

XIII Plenary Session of the Pontifical Academy of Social Sciences

“Charity and Justice in the Relations among Peoples and Nations”

The Vatican, April 28, 2007

Panel entitled “International Justice and Aid. Do We Need some Scheme of Redistribution of Income at the World Level Along the Lines of What Most Countries Have at the National Level?”

By Professor Joseph E. Stiglitz

Thank you very much. This was described as a round table even though the room is square, and I took the spirit of the round table as an occasion to address spontaneously some of these issues that have actually been covered extremely well by the two previous speakers.

Advanced industrial countries, as pointed out, have made a commitment to provide .7% of GDP to the developing countries. With relatively few exceptions, they have not lived up to that commitment. We talked yesterday about some of the motivations and philosophical foundations of those commitments, such as charity, social justice, political processes related to civil society, and self-interest, including the self-interest based on worries about terrorism. Today, I do not want to go over those issues; what I do want to talk about are three particular questions. First, does that level of commitment make sense? I want to spend a few minutes talking about what Prof. Malinvaud discussed concerning aid effectiveness. Second, what are the optimal institutional arrangements that can facilitate the reliability of the flow of assistance and make it more likely that countries will maintain these arrangements? This really addresses the question that was posed earlier: should there be some kind of tax or institutional framework to ensure that aid commitments are fulfilled? Finally, I want to think more broadly about the different elements of assistance, so that we do not narrow our thinking just to foreign aid as it has conventionally been conceived.

On the first issue of aid effectiveness, I feel somewhat guilty in this respect because much of the literature that Prof. Malinvaud referred to grew out of research at the World Bank from the time when I was the Chief Economist there. I was very critical of it then. But, in the spirit of letting a thousand flowers bloom, I did not discourage them from publishing the results, although I thought they were very flawed, and I want to explain why. . The results are plagued by econometric problems and problems of robustness: if you slightly change the data set, the years

or the countries covered, you get different results. We know that there have been important instances of successful aid. I think most people recognise the Marshall Plan made a great deal of difference to Europe. As I have travelled in developing countries, I have also seen some very effective aid programmes that have made a huge difference for the individuals in those countries, and I believe that some of this aid actually adds up, so that it has macroeconomic impacts. The question is, why are so many of the empirical studies looking at the macro effects (and not the micro), casting doubt over aid effectiveness? One of the problems is that, as Prof. Malinvaud pointed out, in order to talk about aid effectiveness you have to look at a long period of time; for instance, if you are giving aid to education, children attending school are not going to be productive members of society for 15 or 20 years. Thus, you have to look at the long-term effects.

The problem is that, prior to the end of the Cold War and the fall of the Berlin Wall, most of aid was not intended for development. It was called “development assistance,” but that was not its true purpose. We gave aid to Mobutu Sese Seko in the Congo, knowing that that money was going to wind up in a Swiss bank account. It did not help development in the Congo, but it did result in Mobutu not turning to the Soviet camp. That was the reason the aid was given, and thus it worked. If you look at aid data today, the United States is targeting substantial amounts of so-called aid right at Iraq. However, if you look at the growth statistics, you will not see Iraq doing enormously well. The delivery of material, mostly in the form of bombs, clearly is not helping Iraq grow, but even the more formal assistance cannot really be thought of as development assistance but more as reparations for damages that have been done. Most of the money is being spent simply for security. Furthermore, other major assistance programmes in the United States are still politically connected. One of the major recipients of US aid is Egypt, which is not based on a development agenda. The same thing is true, actually, of the foreign assistance of other countries, particularly before the end of the Cold War.

There are other reasons why aid has not worked in many cases, including, as Prof. Malinvaud pointed out, the resource curse, and particularly what has come to be called the Dutch disease (the fact that countries with more resources have not done as well as countries with few resources, partly because of the appreciation of the exchange rate; similar effects arise from increased aid flows) Some countries have managed the resource curse well, but in other cases the IMF has imposed macroeconomic policies which completely vitiate the effectiveness of aid. In my book *Globalization and its Discontents*, I described the story of

how, at the time, the IMF was insisting that all the aid money given to Ethiopia be put into reserves; this meant that the additional money that was being given in the form of aid was not going to build schools or hospitals but just to build reserves.

Money put into reserves is clearly not going to have the same social or economic effects as money spent for schools, hospitals and other elements. Another complication is posed by the fact that much of the aid was accompanied by conditionalities, or requirements imposed on these countries, that we now know were actually harmful for economic growth and prosperity. Yes, the countries got money, but that money was accompanied by policies which had the effect of slowing down growth and vitiating any benefits that could have come from aid.

