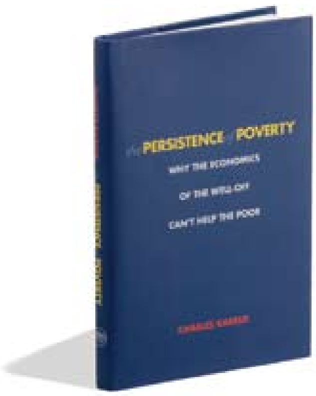
Helping The Poor



Charles Karelis

The Persistence of Poverty

Why the Economics of the Well-Off Can't Help the Poor

Yale University Press, New Haven and London, 2007, 208 pp., $30 (cloth).

Even rich societies have many poor people. And while their situation may compare favorably with that of people in poor countries, they are much worse off than their peers. As a result, they feel excluded and powerless. Sometimes poverty is the result of a disability or a natural disaster, but many poor people seem trapped in a cycle of underemployment, inadequate education, substance abuse, and crime. They often do not make full use of the social services and other opportunities offered in many advanced economies.

Are the poor irrational?

The persistence of poverty is distressing both because we feel compassion for the poor and because poverty is associated with disruptive behaviors, such as crime. It is also puzzling, because conventional economic wisdom suggests that poor people have strong incentives to find employment, get educated, and, more generally, seek to better their lives. If your income is low, you ought to place an especially high value on extra dollars earned through longer work hours or on the future returns on education. It looks as if many poor people do not act rationally.

Charles Karelis, a professor of philosophy at The George Washington University, has provided us with a provocative book that challenges conventional wisdom on this vexed topic.

To explain the puzzling persistence of poverty, Karelis argues, we need to revise our assumption that the marginal utility of consumption generally declines with the level of consumption. Instead, when an individual is faced with poverty, the marginal utility of an extra unit of consumption *increases*, he says. If you are badly off, having a little more to consume is almost worthless, but having substantially more is disproportionately beneficial. Hence, the poor like to vary consumption and take risks for the sake of breaking out of poverty (at least for a while).

This line of argument has a certain intuitive plausibility. Consider the fact that poor people tend to be the most avid lottery players, even though the lottery offers a negative expected return. They play because of the very small chance of a life-transforming win. Indeed, very few people would play if the biggest prize was $100, even if the number of winners were multiplied many times over. Similarly, the temptation to down a whole bottle of alcohol, rather than sip a glass of wine, may be stronger when you have many sorrows to drown.

The hypothesis has immediate policy implications. Efforts to "make work pay" by subsidizing wages earned by the poor (for example, through earned-income tax credits) should be doubly effective—not only will the poor have more reason to substitute work for leisure, but higher income will in itself increase the value they attach to finding employment and earning more. However, even straight handouts to the poor, by raising the marginal utility of income, should strengthen motivation to find employment and earn still more (as well as save for bad times).

Not all the policy implications are equally cheering. For example, Karelis's line of argument implies that self-help efforts, such as the establishment of microfinance institutions or cooperative enterprises, are unlikely to be successful without substantial subsidies. As long as people are poor, they will be bad savers, borrowers, and investors because they (rationally) prefer immediate consumption.

The microfinance example hints at a tension in the book between an emphasis on physical scarcity, when the marginal utility of consumption is supposedly increasing, and on treating poverty as a relative concept linked to a lack of empowerment. Karelis focuses on material poverty in his examples. But what if poor people in the United States are lacking most in respect—for themselves and in the eyes of others? Then, subsidies and other targeted aid will not ameliorate their situation very much and could even make it worse.

"If you are badly off, having a little more to consume is almost worthless."

In Karelis's defense, it should be said that other explanations for the persistence of poverty (such as a lack of opportunities) may yield similar policy recommendations. But the reader—especially if he or she is a trained economist—will be frustrated by the author's reliance on words and a few simple diagrams. Indeed, some of the criticism voiced here could have been forestalled by a more rigorous presentation of the main hypothesis and a comparison with alternatives, followed up by empirical testing.

