This model is typically used in Nordic countries.

In liberal systems, social assistance is the main instrument of social protection. A typical liberal model would have relatively low overall social protection spending, a high share of targeted programmes, relatively low social assistance benefits and liberal value norms vis-à-vis work ethics. Australia and New Zealand are, in a way, extreme representatives of this model, bearing in mind that in those countries there is almost no social insurance, and the targeted benefits are the only instruments available to the poor. The U.S. system, on the other hand, is characterized by a somewhat higher share of social insurance, but social protection to a

5 This classification was introduced by Espring-Anderson in 1990 and despite various subsequently proposed modifications most researchers have accepted the original typology.

significant extent basically relies on a large number of social assistance programmes, which are targeted and include means testing of beneficiaries. Out of the total social protection expenditure, 40% is spent on social assistance and means-tested benefits. The system is characterized, therefore, by a relatively large number of assistance recipients, low benefits and a link between benefits and employment (Neubourg and Castonguay, 2006, p.4, 22).

In continental Europe, social assistance is a secondary, residual protection instrument, which is activated only when all other protection mechanisms have failed in securing the maintenance of a minimum standard of living. Total social protection spending is high and accounts for 20 to 30% of GDP. Primary protection instruments, of an essentially preventive type, are universal benefits and/or benefits based on social insurance – universal health care, universal pension insurance, nearly free education, widespread and relatively high benefits for persons with disabilities, benefits directed to families, and unemployment benefits. More than 70% of social protection spending is allocated to pensions and health care and between 3 and 10% is allocated to social assistance. (Neubourg and Castonguay, 2006).

Outside OECD countries social protection is underdeveloped, the coverage of the population by insurance and universal benefits is low, and more comprehensive social assistance schemes exist in a small number of countries. More complex social protection systems can be found in middle-income countries, while in many developing countries protection instruments cannot even be established as part of a system.

Still, over the last two decades, most of countries have started to develop social assistance programmes. In part, these programmes started to develop in response to crises that broke out after natural disasters and war conflicts (the region of Asia and the Pacific) or economic and financial crises (Latin America).

In the poorest countries, social assistance programmes often constitute the only protection of the poor, more out of necessity than as a preferred choice. Additionally, these programmes are often financed from international sources and do not constitute part of the system, but are implemented on a project basis. Generally speaking, transfers aimed at the poor and vulnerable are characterized by low coverage, lack of sustainable financing sources and difficulties in identifying the most vulnerable beneficiaries. Transfers are sometimes also used for political purposes. The lack of coordination among donors and overlapping competences of several line ministries included in the distribution of assistance additionally contribute to the overall inefficiency of social assistance (Devereux, 2006, p.2, 5-14; Smith and Subbarao, 2003, p.9, 21- 28).

In the region of Latin America, in the countries with relatively high social protection spending, social insurance spending is substantially higher than the spending on social assistance programmes, which account for 1.8% of GDP on average. Countries with low total spending on social protection, in which there is marked domination of social assistance programmes over other instruments of protection, allocate roughly 1% of their GDPs to these programmes (Lindert *et al.*, 2006, p.18).

In the region of Asia and the Pacific, many social assistance programmes are financed through grants and loans of international donors, and they are not sustainable. The World Bank estimates that social assistance in cash, which exists in just a few Asian countries, does not exceed 1% of their GDPs. The transfer-to-GDP ratios in the North Africa region range between 0.2 and 1% (Howell, 2001, p.285; Tzannatos, 2000, p. 25-26).

Characteristics of justifiable social assistance programme

Which characteristics should a social assistance programme have in order to justify the redistribution of budget resources in favour of the poor?

Targeting the Poorest (Whom to help?)

First and foremost, social assistance programmes should be targeted at **the poorest.** The question of who is really poor was discussed earlier in this study (Chapter 1). In line with those deliberations, assistance should be aimed primarily at the extremely poor who are not able to meet even the most basic needs for food, while in developed countries its coverage should also include those who cannot meet other basic needs according to the absolute poverty criterion (hygiene, housing, culture…). In the poorest countries where the number of the extremely poor is high and budget resources are very scarce, it is necessary to target those extremely poor categories that are also vulnerable in other terms - disability, single parent status, etc. Thus, assistance would be distributed only to those who are eligible according to more than one criterion – poverty and disability, for example.

