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Introduction

The conventional wisdom, espoused by politicians, interest groups and charities is that it is within the power of Western countries to oversee the development of the underdeveloped world by following particular policies on trade and aid. With regard to trade, this means the west removing its trade restrictions aimed at poor countries and allowing developing countries to protect their own markets. With regard to aid, this means providing countries with increased development aid, to be spent particularly on investment in infrastructure, health and education. In the recent frenetic activity that surrounded the G8 summit and the Live-8 concert, there was a hearing given to an alternative point of view. I think that alternative point of view also struck a chord with many who are instinctively sympathetic to the poor in developing countries. That alternative point of view is that aid is at best benign and might be harmful and that the main requirements for development are a reduction in the interference in economic systems by governments combined with good, uncorrupted, governance.

I am going to structure this presentation as follows. First I will dissect the case for foreign aid. The conclusion will be that empirically and theoretically it does not work and may be harmful. I should add that the aid I am talking about here is not relief to starving people in the event, say, of a famine but long-term development aid. I will then look at some of the issues surrounding trade that were discussed at the G8 summit. Finally, I will look at the requirements for economic development and talk about precisely what we mean when we say that good governance is the key to development.

Foreign Aid

If foreign aid were the solution to the problems of the developing world, it would have worked by now. Gordon Brown has called for a "Modern Marshall Plan" for Africa. But, Africa has had a Marshall Plan several times over and it seems that growth is negatively related, not positively related, to aid. There are good reasons why aid does not work.

You will probably be familiar with some aspects of Keynesian economics, which were developed to explain very specific problems and then applied in more general circumstances, with disastrous results, in post-war Britain. One aspect of Keynesian economics is that national income is made up of investment, government spending and consumption. If we increase investment the Keynesian model suggests national income will increase. It probably seems remarkable today, but mainstream economists in the UK actually believed this, at least until the early 1980s. This idea fitted into the belief that, because income was so low in developing countries, saving would be low too and would be insufficient to finance the necessary investment. If developed countries provided the investment funds, developing countries would grow because the savings gap would disappear.

The idea is that aid breaks into the vicious circle, allowing countries to take their first step towards self-sustaining development and growth.

Economists in the 1960s were also concerned about the difference between imports and exports in developing countries. If the imports of raw materials necessary for higher levels of production were too expensive, there would be a shortage of foreign exchange. Again, foreign aid neatly filled that gap. Partly because of the concern about foreign exchange, and partly because of other flawed economic theories that were being applied, there was a tendency to use aid for investment purposes, not where it would be most productive, but in import substituting industries, aluminium smelting plants and the like. These policies of import substitution were combined with protectionism.

Now this process has been going on since the 1960s. Those many countries that have developed since have not, on the whole, used aid to finance their development. So let us look at two questions. Did the policies work? And, if they did not work, why did they not work?

Aid and Development

Aid as a percentage of GDP grew continually in Africa from 1970 to 1995 from 5% of gross national income to 18% of gross national income of African countries. But this growth was not uniform. In the 1970s, aid was relatively low as a proportion of African national income and national income grew at about 2% per annum. Growth collapsed in the 1980s and was negative for much of the period between 1984 and 1998 whilst aid increased dramatically. Growth then crept up again in the late 1990s when aid fell quite dramatically. Overall, from 1970 to 2000 Africa received $400bn of aid but there was little economic progress.

On their own, these figures are not too helpful. It could be that the West increased aid in response to poor growth rates. It might also be the case that looking at the continent of Africa on aggregate prevents us from seeing individual success stories. However, one thing is pretty clear. Aid does not lead to growth. If those who believed in the development economic theories that I have just been discussing were correct, surely Africa would have grown.