But these suggestions should not detract from the main insight: that any explanation of persistent poverty, and policies designed to lift people out of poverty, must fully take into account the effects of poverty itself on the motivations of poor people.

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BOOK REVIEWS

Explaining Sustainomics

Mohan Munasinghe

Making Development More Sustainable

Sustainomics Framework and Practical Applications

MIND Press, Colombo, Sri Lanka, 2007, 650 pp., $40 (paper).

Having adopted the sustainable development label, most analysts initially struggled to agree on a good definition of what it means in practice. Other challenges quickly followed, including how to develop quantitative measures of relevant factors, how to find a common metric to deal with often conflicting objectives, and how to explain why so many obvious "win-win" solutions to further sustainable development have failed to gain traction. More recently, the big challenge has been to include climate change in an overarching analytical framework for sustainable development.

Professor Munasinghe, who recently shared the 2007 Nobel Peace Prize with Al Gore in his capacity as Vice Chairman of the United Nations Intergovernmental Panel on Climate Change together with other colleagues, is a long-standing champion for bringing together the economic, human, and environmental aspects of development. He has developed a new analytical framework for doing so, called "sustainomics." This book summarizes advances in the theory and practice of sustainomics and is the result of an extremely thorough literature survey, brought to life through case studies.

In the first part of the book, Munasinghe explains the complex relationships underpinning sustainomics. The not-so-surprising conclusion seems to be that there is no accepted measure of sustainable development on par with measures of economic development.

Munasinghe offers alternative—and less-than-perfect—mechanisms to help the analyst bring environmental degradation and social costs into the analysis. He discusses the analytical frontier of negative discount rates for long-term challenges and, at one point, even appears to anticipate the recent *Stern Review on the Economics of Climate Change*, which seeks to build an economic theory as dictated by the science of climate change.

Applying the theory

Having told us about the limitations of sustainomics, Munasinghe brings much more excitement to the second part of the book, with its excellent and diverse case studies.

These studies demonstrate how the analytic framework has, in some instances at least, become robust enough to offer strong conclusions. For example, we learn that Bolivia is on an unsustainable development path and that a per capita allocation of greenhouse gas emissions produces the greatest average welfare gains.

The book also offers top-notch analysis of the transport sector in Sri Lanka, which combines technical, environmental, and social dimensions into an impressive quantification of the health costs of pollutants. The fact that some of the findings are counterintuitive—for instance, one case study comes out against railway electrification—simply serves to underline the importance of good analysis to support decision making.

Brighter times ahead

Throughout the book, Munasinghe's underlying optimism can be sensed: things will get better as incomes go up and as increased awareness of environmental issues results in better policies. But if rich people cause 20 to 40 times more environmental degradation than do poor people, will higher incomes really help the environment? Or will rich countries simply transfer pollution to poor countries or to regional and global commons?

In searching for effective answers, the author's basic mantra is the importance of internalizing environmental and social costs, eliminating market failures that lead to degradation, and pricing natural resources to include all externalities. This mantra is backed up by analytical tools that are well presented. But why is the mantra rarely applied? According to Munasinghe, environmental enhancements to mitigate pollution damage cost only 5 percent of investment costs. This makes one wonder why pollution levels in the most populated cities show little sign of decreasing.

In sum, the policy analyst is well served by this book, with its analytical tools, real-world applications, and superb bibliography. However, the policymaker, who must look hard to find some basic rules of thumb, may not feel as well served.

The book points but a weak finger at governance, despite acknowledging that in sustainable development there is no single policymaker controlling all the relevant levers, no single criterion, and no clear metric. The power of rent seekers—those who live off natural resources and undermine legitimate political processes—is legendary. The voice of those who may want things to be different, some of whom may not even be born, is too weak to galvanize change.

Munasinghe reaches out to values, beliefs, and religion to create better incentives to protect the environment for future generations and to reverse the unsustainable materialism of current times. Perhaps, in the process, he misses out on giving more weight to and examples of the role of well-informed advocacy and a proactive judiciary in achieving change.