In recent decades, particularly in the European Union, the criterion of relative poverty has been introduced, which potentially impacts on the inclusion into different types of assistance of families/individuals that can meet their basic needs, but their standard of living as a whole is considerably lower than that of other people in a given country. Although in reality this criterion does not explicitly affect amounts of cash benefits, its significance is growing in the context of "social exclusion" analysis and it has had an impact on benefits in kind and other types of channelling funds from the budget.

When designing the system of support for the poor it is also useful to make a distinction between short term (temporary) and transitional poverty, on one hand, and long-term poverty on the other.

Potential candidates for governmental assistance can be divided into three main groups. The first group includes people living in long-term poverty. This category is usually unable to work or insufficiently capable of working and earning a living for themselves and their families. Population groups often associated with long term poverty are persons with disability, children and the elderly.

The second group consists of persons that fall into short-term (temporary) poverty due to temporary hardship, such as economic shock, loss of employment, bankruptcy of the firm and so forth. These people have the capability to work and earn sufficient income, but they need assistance for overcoming temporary hardships.

The third category of candidates for governmental assistance are people falling into poverty due to economic transition, such as those immediately hit by reform measures in countries that are heavily restructuring companies and its economy. Similar to the group of short-term poor, this group also has the capability to work but has difficulties exploiting this capacity due to a temporarily unfavourable environment (transitional recessions, lack of demand for employees of their qualifications etc.).

Social Assistance

The next requirement which a good programme should meet is to be **well targeted.** It should not leave out those who are poor, according to the established criteria, and should not include those who are not poor. Social assistance loses its point if a significant portion of the poor, especially those extremely poor, do not receive assistance, as well as if the significant part of the assistance does not go to those who are really poor, but “leaks” and ends up in the pockets of well-off segments (the so-called error of exclusion and error of inclusion). This requirement should be met through a careful choice of a good targeting mechanism.

Social assistance targeting mechanisms can be very complex, but also very simple. There are three basic types of social assistance targeting:

1. On the basis of disposable income and the resources of an individual or a family. This type of targeting implies means testing, a check of the material status, in order to secure that the right to assistance pertains to all those who are below the officially set poverty threshold. Means testing as a criterion for receiving assistance is applied in all developed countries and in most transition countries.
2. Indicator-based or proxy means tests, when the right to assistance is determined on the basis of one or more indicators that are clearly correlated with poverty. Indicator-based targeting is applied particularly in those countries where it is difficult/impossible to collect evidence for assessing income or assets. Indicators can be, for instance, the size of a household or region. In such a case, all households with a large number of household members or households that live in a poor region/part of a country are entitled to assistance. Indicators can also be linked to the level of education and occupation of the beneficiary, ownership of land or certain consumer goods, to housing conditions (e.g. packed-earth floors in houses).
3. Self targeting which, in fact, implies such a design of social assistance programmes which makes them acceptable only to the poorest, because of the specific nature of services, low benefits or high opportunity costs. If social assistance is low and application procedures require a lot of time and waiting,

the opportunity cost for all those who do not really need assistance becomes too high, and hence only the poorest apply for benefits. Public works also belong to typical programmes of this kind because they offer very low wages or food as remuneration for work, which is acceptable only to those who have no other source of livelihood. Benefits in kind involving products of a relatively low quality or on locations where the poor live will also fail in attracting those segments of the population that are relatively better-off.

Of course, combinations of these models are also possible. Thus, social assistance entitlements can be received only by large families with income below a certain level (a combination of indicator-based and means-tested targeting).

As a separate mechanism, it is possible to single out community-based targeting, with local groups or organizations deciding on the social assistance entitlements. There is not enough evidence to prove the efficiency of this mechanism that is applied in certain underdeveloped countries with insufficient administrative capacity, although there is a positive evaluation for a few countries (World Bank, 2006, p. 151).