This intuitive conclusion is confirmed when we look at aid and economic growth in East Asia and the Pacific, and South Asia. It is tempting to think that the evidence from these countries is less important because many of them are developed now. In fact, at the beginning of the 1970s, many of these countries were poorer than many African countries either were then or are today. It is remarkable to think that Nigeria's income per head was equal to that of South Korea's just 50 years ago, now it is just 5% of the South Korean level. Aid has roughly halved in Asia and the Pacific in the thirty year period from 1970. During that time, national income per capita has grown four fold in

South Asia – and that ignores the recent China explosion - and about eight fold in East Asia and the Pacific. Growth was highest when aid was falling most quickly.

So far, this story is not very rigorous. But, it is clear that it does not matter how you sort the data, you do not get an “aid helps growth” story.

This is not surprising. These savings gap theories of development are simply wrong. Poor nations do save during the process of their development – again look at Asia it has very high savings ratios. It is not a shortage of saving that inhibits development. The investment of aid funds in import substitution industries, such as steel and other heavy manufacturing, combined with the protection from imports was also a disastrous policy. It led to the allocation of resources away from where these countries had a comparative advantage, and frequently, away from export industries, towards production in areas where these countries were very inefficient. When aid funds are used to finance investment, capital is subsidised and industry uses less labour, despite wages being very low. Almost all the outcomes of the aid programmes of the 1970s and 1980s were diametrically opposite to the intended outcomes.

So, at best, aid was wasted. But, in fact, it is worse than that. Aid retards growth for reasons I will explain at the end. I will now look at the G8 trade agenda.

Trade Regulation and Developing Country Protectionism

The G8 summit agreed, as part of its proposals, to allow developing countries to regulate trade in contravention of the normal principles of World Trade Organization rules. This is part of a package often promoted as “trade justice” by development charities and political campaigners.

It is commonly suggested that under-developed countries need to be able to protect their industry, particularly agriculture even if the West does not protect their industry. The reason for this, it is suggested, is that under-developed countries will not be able to “compete” with efficient agriculture in non-protectionist countries such as New Zealand. This is a common fallacy that was dealt with in the classical economics literature a couple of centuries or so ago and with which you will be familiar.

The whole basis of trade is that we produce what we are *relatively* best at producing. If wine and bananas are the only two goods and, if Portugal is more efficient at growing both bananas and making wine than, say, Brazil, Portugal will not end up growing bananas and making wine and Brazil doing nothing. If Portugal has even more of an advantage in wine than bananas (a comparative advantage in wine in the economic jargon) Portugal will gain from devoting all its resources to wine (because it is *so* much more efficient) and selling wine to Brazil in order to buy bananas produced there. Everybody is better off from trade although Brazil will end up poorer than Portugal. Countries do what they are *relatively* best at when we have free trade.

Trade regulation simply encourages resources to flow into industries that are less productive. If Brazil protects its wine industry it will cost it more to make wine, in terms of bananas forgone, than it would cost it if it grew bananas and traded them for wine.

One of the Trade Justice Movement's main objectives is to allow developing countries the power to regulate trade to allow themselves time to develop. But it is, in fact, invariably poor countries that regulate trade the most. Compare Chile with Brazil; Botswana with Ghana; Hong Kong with Nigeria; Estonia with Rumania. The first of each pair is the more open to trade and absolute poverty has become or is becoming history. The latter of each pair is unremittingly protectionist and they will be poor for decades to come unless they change.

It might be added that trade is particularly vital for the world's poor. The anti-globalisation movement is an "anti-poor-people movement". Poverty and inequality in the world have reduced markedly since trade liberalisation has developed over the last 30 years, as many previously poor countries have lifted themselves to unprecedented levels of prosperity. China, for example, has lifted 300 million people out of "dollar a day" incomes, simply by opening to trade. There are still many desperately poor countries because, whilst freer trade has allowed rich and poor alike to prosper more, there are some countries that are still mired in absolute poverty because of the way they are governed and because they simply do not engage in trade with the outside world at all.

So I would argue that the proposals for greater trade regulation, adopted at the G8 summit and proposed by the Trade Justice Movement, have the potential to keep people mired in poverty. But, to its credit, the Trade Justice Movement, quite rightly, wanted the West to liberalise trade too. Let us look at this agenda.