Finally, one problem always plagues this kind of analysis; while a few people have tried to deal with it, most of the studies that we have referred to do not. If you conducted a study and asked what the relationship is between people dying and hospitalization, you would find that going to the hospital increases your probability of dying. However, most of us believe that when you have a serious disease, hospitals can help you. This holds true for aid: some of the aid is in response to particular problems or crises that a country faces. Countries facing a crisis get more money, and therefore ascertaining whether that money helped resolve the crisis or made the crisis worse is often very difficult. Anybody who has experienced a crisis, for instance people in Argentina, knows that it was not the money that caused the problem; the conditions that the IMF imposed at the time of the crisis were the cause. This discussion, I think, is useful in highlighting the fact that money has to be spent carefully and that it does not automatically lead to enhanced growth or poverty reduction. However, it also highlights that one has to be very careful in taking seriously the studies that have argued that aid is ineffective.

It is interesting that one of the conclusions reached as a result of many of these criticisms of aid in general is that it should be directed at things like education, and yet studies in the United States that have looked at the economic returns to education almost always have exactly the same kind of econometric problems. It is very hard to show that education leads to higher incomes. (There are a few successful studies that have been done more recently, but the cross-section studies mostly conclude that it is very difficult to show any evidence that education makes a difference, even though all of us know in our hearts that education is important.) This is only a word of caution in using these studies.

I want to turn to the next issue, and that is whether there are ways of ensuring a more regular flow of assistance to the developing countries. Should there be some taxes or a source of revenue that would support development? There has been some reference, such as in Mr. Landau's remarks, to some important initiatives that France and a few other countries have undertaken, in what they call "innovative approaches" to financing development. There are three of these innovative approaches to which I want to call attention. The first is that, as there are a lot of global natural resources, it makes a great deal of sense to use these to generate revenue for the provision of global public goods, including development, through the efficient management of these global resources. For example, one of the important global resources that needs to be managed are world fisheries. There is a real risk of the depletion of these fisheries, which are a common public good, and right now they are not being well-managed. We know the basic principles of fishery management. We know that, for instance, auctioning off the rights to fish is one of the things being done within countries, but it needs to be done now at a global level. The revenues from the auctioning off of global fishing rights could be used to finance development. We need to use these revenues to create a global development fund.

Another example is the limited space for satellites. Basically, the way that space has been allocated so far is that the United States and a few other countries have just taken it; they have used a treaty framework to appropriate for themselves the very large economic returns to the ability to launch satellites. This is becoming a major problem because there are so many satellites that they may actually start interfering with each other. Again, we can auction off the rights to space, and the revenues from that can be used for global public goods, including global development.

The same could occur with the sea bed. I was at a meeting at the World Economic Forum in Davos, where an oil executive pointed out that one of the silver linings in global warming is that the oil beneath the Arctic Ocean will be less expensive to extract. To the extent that this is true, resources under the ocean ought to be viewed as a global public good, and one ought to auction off these resources to the benefit of the whole world. This is one way to ensure a regular flow of development aid to countries.

The second source of revenues that I want to discuss is, in many ways, related. There are a whole set of global negative externalities, and the standard way that economists recommend for dealing with these negative externalities is the imposition of a corrective tax. The revenues from these corrective taxes could also be used for supporting

development. An example would be taxing those people who engage in greenhouse gas emissions which pollute the global atmosphere, or taxing countries that have emissions above certain levels. The revenues could be used as a regular source to support development. Another example that many people in Europe have talked about for a long time are taxes on cross-border short-term capital flows. There is no doubt that these short-term speculative capital flows can add, particularly in the context of developing countries, significantly to global instability, which is bad for growth and also for inequality. Small taxes on these, however, could have a positive effect.

There are other examples, such as the initiative of France and some other countries to have an airlines tax. This tax is what might be called a luxury tax, but it is also a tax on high levels of pollution in the upper atmosphere from the carbon emissions from these jets. The same thing goes for international shipping, where there is a lot of dumping of waste. These taxes are a second set of revenues that could be used.

A third has to do with a proposal that I talk about in my book *Making Globalization Work* and which is an elaboration of an idea that Keynes talked about some 75 years ago: the creation of a global reserve system. Every year, the countries of the world bury somewhere between \$400 and \$600 billion in the ground. In the past, there was a very peculiar system where gold would be dug up from the ground, with very bad working conditions and adverse effects on the environment due to the cyanide used for extracting the gold. Then, after purifying the gold, another hole would be dug, and it would be buried back in the ground. Somebody from Mars looking at this system would say, this is a very peculiar thing that people on Earth do; they would not understand it. We have gotten somewhat better and more efficient, in that now we print little pieces of paper that are then buried in the ground in a very similar way. However, the global reserve system itself is fundamentally inequitable, flawed and unstable. Burying this amount of purchasing power in the ground adds to global deflationary pressures. It also means that the developing countries are lending something like three to four trillion dollars to the United States and, to a lesser extent, to Europe, at low interest rates. They then borrow it back at higher interest rates, so the net foreign aid of the developing countries to the United States is far larger than the aid that the United States gives to the developing countries. This is clearly a very peculiar situation that needs to be rectified. If you think about global social justice, this system is neither just nor efficient, and it is the cause of a great deal of global instability. The dollar reserve system is fraying, and the only thing worse is that, as it is fraying, the euro is becoming a reserve currency. The history of two-