The choice of the targeting mechanism clearly depends on the circumstances specific to individual countries, on administrative capacities, as well as on a reply to the question of the cost of more complex mechanisms. The income level as a criterion for receiving assistance is certainly not appropriate for underdeveloped countries where the poorest live in rural regions and they are not employed and earn no income, in those countries where the grey economy is highly prevalent, even dominant, or where household incomes greatly depend on unregistered remittances from abroad. More complex targeting mechanisms are also not applicable in those systems where administrative capacity is not developed or in poor countries, which cannot afford to have expensive administrative procedures in the circumstances in which they can pay to needy beneficiaries only very low benefits.

In more developed countries means testing is feasible and yields fairly good results. For less developed countries some kind of proxy targeting is probably the only acceptable solution, provided that relevant data is available. In the poorest countries, poverty indicators must be easily identifiable. In order to improve the efficiency of targeting, it is important for both developed and less developed countries to include some of the elements of self-targeting, which should "deter" all those who do not really need assistance. Likewise, monitoring and evaluation are necessary requirements for further advancement of targeting mechanisms.

Targeting the Family

The third requirement is that assistance is aimed at a **family/ household, rather than at an individual.** Regardless of the individual's characteristics, if a person lives in a family, it is reasonable to take into account the financial status and characteristics of the household. An elderly person with a minimum pension or an unemployed single mother who lives in an extended family is not necessarily poor. In most OECD countries, social assistance as part of the guaranteed minimum income scheme is aimed at the household, not the individual (OECD, 2004, p.28).

Relatively Low Amounts of Benefits

The fourth requirement is that **the amounts of benefits** are determined in a satisfactory manner and that they do not give rise to moral hazard. If benefits are in cash, and the programme is part of guaranteeing a minimum income necessary to survive, the amounts of minimum wages and minimum pensions have to be taken into account in determining the level of benefits, for instance. Amounts cannot be determined so that those receiving social assistance are in a better financial position than those who work or who have been paying pension and disability insurance for many years. Similarly, the amounts of benefits must not give rise to moral hazard, which means that they must not produce incentives for an individual not to work or seek a job. The amounts of benefits are usually modelled in line with the endeavour, to prevent their levels from acting as disincentives for beneficiaries to get engaged in the active resolution of their subsistence-related problems.

The most equitable system for setting the total amount of benefits is the system of income top-ups, which implies that a household receives the difference between its actual income and the "poverty

Box 7.1
OECD countries

In most OECD countries the amounts of social assistance cash benefits are lower than the actual poverty threshold, and the income of families living exclusively on social assistance is low (at the level equal to roughly 20% of the median household income). (OECD, 2004, p.12). The amounts of benefits are usually modelled in line with the endeavour to prevent their levels from acting as disincentives to beneficiaries to get engaged in active resolution of their subsistence-related problems.

In almost all OECD countries, the explicit amounts of social assistance cash benefits are based on the top-up principle; they depend on the household's disposable income, i.e., resources, and supplement the household income up to the level defined as the minimum standard of living (OECD, 2004, p. 22). Total amounts vary depending on the composition and age structure of a household.

Box 7.2
Latin America

In Latin America, in the countries paying conditional cash transfers, amounts of benefits vary considerably and depend on the type of the programme and on the targeted population. In Mexico, benefits are conditional upon children attending schools, and cover direct costs of education – tuition fees, transportation expenses of commuting to school, etc., as well as opportunity costs, to compensate for the foregone revenue because children are going to school and do not contribute by working in the household. In Columbia, transfers are paid to the indigenous population in the amount which makes it possible to reach the extreme poverty line (provision for basic food needs). In Honduras, benefits reflect the value of time spent by mothers on travelling to a health centre and waiting for a medical examination. In Chile, the explicit amount of assistance is $22 PPP per household on a monthly basis. (de la Brière, Rawlings, 2006, p.9. p.14) line". A different solution would be unjust to those who are just above poverty line and thus not eligible for receiving assistance.

On the other hand, one still has to bear in mind that this arrangement is not flawless, because it disincentivises individuals with very low wages to work, since the amount of assistance is falling with a rise in other incomes of a household, including labour income. This fulfilment of the last requirement is, of course, not possible in the countries that do not use means testing based on income and assets, i.e., in poor countries. But even in the poorest countries one has to be careful to avoid the creation of disincentives to work because of the amounts of benefits.