Free Trade and Western Protectionism

The lack of progress on developing free trade in agricultural and certain manufactured goods by the West is lamentable. Processed food is one particular example of the most abysmal protectionism, agricultural products are another. Take chocolate for example – it is a microcosm of the problem. 90% of cocoa is produced by developing countries but only 4% of chocolate. There is no EU tariff on cocoa, but the EU tariff on processed chocolate is twice the average profit margin on chocolate at 18%. As another example, it will not surprise you to learn that the cost of protecting the US sugar industry is $1million per job per year. Alternative opportunities for the poor in the developing world are limited by these practices.

I have no sympathy for the trade restrictions of the developed world (basically they are imposed by the US, Japan and European countries) however, it is important not to be seduced by a particular argument with regard to these. It is commonly suggested (or at least implied) that the West is feathering its own nest by protecting its own agriculture and preventing developing countries protecting theirs. It should be understood that protectionism mainly (and sometimes only) harms the *protector.* The main losers from EU agricultural protectionism are EU consumers and taxpayers. The gainers are a small number of farmers. Developing countries also lose too but the protector does not gain. Similarly, the losers if developing countries respond by protecting their agriculture are developing countries themselves. Retaliation is an appropriate response to other countries' protectionism only in very rare circumstances.

Good Governance

I now want to turn to issues relating to "governance".

In the recent discussions and debates surrounding the G8 summit "good governance" was frequently mentioned as a pre-requisite for economic development of poor countries. It is not only the case that "good governance" is more important than any other factor in development it perhaps should be regarded as the only important factor.

What do we mean when we talk about good governance? And what are its effects?

What do we mean by good governance?

When politicians talk about good governance they invariably talk about the establishment of democracies. If by democracy we simply mean the election of our law makers by the people then it is true that democracy may be an effective constraint on the abuse of power by rulers and thus democracy may be useful in promoting good governance. The greatest value of democracy lies, perhaps, in its ability to reject a government that does not observe the basic norms that we will talk about a bit later.

There is a danger though that any action becomes legitimate because it is undertaken by a democratic government. The greater the apparent legitimacy a government possesses the more likely it may be to abuse its power. We do not have to look very far to find examples of this problem. Many ex-communist leaders were re-elected in ex-Soviet states and have ruled in a way that is not compatible with basic human dignity and freedom. The same is true in Africa, of course. Though we suspect that Robert Mugabe rigs elections, it is probably the case that he would be elected even if he did not.

So, if democracy is not synonymous with good governance, what do we mean by good governance? The characteristics of good governance are: peace, the rule of law, the authority of law, the absence of corruption, independent judicial processes, the enforcement of contracts, basic free markets or freedom to exchange goods and services, and the enforcement of property rights. It is impossible for us in the West to envisage what life is like in countries where these conditions do not exist. For example, to live in a country where we cannot prove that we own land we have farmed for decades; to not be able to borrow money to start a small business because we cannot prove title to our house; or to not be able to obtain a licence to trade without bribing an official, and so on.

These issues should be the basic starting point for any constructive discussion of poverty. Every other economic policy in the economist's toolbox is secondary to having these basic requirements of good government in place.

I am going to take these characteristics of good governance one at a time, explain what they are, how they manifest themselves and how their absence destroys wealth and denies opportunity for development.

The Characteristics of Good Governance Explained

The rule of law and the authority of law

When we talk about the authority of law, we simply mean that laws are obeyed and enforced. However, this is not good enough by itself if the laws are unjust or the methods of enforcing them are unjust. Thus what we call the "rule of law" is as important as the "authority of law". By the rule of law we mean broadly that:

- Those who make the law are subject to the same laws as other citizens.
- There is a separation between those who make the law (the government), those who enforce the law (the police) and those who administer the law (the judiciary).
- The law itself is subject to constraints. These constraints may be in the form of the common law and unwritten constitutions (like in the UK) or written constitutions (like in the US). Those constraints should define the areas where the law cannot intervene – for example it should not be able to intervene to expropriate justly acquired property.