reserve currency systems suggest that this new system may be very unstable, and for Europe it would present real problems, since the trade deficits associated with the capital inflows (as foreign countries buy euro bonds to put in their reserves) will depress the European economy, already marked by high unemployment. The system to which we are moving is worse than the current system. There is a need for a global reserve system. The issuance of these new bank reserves, this new money could be used to help finance development; it would be a regular source of income of significant magnitude, making up all, or at least a significant fraction, of the amounts that have already been committed for assistance by the advanced industrial countries.

I want to talk for a moment about the manner in which aid is given. There is a great deal of debate about tied aid and earmarking sources. In general, public finance economists do not like earmarking and tying. This is an area, however, where it may be desirable to do so; for instance, France has tied the airline tax to aid. The advantage is that people can see that this is a tax that is going for a particular purpose. If a fund is earmarked for health or for education, it is likely to mobilise broader public support. There are a lot of criticisms about aid effectiveness, but no one says we ought to get rid of the military because some of the money is misspent, even though we all know that a lot of our military money is misspent. The fact that some aid is misspent seems to be put forth as a reason for getting rid of it, but having special funds, like the malaria fund or the education fund, may be a good way of engendering popular support.

One form of aid that is particularly important is Aid for Trade; this has become part of the discussion of the World Trade Organization Development Round of trade talks. The fact is that trade liberalisation has not brought the benefits to the developing countries that were promised. Even Europe's very generous Everything-But-Arms initiative, which eliminated all tariffs on the poorest countries, generated almost no new trade in the areas that were liberalised. The reason is that these external barriers to trade are small relative to what are sometimes called the internal barriers to trade. Even if there are no tariffs, if you do not have ports you cannot export your goods. If you do not have roads to bring your goods to a port, you cannot export. Thus, if you are going to talk about trade, you have to facilitate trade, which means there has to be aid for trade. The Aid for Trade agenda includes trade facilitation (such as improving customs procedures), building infrastructure and providing finance for new enterprises to take advantage of the new opportunities. What is interesting about this agenda is that these could be commitments on the par of other commitments made within the WTO and the

development round. Just as countries commit to lower their tariffs, they would also commit to provide a certain amount of aid. In the past, the United States and other developed countries have not lived up to their commitments, but these would be enforceable within the WTO framework. For instance, a specific tax structure could be used for countries that benefit most from trade, i.e. countries that export a great deal to the developing countries, so that they would pay more into this Aid for Trade fund. This fund could be administered by the developing countries themselves, for instance, through the UN Conference on Trade and Development.

I want to spend one minute reminding us that when we think about assistance, we should think not just about aid itself, though that is important, but we should see aid as part of a broader agenda, some of which was talked about yesterday in the letter that Pope Benedict sent to Chancellor Merkel in the context of the G8. For instance, the trade regime is very unfair to the developing countries: the Uruguay Round was so unbalanced that it resulted in the poorest countries of the world, especially sub-Saharan Africa as a region, actually being made worse off. The asymmetries between capital and labour liberalisation have meant that there is more mobility of capital than labour; these asymmetries also result in lower wages and greater inequality around the world. It is important to think about a fair trade regime as part of our commitments to the developing countries.

Miracle drugs have had a very important effect in extending longevity and in improving living standards, but the Uruguay Round, with its intellectual property provisions (called TRIPS), made access to generic medicines more difficult, which is very bad for developing countries. TRIPS was *designed* to make access to generic medicines more difficult, and it succeeded. As a result, it had the effect of condemning thousands of people in developing countries to death. We should have recognised that this would happen when the agreement was signed in Marrakech in the spring of 1994, and it needs to be rectified. Mr Perigot and I were on the World Commission on the Social Dimension of Globalisation, and one of the conclusions of our Commission was that we need to revisit TRIPS. Unfortunately, in the bilateral agreements that the United States has been signing, rather than correcting the failures of TRIPS, we have made things worse: it is now more difficult for developing countries to have access to generic medicines. There is a real moral issue here.

The scientific community in the United States is also convinced that TRIPS is bad for American and global science. It was an agreement that was pushed by the pharmaceutical industry of the US and, to some

extent, of Europe, and by the entertainment industry; it was not an agreement that was based on what was good for science or for people.