In principled terms, the amounts of benefits should be at the level that satisfies minimum needs, whose definition depends on the historical and social context. In reality, the amounts of benefits are mostly not based on a poverty line or, for example, on the basket of essential goods and services, but quite the opposite. Social assistance, together with other social benefits, defines the level of the minimum standard of living which an individual society is willing to support/finance, and also greatly depends on the "budget reality", particularly in less developed countries (Adema, 2006, p.16, 28).

Box 7.3
Mozambique and Malawi

In the poorest countries the amounts of benefits are very low. In Mozambique, for instance, a programme of cash assistance, which in the mid-1990s covered nearly 80,000 extremely poor urban families, made a redistribution in the amount of a mere $1 a month per household member. Still, it has been estimated that even such low amounts were significant for poverty reduction. In Malawi, the distribution of fertilizers and seed, which were transferred to small farmers over a three-year period as one-off assistance, was worth the equivalent of $15 per household (Smith and Subbarao, 2003. p.21).

The fifth requirement is for the long-term assistance to be aimed primarily at the poor who cannot compete in the market (like persons with disabilities, the elderly, etc.), while for **able-bodied beneficiaries it should be temporary** and include compulsory work in return for benefits to avoid creating dependency.

Social assistance can stimulate a passivity and dependency syndrome in able-bodied beneficiaries. Instead of continuing to search for jobs and making an effort to provide for themselves and their family, social assistance beneficiaries can become passive and simply just rely on social assistance. Especially in the case when welfare assistance is sufficient for a decent living, the beneficiary may, through simple mathematics, reach the conclusion that work does not pay off and that it is better to receive the benefit. Social assistance almost inevitably affects the behaviour of the recipient, by demotivating the person to work (the choice between work and leisure).

This requirement, however, in practice leads to many dilemmas and constraints. First, the question is raised of how to deal with individuals who formally belong to the able-bodied part of the population, but cannot find jobs due to insufficient or inadequate qualifications, in particular if they are older. That is, if unemployment is already high or if the structure of labour demand is such that employment is not really possible for some. Which degree of disability qualifies an individual as incapacitated for work and should a person be automatically entitled to assistance, if, at the same time, there are people with same difficulties who work? How to treat single mothers with small children or a person who is caring for someone with a disability, if the amounts of benefits are barely enough to cover the basic costs of life? How to formulate compulsory work, and is it desirable for the state to organize this kind of activity? How do these programmes affect employment of other people and will they reduce incentives to social assistance beneficiaries to find regular employment? Finally, what will happen with the poor once their right to assistance has expired, in those cases where it is time-limited?

The U.S. belongs to those countries that have most radically reformed their cash benefit programmes, by introducing elements of time limits and work requirements for able-bodied beneficiaries. A rise in the social protection expenditure in the last decade of the 20th century made it urgent for European countries as well to have a debate, not only about the priorities and the need for expenditure cuts, but also about the usefulness and justification of benefits, particularly for able-bodied beneficiaries. In a sizeable number of countries, welfare reforms thus started to move toward changes whose main thrust was focused on putting beneficiaries under an obligation to "activate" themselves in return for benefits, instead of defining benefits within the social rights discourse.

Concrete measures for «activating» beneficiaries of social assistance are also very different, ranging from those which are actually more on the side of extended active labour market policy measures such as compulsory re-training and additional training, to engagement in community service projects, to strict work requirements for those receiving assistance. In some countries interventions are predominantly on the labour supply side, being focused on development of skills, work experience and labour flexibility (Denmark, the Netherlands, the UK), while in other countries they also include the component of influencing the demand side (Germany, France). In European countries, programmes are predominantly aimed at youth, although they have subsequently also been extended to other vulnerable groups (Lodemel and Trickey, 2000). Some transition countries, too, have introduced the obligation on the part of social assistance recipients to be engaged in work in the public sector (Romania, Bulgaria). (World Bank, 2006, p. 151).

If the state is directly engaged in employing people, then the difference between programmes for activation of able-bodied beneficiaries and programmes of public works begins to fade out. The difference is that public works 1) use the mechanism of self-targeting since wages (in food or in cash) are so low that they are not attractive to those who are not really poor and 2) the state does not have to spend large amounts of funds, otherwise necessary for a comprehensive social assistance programme. Indeed, these are important reasons for which many less developed countries resort precisely to this type of assistance for the able-bodied poor. In most of the cases, public works programmes involve the construction of infrastructure, and they have often been developed in the context of post-conflict situations and natural disasters.