The definition and enforcement of property rights

The lack of definition and enforcement of property rights is perhaps the key economic problem in underdeveloped countries. This is tied up with the lack of the rule of law because one of the basic functions of the legal system is to define and enforce property rights justly. In the West, we take it for granted that property rights are defined and enforced. Occasionally, we get an exception to this general rule and it causes much angst: perhaps if we cannot prove that we have access rights over our next door neighbour's land to get to our garage. But, imagine that you went home tonight and your parents said to you, "I am sorry, the authorities have come round and we have to vacate the house we thought we owned."

A fundamental problem in most under developed countries is that property rights are informal: they are not properly defined. People who believe they own property cannot prove it. They might be able to carry on living where they live or farming where they farm for a very long period of time. They might already have done so for generations. But, one day, the action of a local council, government or powerful business man might simply remove them from their property or land and there will be no redress in the courts.

This problem does not just pervade African countries but is rampant throughout all parts of the world that are poor. In Delhi and Bombay, for example, these problems lead to land values being ten times as high relative to income as they are in Tokyo. Economic life and development simply cannot get off the ground in such circumstances when property rights are not recognised or enforced.

Recognition of contracts, corruption

The next problem is the lack of recognition of contracts combined with corruption. The success of the British capitalist economy in the nineteenth century relied in large part on the security of contracts. When contracts were made they were adhered to. On the odd occasion they were not adhered to they were enforced by the court or by another body (such as a stock exchange). This was true even of verbal contracts, hence the stock exchange motto “my word is my bond”. Again, it is difficult to imagine these problems in the west. We can broadly trust people we do business with and we can trust courts to enforce contracts when they are broken. Imagine though a small businessman who makes a contract with a large steel producer and provides £50,000 of equipment for pressing steel. Perhaps this is equal to 200% of a year’s profits for the small businessman and, say, 10% of annual turnover. The equipment is delivered, an invoice follows and is never paid. The small firm takes the large firm to court and the large firm bribes the judge. The judge finds in favour of the large firm.

When such patterns of behaviour develop business grinds to a halt except where it is conducted on an informal level between individuals. Small businesses, in particular, suffer at the expense of the rich and powerful – and the rich and powerful are often connected with government.

Related to both these problems of property rights not being recognised and contracts not being enforced is the problem that businesses often cannot get incorporation recognised or, indeed, it may be illegal for a business to operate without very strict conditions being fulfilled.

Thus when we talk about good governance in the economic sphere, we mean the definition and enforcement of property rights and business incorporation, the legal recognition and enforcement of contracts and the absence of corruption. We also mean, though this is more obvious and needs less explanation, the absence of intrusive regulation that impedes business and prevents individuals from going into business. In the legal sphere, for these economic aspects of good governance to exist we need political structures to be established under the rule of law and for the authority of law to be upheld.

The effects of bad governance

We can see the effects of bad governance and the benefits of good governance by making comparisons between countries within Africa because, despite the bad press that Africa gets, there are some countries, not many but a few, that have actually made significant progress. And time and again, when we compare these countries with those that have made no progress, the ingredients of success are obvious.

Compare Nigeria with Botswana. Botswana is land locked and has nearly 40% of its population infected by Aids – not a promising background. Yet it has had a high economic growth rate for years and has average income per head of £2,000 per annum. The US Department of State says about Botswana, "The legal system is sufficient to conduct fair commercial dealings" and the government has "abolished all exchange controls…[has] undertaken largely successful efforts to combat crime, including corruption, and to improve the delivery of the judicial system".

Nigeria has great oil wealth, but an average income of less than £100 per head. The Economist Intelligence Unit says of Nigeria, "as much as two-thirds of all economic activity takes place in the informal sector" (that is the black market) and that corruption is "what brought the economy to its knees…Transparency is lacking and financial malpractices are deeply rooted at all levels of public administration".

There are plenty of other examples that make the case for absence of corruption and the market economy. But I want to move on to the more subtle issue of the definition and enforcement of property rights to see what effect it has when governments do not perform their basic functions.