Another part of assistance is debt relief, and one of the important statements in the letter that was read yesterday was that we have to be careful to avoid the recurrence of these kinds of debt problems. Unfortunately, there has been too little discussion of why this is a recurrent problem and, unless we think about that more, the problem of excessive indebtedness will continue. The remarks this morning from Minister Derbez highlighted the nature of the problem, which is that, for the most part, developing countries have to borrow in hard currencies. The consequences of this were seen very clearly in Moldova, one of the former Soviet Unions, which had no debt at the time of its independence. I visited Moldova around 2002 and, at that point, 75% of the government budget was being spent on servicing the foreign debt. The country could not buy oxygen for the hospitals or repair roads; there was a process of de-development. How did this happen? They obviously borrowed too much, but the real problem was that they had borrowed in German Marks, in hard currencies. Their currency was linked to the Ruble, so when the Ruble fell by six fold, in the Russian ruble crisis of 1998, their debt increased in their own currency by six fold. What was a manageable debt became a non-manageable debt.

There needs to be a better way of managing risk. Wall Street and financial markets are very proud about how they have been able to slice-and-dice risk by moving the risk from those who are less able to those who are more able to bear it. However, this has not happened for the most part in the case of developing countries: they still bear the risk of interest rate and exchange rate volatility. This is part of the reason for the Latin American crisis and so many other debt crises around the world.

There are some indications that things are getting a little bit better. In the last two to three years, the amount of borrowing by developing countries in their own currency has increased significantly, as they have become more aware of the problems in borrowing in other currencies. However, the IMF and the international community need to take a better look at how they can bear more of the risk, and this shifting of risk to those more able to bear it ought to be one of the highest elements on the agenda. Unless that happens, we will find ourselves in a world in which the debt problems arise again. Even when countries borrow moderately, a moderate debt can turn into a very high debt.

Finally, I cannot help but spend a minute responding to the very provocative quotation that Prof. Landau quoted from Robert Lucas, that redistribution has not had any effect on increasing the well-being of

people, which I think is outrageous. Now, it is true that if you assume everybody is identical (as Professor Lucas has done in much of his own research), then redistribution in your theoretical models is not going to have any effect, because it is simply moving money from the left pocket to the right pocket. There is no economic theory that could say why that would make any difference, but that is precisely one of the reasons why the models that Lucas and the Chicago School have been exploring for the last 30 years are so flawed and give us absolutely no insight into the way the world works.

Let me first remark that Lucas talks solely about GDP and not general welfare. GDP is not a good summary of general welfare: GDP can go up while most people become worse off. That is what has been happening in the United States. Median income in the United States has been going down for the last five years, even though GDP has been going up year after year. Most Americans today are worse off than they were five years ago. Is that good growth? Is that the kind of growth that society should emulate? I think clearly not.

The second point is that the empirical statement is simply wrong. Among the major successes in growth and development are Taiwan, Japan, Korea and China, all of which began their successful programmes through land reforms, which were major land wealth redistributions. Thus, there is a clear link between land reform and successful growth. In a way, it is almost obvious, especially if you are an economist like Bob Lucas that worries about incentive effects; in most of these countries the form of land tenancy was sharecropping. Workers were paying 50% of their income to the landlord, which is effectively a 50% tax before you begin. If you think taxes discourage effort, then all these people are paying taxes at 50, 60, 70, or 80%. However, land reform eliminated at least that 50% of the tax. The fact is that there are good economic reasons why land reform should have a beneficial effect, and it did. So, the statement empirically is totally wrong. In fact, if you look around the world at the countries that have responded well to globalisation, the countries of East Asia are excellent examples. During their high growth period, they were able to keep inequality low. Not only did they reduce or even eliminate poverty, but they kept the level of inequality very low. Part of their success was based on egalitarian education systems, including providing public education to women, but they had a broader egalitarian agenda. The countries in Europe which have been experiencing, for the most part, the most success in facing the challenges of globalization are the Scandinavian countries: I say success not only in terms of GDP but also in terms of other measures, like the broad human development indicators of the UNDP, including life expectancy and

literacy. Among countries with the highest human development indicators are the Scandinavian countries, and those are also countries that are marked by high levels of redistribution and have the highest taxes. I was talking to the former Finance Minister of Sweden the other day. The question was, was Sweden's success in spite of the high taxes. The answer was no, that it was because of high taxes--money that was well spent and provided a strong safety net, allowing those within the country to take risks, which is critical in responding to globalisation.

I think by now the point is clear. Lucas' statement that there are no benefits to be had from redistribution is a dangerous statement, but it is a statement which has no basis either in theory or in historical experience.

My general conclusion is that aid can play a very important role, both in enhancing growth and reducing poverty and inequality, but obviously one has to spend aid well. We have learned a great deal about how to spend it well, but we should also be thinking about systematic ways of generating revenues to make those aid flows more stable and reliable.