Box 7.4
South Asia

In a large part of South Asia, public works were initiated in the early 1950s through «food-for-work» programmes. As remuneration for their work, workers received food donated through aid programmes by countries of Western Europe (Subbarao, 2003, p.1). In more recent history, one of the most glaring examples is the public works programme implemented in Korea after the 1997 financial crisis. Faced with high unemployment, Korea introduced a wide-ranging public works programme, aimed at those population strata who were not covered by insurance against unemployment and who, according to very strict criteria, were not eligible for social assistance in cash. For the most part, financing was secured from the national budget (70%). Works included infrastructure projects, provision of social services, environmental protection activities and information technology related tasks, geared to engaging young and educated individuals. The public works project was the most large-scale social assistance programme in the history of Korea. (Kwon, 2002, p.5-7)

At the same time, the limited amount of funds and lack of administrative capacity put constraints on successful designing, planning and implementation of public works. Therefore, it happens that employment on public works is offered at the time of year when the poorest can secure their livelihood by working on seasonal jobs, or the quality of the constructed infrastructure is poor, or wages are not low enough so as to attract only the poorest. And, thus, additional criteria are introduced, which do not yield successful results in targeting… Such deficiencies, of course, create a dilemma of whether the state is capable at all of successfully organizing public works, even in developed countries, let alone those underdeveloped.

In many countries in Africa public works are donor funded while local authorities are responsible for their implementation (Tanzania, Kenya, Botswana). Owing to an insufficient capacity of the public administration, as well as to an inadequate focusing on the programmes as such, the results have not been satisfactory, either in terms of assisting the poor or in terms of the quality of the infrastructure built (Subbarao, 2003).

The experience of Africa, and in particular of the poorest African countries, has shown that a special problem was posed by the absence of donor coordination and the fact that the investment criteria depended more on the availability of donor funds than on actual needs (Subbarao, 2003). On the other hand, programmes have proved to be successful in some countries, particularly middle-income countries, like Chile, Argentina, South Africa (World Bank, 2006, p. 152).

Linkage to Other Objectives

Sixth, in relatively poor countries, social assistance should also be linked to the accomplishment of certain **long-term objectives** of relevance to poverty reduction, such as those in the fields of education and health. In a large number of countries this role has been assumed by conditional cash transfers.

Less developed countries, and in particular the very poor, face at least two major problems in endeavours aimed at introducing certain assistance programmes: (1) selection of the poorest, when there are many vulnerable groups and insufficient financial and administrative capacities, and (2) competition between numerous priorities important for poverty reduction. A solution for some countries, at least partial, can be found in some kind of conditional cash transfers. Nevertheless, not even these programmes are implementable in all countries, and that a particular objective constraint is placed simply by the non-availability of educational and health services in certain isolated areas (World Bank, 2006, p. 153).

Coordination among Different Types of Programmes

The seventh requirement is to **avoid overlapping** of individual social assistance programmes. The fulfilment of this requirement would also contribute to cuts in administrative costs. The main reason, however, for which importance must be attached to this requirement is in the domain of fairness, bearing in mind that social assistance programmes are financed out of budget resources and constitute apparent income redistribution. More specifically, as a result of lack of coordination among various programmes, the eligible poor could receive assistance from several sources and attain a standard of living that is higher than that of people immediately above poverty line. In most cases, the overlapping is a consequence of the fact that individual assistance programmes fall in the competences of different ministries and government institutions.

Recent experience is not very encouraging. Even in developed countries, there is very little thinking about the overall effects of programmes (Stiglitz, 2004, p. 414). In many European countries, for instance, the beneficiaries of social assistance in cash receive concurrently both child benefits and housing benefits (Adema, 2006, p.15). In the poorest countries, the overlapping is also a result of lack of donor assistance coordination, as well as of insufficient capacity of local administrations.