Hernando de Soto, a Peruvian political economist undertook practical work in Peru to examine the impact of the lack of definition of property rights and the inability of businesses to get legal recognition.

These are the costs imposed on businesses that cannot incorporate legally (and which therefore have to operate illegally or lose their livelihoods): they have to shelter their activities from the tax authorities and probably pay bribes to them; they cannot obtain any credit except from informal money lenders; they cannot obtain long-term finance (issue shares etc); they cannot have limited liability; they have no insurance coverage; they are forced to divide their production activities between many sites so that no site becomes big enough to be seen by the authorities; and they cannot advertise.

In Peru, on average, 15% of turnover in manufacturing businesses is paid out in bribes. To become legal and register its property (without using bribes to oil the wheels of the process) it takes a small business in Lima over three hundred working days, working 6-hours a day – just on the registration processes etc, at a cost of thirty-two times the monthly minimum wage. A person living in a housing settlement where title was not formally registered would have to go through 728 bureaucratic steps to register title with the city of Lima authority alone. De Soto describes all the informal businesses and housing units as "dead capital". The houses can be lived in and the people who have the businesses can live a hand to mouth existence but economic development is impossible. The value of all these extra-legal assets is five times the value of all the assets on Lima stock exchange and 14 times the value of all foreign direct investment. In other words, Peru has a great capital base but the owners cannot use their capital, cannot run their businesses, have to make informal contracts that cannot be enforced in the courts, cannot buy and sell their houses or businesses and so on. Big business, of course, then does not face competition either in the labour market or product markets and exploitation of the poor results. Politicians, judges, the police and so on benefit greatly from these arrangements. Bribery and corruption are necessary to obtain legal sanction, because contracts do not have any legal authority. This is not just anecdotal, the Economist Intelligence Unit reports that, "The Peruvian Judiciary is plagued by corruption." In a different country with the same problems, India, The Economist reports that, Delhi's 250,000 bicycle rickshaw pullers collectively pay bribes of 20m-25m rupees a month for the privilege of being allowed to pursue their profession.

There is no point going through further examples throughout the world. But, just so that you do not think this is a problem specific to Peru, the World Bank and the International Finance Corporation has just published its third, *Doing Business* report. Here are some sample statistics from it, and a few more from elsewhere:

- The start up cost for a business in Zimbabwe is 14 times annual income.
- Overall, in developing countries, 70% of jobs are in the informal sector.
- In Belarus, a business has to pay 11 separate taxes, involving 113 payments to three different agencies, taking on average 1,188 hours to complete the administrative process (Belarus has an average income per head of £1,000 per annum, less than 40% of that of nearby-Estonia).
- Of the 30 countries with the greatest legal obstacles to business 23 of them are in sub-Saharan Africa.
- In India it takes 89 days to start a business and ten years to complete insolvency procedures.

When government does not perform its fundamental functions so that there is poor governance, people are mired deeply in absolute poverty and cannot escape from it. Resolving this problem is the only policy that will reduce absolute poverty.

Bad Governance, Aid and Trade Regulation

If, as I have suggested, good governance is by far and away the most important factor underlying development, it would be alarming if good governance were undermined by the policies the G8 have agreed to pursue.

Those of us who believe in free trade were desperate for the G8 to agree to liberalise trade in food and manufactured goods. This is desperately important for the developing world. Sadly, the proposals here were merely aspirational.

The G8's main proposals, as I have mentioned, related to aid and allowing developing nations to regulate their own trade to a greater degree – making them even more protectionist. These proposals were in line with the policies of the trade justice movement. Even in the best of hands, trade regulation has the unhappy knack of keeping resources in the least productive parts of the economy, as I have discussed briefly, and as you will probably know from your own study of trade.