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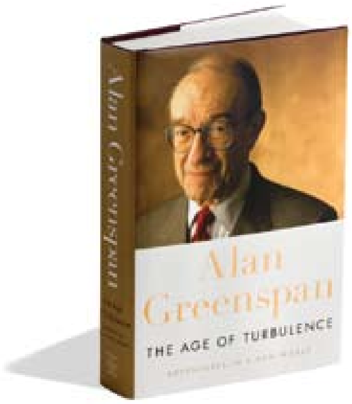
Greenspan Unplugged



Alan Greenspan

The Age of Turbulence

Adventures in a New World

Penguin Group, 2007, 531 pp., $35 (cloth).

At an event promoting his new book, Alan Greenspan was asked how it felt to no longer be chairman of the Federal Reserve Board. "A bit light-headed, perhaps?" the questioner suggested. "No," Greenspan responded, "light-shouldered." Reading this book, one senses Greenspan's relief that after nearly two decades of weighing every decision and word, he has finally been able to spill out almost two hundred thousand words of his choice.

The book splits evenly into an autobiography and a series of essays on economic issues. The former is a book in itself and makes for compelling reading. Greenspan tells the story of his life in a simple and engaging way. Growing up in New York City, he was obsessed with math and music, along with New York Yankees baseball. "I learned fractions doing batting averages: 3 for 11 was .273," he writes.

Jazz musician turned economist

Greenspan first wanted to be a jazz musician. Touring with the Henry Jerome Orchestra, he was known as "the band's intellectual" because he would read books about stock markets and financiers between sets. It wasn't long before he gave up on a career in music and turned to economics. Two famous economists, Geoffrey Moore and Arthur Burns, were early influences. From Moore, Greenspan acquired an interest in the nuts and bolts of the American economy, and from Burns the belief that markets had the capacity to self-correct. Greenspan's support of laissez-faire was cemented by what he calls "a meeting of the minds—mostly my mind meeting hers"—with philosopher Ayn Rand.

Greenspan found his calling as a business consultant starting in the 1950s. Over the next two decades, his consulting firm, Townsend-Greenspan, built up an impressive roster of clients among U.S. blue-chip companies. On the side, Greenspan wrote articles on economic issues, which added to the attention he was getting from political circles. Greenspan ended up serving in various capacities under Presidents Nixon and Ford, but it was President Reagan who, in 1987, gave him the role of a lifetime—chairman of the Federal Reserve Board.

From crashes to bubbles

Greenspan's belief in the tendency of markets to self-correct was tested early in his tenure by the October 1987 stock market crash, the biggest one-day loss in stock market history. Greenspan issued an uncharacteristically clear one-sentence statement affirming the Fed's intention to provide liquidity to the markets as needed, in keeping with its role as lender of last resort. "It was as short and concise as the Gettysburg address," he says, "although perhaps not as stirring." Greenspan continued to be tested in the years that followed the 1987 crash. He was late to recognize the recession of 1990 and may have been too slow in cutting interest rates. That certainly was the opinion of former President George Bush, who said later of Greenspan: "I reappointed him, and he disappointed me."

Greenspan fared better in the Clinton years, as the reining in of fiscal deficits lowered inflationary expectations and, thereby, long-term interest rates. Greenspan matched this commendable fiscal policy with increasingly deft handling of monetary policy. Convinced that inflation was resurfacing, Greenspan guided the Federal Open Market Committee to raise interest rates in 1994, engineering a slowdown but not a recession—a soft landing. Then he cut rates, and growth picked up again with little sign of inflation.

During the mid-1990s, Greenspan argued persuasively that the U.S. economy was experiencing an unprecedented burst in productivity that was not being recognized by government statisticians and academics. The evidence he marshaled helped Greenspan persuade his Fed colleagues to keep interest rates lower than they might have otherwise.

These lower interest rates and his championing of the so-called new economy, however, may also have helped further a stock market bubble. Greenspan tried to warn against the euphoria in his famous "irrational exuberance" speech, but he ultimately decided that the Fed was powerless to determine, in real time, whether there was a bubble and how to prick it.