Conclusion

In all countries, there are a number of people who are poor and who cannot secure even a basic livelihood. And almost all countries implement some kind of social assistance programme. Social assistance, however, does not occupy a significant place in overall government intervention and the share of social assistance is also not high, both in terms of total social protection spending and in terms of the ratio to GDP in individual countries.

In liberal regimes spending is not very high because of the prevailing philosophy that assistance should be provided primarily to those who belong to the category of the deserving poor. In conservative and social democratic regimes, owing to the fact that social assistance is a residual protection instrument, this last option is intended only for those who have “slipped” through all other parts of the social safety net. In the poorest countries, where social assistance programmes are also the primary protection instrument, the role of social assistance is not big due to limited resources, a large number of the poor and a large number of competing public expenditure requirements. According to the recent findings, however, this assistance has a great significance for the beneficiaries, particularly if programmes are well targeted and really aimed at the poor.

Social assistance is not a solution to poverty, but rather an instrument to alleviate its consequences. Despite major, easily identifiable differences, this is actually how social assistance is formulated in most of the systems. Still, in recent decades, an increasing number of social assistance schemes have been developed not only to provide relief from poverty, but also a solution to poverty. These schemes involve proactive measures for beneficiaries in the area of employment, education and health, thus contributing to sustainable poverty reduction.

In the last two decades, in developed countries changes in modelling social assistance and the shift of the emphasis toward active policies are in evidence. Instead of passive payments of benefits, an increasing number of countries focus on more active use of funds and activation of beneficiaries, which implies the development of training and retraining programmes, design of policies aimed at increasing labour force mobility and flexibility, inclusion of different incentives for job-seekers, compulsory work for recipients of social assistance and the like. In that sense, it is even possible to talk about a certain convergence of different assistance models.

In transitioning countries, in addition to initiatives for including work incentives to beneficiaries in programmes, emphasis is also on the further reform of programmes in order to increase their efficiency, adequacy and orientation toward the poorest segments of the population. The analyses that were carried out warn that particular caution should be exercised with respect to reforms toward decentralization, which was implemented prematurely in some countries, thus leading to the disintegration of minimum social safety nets.

In the poorest parts of the world, designing adequate assistance programmes is one of the major challenges. The implementation of programmes is inefficient owing to lack of financial, management, technical and logistic capacities. The capacities are particularly inadequate for establishing regular assistance to the population living in remote and isolated rural areas. In almost all countries there are problems with targeting, particularly if the eligibility criteria for entitlements are not easily identifiable and obvious. A significant number of programmes under implementation are not part of the system; they are rather implemented on a project basis.

A special problem is posed by a large number of donors that provide assistance in line with their own agendas, and it is often not based on the actual needs of the aid-recipient countries. Therefore, changes must focus on more efficient donor coordination, the selection of the poorest among the poor and on the effort to turn assistance into some kind of investment in development.

8. Conclusions and Recommendations

Poverty is the incomplete satisfaction of basic human needs. It is at its core a phenomenon of individuals, not of nations. It is individuals and households who are poor, not nations. Poor nations are simply nations of poor people. Accordingly, policies to address poverty are policies that must be focused to individuals and/or families.

The only relevant concept for considering poverty and the path from poverty to prosperity is absolute poverty. Relative poverty (poverty of an individual considered relative to the poverty of another individual in the same society) is basically a measure of economic inequality, not of poverty.

The only sustainable way out of poverty is economic growth. Although the prosperity of individuals can, in the short run and up to a point, be provided by redistribution, that solution is not sustainable. Redistribution removes incentives for wealth creation to both rich and poor people alike. For example, a high marginal tax rate, as one of the crucial mechanisms of redistribution, decreases and even eliminates incentives to rich people for economic efficiency, and in some cases even provides them incentives to move away from the high tax business environment: why should one work hard when the results of that work will be expropriated? Huge transfers to poor people eliminate incentives to them to be economically efficient, even active: why should one work hard, or work at all, when transfers will enable him/her some sustenance?

Economic growth is synonymous with the path from poverty to prosperity. It is the only way of sustainable elimination of poverty.