But there is a much more serious issue than this. The countries that are going to be allowed to regulate trade more are those with the worst governments: it is in those countries that the poorest people in the world live. Trade regulation in the hands of such governments is potentially catastrophic. It leads to greater politicisation of economic life – something the people of poor countries are trying to escape from. When trade regulation involves quotas and tariffs, the opportunities for corruption are huge – and those opportunities are taken with relish. Quotas are exchanged for favours, tariffs can be avoided by bribes.

Free trade and good governance reinforce each other and precede growth. You do not have to go to Kenya to see how trade regulation feeds corruption. Our own European Union accounts have not been signed off by the auditors for a decade largely because of corruption in the Common Agricultural Policy. Trade regulation attracts corruption like a magnet and corruption together with the politicisation of economic life, as it manifests itself in the ways I have discussed, are the biggest enemy of development.

So if the proposals to allow poor countries more autonomy in developing trade regulation are deeply damaging, not just economically but in terms of undermining the development of a liberal political culture, what about the proposals to increase aid? Surely, aid is a free gift. The worst that can happen is that it is wasted. This is not so.

Aid, even where it is used to finance services that people might regard as intrinsically good, such as health and education, has the effect of bolstering the political system. It increases the role of the political system in allocating economic resources and therefore increases the politicisation of economic life. If a large percentage of a country's GDP comes through aid then talented people do not pursue their self-interested wealth accumulation through entrepreneurship and business but through obtaining the benefit of the aid resources allocated through the political system. Again, we do not have to go to the developing world to see this. We see it in British universities today. So many of the funds that are available to universities are available in return for jumping bureaucratic hoops (for example access funds for undergraduate students, research funds from the ESRC, special funds for EU exchanges through the European Commission, research funds through the dreaded research assessment exercise). Talented academics, instead of using their talents for teaching and research have a huge percentage of their time allocated simply towards obtaining these resources allocated through politicised and bureaucratic systems. Indeed, whole departments are dedicated to this function, with the most talented administrators being employed there. The same problem happens in developing countries.

Furthermore, with such large resources being allocated through the political system, the opportunities for corruption are huge. Aid feeds corruption. The private resources of the African elite held in banks abroad are much bigger than foreign aid inflows. Aid keeps the rich and powerful rich and powerful. I will give just two examples that illustrate the sort of problems that can arise. They way that aid distorts the priorities of politicians and entrepreneurs is well illustrated by Tanzania – in 2001 its government produced 2,400 reports and studies on different aspects of present and future aid for donors. What happens to the aid? World Bank economist Lant Pritchett visited an aid-financed industrial estate in Tanzania in the 1990s. He found no worthwhile economic activity taking place. There is the infamous Morogoro shoe factory in Tanzania, financed to the tune of $40 million by the World Bank – it never produced more than 4% of its planned capacity. Pritchett estimates that only 8% of officially measured investment aid translated into tangible machinery and equipment. Aid can slow down the process of developing good governance.

The G8 summit was a summit of politicians from the developed world to which politicians from the developing world were invited. There were four options on the table. The first was to increase aid – that is increase the power of Western politicians to tax their citizens to give money to politicians in the developing world. The second was to increase trade regulation in developing nations – that is increase the power of politicians in developing nations to regulate trade. Surprisingly enough, a meeting of politicians accepted both these proposals. The third proposal was to reduce trade protectionism in the West. The fourth was to do something serious about good governance in the developing world – in other words reduce the power of political elites in Africa and make sure that governments perform their proper functions properly. Surprisingly enough, a meeting of politicians rejected both these proposals to reduce political interference in the economic system and to hold politicians properly to account.

It has to be said though, that dealing with issues of governance is not easy. And those of us who really would like to make poverty history have a genuine dilemma. And I am simply going to leave you with that dilemma. Most of the world has been poor throughout most of history. We know that the poor do not get rich simply by transferring the resources of the rich to the poor through aid. We know the secrets of development, though they are perhaps quite subtle. But, we have not yet discovered how we in the developed world can best bring to fruition in the under-developed world those policies that we know will lift people out of absolute poverty. Unless there is mass copying of the recipe for good governance that I have described here, we will not and cannot make poverty history however many white wrist bands we wear.