If redistribution works at all, it works only temporarily. Individuals should be at the centre of the change from poverty to prosperity, since it is the responsibility of the individual to take care of himself/herself and the family. Accordingly, incentives should be created for each individual for the pursuit of his/her own prosperity. The most efficient incentives are those of the free market. The invisible hand of the free market creates rewards for the successful and penalties for those who are not. Everyone will use all his/her talents to achieve the best possible results at the market. That is the consequence of the basic human desire for success and the fear of failure.

The basic recommendation for policy makers that would like a nation and individuals to start their way from poverty to prosperity is to let the market work – let it create incentives for all decision makers. This assumes the creation and preservation of basic economic liberties, liberties to exchange with other economic agents and to withhold and safely posses the results from that exchange.

It is entrepreneurship that within the framework of the free market creates an impetus for economic progress and prosperity. It is of paramount importance that public policies of the country are those that would enable entrepreneurship to be allocated in the area of creation of value, not its redistribution (like rent seeking) or destruction (like criminal activities). The allocation of entrepreneurship among these three types of activities depends on the relative returns. It is exactly public policies that create an environment for these relative returns. Strong protection of private property rights (from both government and private predators) increases returns for value/wealth creation activities and provides incentives of entrepreneurs to be engaged in these activities, not in redistribution and destruction of wealth. The success of free market economies and the growth miracle they provided in the last two centuries is exactly because entrepreneurship in these countries has been allocated in value creation activities.

Government organized redistribution creates incentives for redistributive activities. If compulsory redistribution is excessive, there is substantial opportunity for virtually every individual to influence the process in such a way that the redistribution is directed to him/her. That decreases incentives for individuals to be responsible for themselves, and in turn creates more demand for (compulsory) redistribution. There is the vicious circle of compulsory redistribution: an increased level of redistribution creates demand for more redistribution.

As to the public policy principles, the bottom line is that compulsory redistribution should be applied only if voluntary redistribution is unavailable or/and insufficient and should be limited to the benefit of only those people who have no other choice. The organized care of individuals who are not capable of taking care of themselves even on the lowest attainable level should be the basis for a sound policy of redistribution.

The great arena for competing philosophies is the issue of international trade. Protectionism has been competing with the concept of free trade for centuries. And the battle is not over yet, since protectionism is alive and well and even growing in many parts of the world. Curiously, economists, who usually bitterly fight over various public policies, generally agree that free trade is a nation's first best policy. It is free trade that creates the solid ground for the path from poverty to prosperity. Even if other countries do not pursue free trade and are embracing protectionism, free trade is always the first best policy for a nation. Some very specific theoretical exceptions are not relevant for real world economics.

Hence, it is of paramount importance to understand why protectionism has survived so long. Because special interest politics are the driving force of protectionism, the crucial prerequisite for promoting free trade is mitigating special interest politics that foster protectionism. In short, those who favour protectionism due to their desire to shield their own inefficient business operations should have their concerns addressed through the political process and not hold the national trade policy hostage to their own parochial issues. There is no universal blueprint for this; the strategy heavily depends on the local constellation of special interest groups and their organisation. Any policy for foreign trade liberalisation should be introduced after the general public is thoroughly informed about the activities of the interest groups in protectionism and the consequences of these activities.

Non-tariff barriers to trade are more distorting and sometimes more harmful than tariffs. If it is not politically feasible to eliminate all trade barriers, non-tariff barriers should be eliminated first. Hidden non-tariff barriers (quality control, environmental standards, etc.) are very dangerous because they are not evident as barriers and sometimes are neglected in the process of trade liberalisation.

Free trade and outsourcing as a part of free trade does not destroy jobs in the long run. The jobs lost in free trade and outsourcing would be lost anyway in the process of globalisation. Globalisation and free trade will create more jobs than destroy. Furthermore, that process will increase economic efficiency and overall enhance the welfare of the people.

Government subsidies are an important factor in the consideration of foreign trade and its liberalisation. Although they are not, strictly speaking, barriers to trade, they distort incentives and prevent nations from specializing in ways that maximise economic efficiency. Most subsidies today come from the most developed countries, like the EU member states, and heavily distort the trade of agricultural products. Free trade, as well as increasing political pressure for the public of the EU member states to realise the harm that is done by such subsidies, is the only answer for non-EU states.

Although many people still consider foreign aid to be the most important and effective way from poverty to prosperity, it has been demonstrated conclusively that this is not the case. Massive foreign aid that is channelled via local governments and state budgets creates macroeconomic problems and undermines a country's competitiveness, makes government accountable to foreign donors instead of to its own citizens and, in general, undermines sound economic policies and good economic and political institutions. Economic growth depends most on sound economic policies and good economic and political institutions. Foreign aid does not have a record of promoting such policies and institutions, and sometimes can even harm growth.

The idea that foreign aid should be conditioned by good public policies and development of good institutions has not proven to work. First, many donors effectively do not care about these policies but use foreign aid for their strategic purposes. Second, donors are not in a position to effectively condition their aid, since there are an ample number of strategies that a recipient country can apply to "cheat", i.e., to avoid substantial policy and institutional reform while sustaining the image of the reform. Third, donors have their own view on what good policies and institutions are and then impose these policy and institutional solutions on the recipient – irrespective of whether these solutions are really good and disregarding that the bulk of institutional development, particularly regarding economic institutions, comes from the bottom-up rather than the imposition of "top-down" mandates.

A huge amount of the public sector foreign aid disbursed in last few decades proved to be a futile effort for setting the least developed countries on the path from poverty to prosperity. Nonetheless, that does not mean that there is no room for foreign aid from both the public and private sector. The crucial prerequisite for effective aid is that it comes to the people who really need it. Aid does not work when given to a budget that is controlled by the government accountable to a foreign donor rather than its own citizens. Well-specified local projects funded by private and public donors can improve the welfare of the population and remove the obstacles to economic growth.

One of the reasons for the failure of foreign aid to generate sustainable economic growth is bad governance in recipient countries. Bad governance cannot provide the rule of law environment which is so vital for entrepreneurship and business decisions that lead to economic growth. The crucial product of the rule of law is the protection of private property rights from both private predators (bandits) and from a greedy government. The provision of the rule of law is a crucial role of the government of any country. Rule of law is a public good that must be provided by the government.

Government decisions are crucial for creating a business framework, which is based on sound laws that are consistently enforced. A business framework that protects private property rights and decreasing costs of doing business provides incentives for entrepreneurship to be allocated in value creating activities. On the contrary, lax protection of property rights and increasing costs of doing business will provide nothing but incentives to businesses (entrepreneur and capital) to move away from such environments (countries). Other countries will have the benefits of economic growth, but not those with bad governance, embodied in corruption, lax protection of property rights and huge costs of doing business. At the end of the day, due to the weakened tax base, those in government who created such bad policies will pay a price.

Good governance should focus on the strict protection of private property rights, an efficient judiciary as one of the most important ways of protecting these rights, low and non-progressive tax rates, an efficient provision of other services of the government (public sector) and liberal regulation of business activities. It is still not fully determined whether democracy is a necessary condition of the rule of law to emerge, but there is little doubt that the two reinforce each other – rule of law in dictatorships is not likely to become sustainable in the majority of cases.

Public finance is an inevitable part of any business environment. On the taxation (fiscal revenues) side, the formula of success is rather straightforward – the lower the better. Nonetheless, fiscal revenues should always be considered together with fiscal expenditures, i.e., operations done by the government. One way or the other, a tax system favourable for economic growth is based on a relatively low tax burden, simple tax rules and fair and efficient tax administration. Government spending should be focused on the provision of public goods, particularly these public goods that improve the business environment in a country, including macroeconomic stability. Although it is inevitable that every government operation affects income and wealth distribution, the government role in compulsory redistribution should be limited to the minimum.

Finally, very limited compulsory redistribution of income is desirable. Such redistribution is the ground for social assistance. Social assistance is an instrument that should be used only when no other instrument or policy can be used. The crucial features of good social assistance are that it be limited, well targeted, and does not eliminate incentives for economic efficiency. Some individuals for well justified reasons cannot take care of themselves in a way to provide a minimum of subsistence. It is these people without choice, who should be the target of social assistance.

It is economic growth, not redistribution, which can bring prosperity to citizens. Rich nations are nations of rich individuals. The more incentives for economic efficiency, the more responsibility of individuals for themselves, the more profit as competitive return of the economic activities, the more economic growth and prosperity. Only then will there be less misery and more human happiness.

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