A good batting average

In the essay section of his book, Greenspan voices deep concerns about the increasing inequality of income in the United States, overdue reforms of Social Security and Medicare, the struggle to maintain a balance in regulation following corporate scandals, and his country's "addiction to oil." But the U.S. economy would surely be in far worse shape today without Greenspan's successful innings as Fed chairman. Alan Blinder, former vice-chairman of the Fed, was right in comparing the Volcker-Greenspan era to "the New York Yankees' good fortune in being able to replace Joe DiMaggio with Mickey Mantle in center field." In the conduct of monetary policy, as in baseball, greatness does not require a 1.000 average.

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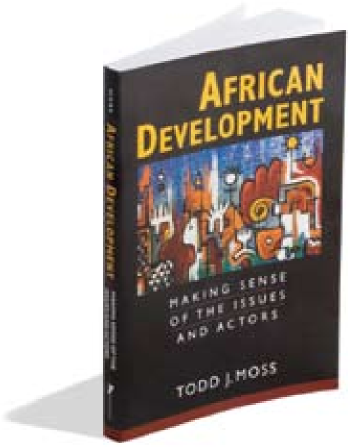
BOOK REVIEWS

Africa Explained



Todd J. Moss

African Development

Making Sense of the Issues and Actors

Lynne Rienner Publishers, Inc., Boulder, Colorado, 2007, 250 pp., $22 (paper).

Sub-Saharan Africa's early post-independence years were hopeful, and an international development industry quickly emerged to help the new countries. But as we all know, the region's experience has been deeply disappointing. Notwithstanding a recent pickup in economic growth, most countries are unlikely to meet the Millennium Development Goals by 2015.

Todd Moss offers neither solutions nor clearcut answers to why Africa's economic performance has been so poor. Instead, the book is "intended to give a simple, but hopefully not simplistic, introduction to the main themes, trends, and players in contemporary African development." In that, it mostly succeeds.

"Big men" and bad legacies

Moss presents a fast-moving account of development in sub-Saharan Africa starting with an overview of the legacy of colonialism, the role of "big men" and personal rule, conflict and civil war, and contemporary political change and democratization. He addresses core development questions, including the slow-growth puzzle, issues in economic reform, and the role of international aid. He concludes by discussing regionalism and sub-Saharan Africa's place in the global economy.

The book has four underlying themes. First, sub-Saharan Africa has had an unlucky history and faces many structural factors that impede development, but the challenge is to harness the region's other advantages and work around these obstacles. Second, transforming the African state to improve accountability and the management of resources is key to attracting larger aid flows. Third, aid should be increased, but also become more effective. Finally, there is a shared responsibility between the region and the world to ensure that the former is able to take advantage of global economic opportunities.

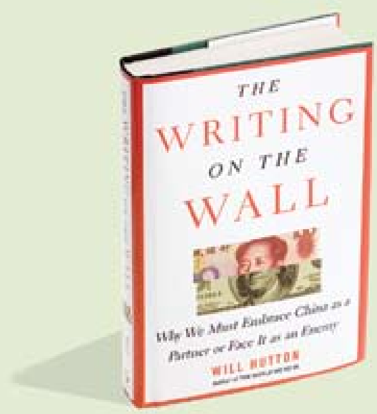
Moss emphasizes how little we know about the development process and what makes aid effective. He is adept at presenting different, sometimes con-

China Rising

China's radical transformation from a moribund centrally planned country to the world's fourth largest economy is one of the fascinating stories of our era. Indeed, the transformation has been so profound as to prompt the question, Will the 21st century be Chinese, just as the 20th century was American and the 19th century British? *The Writing on the Wall* by economist and correspondent Will Hutton addresses this question head-on, and with a narrative skill not always found in economic and political literature. His arguments are well researched and his reasoning, although at times tangential, clearly laid out.

There are really two books here. One deals with China's political and economic transformation and its implications for the rest of the world. It examines China's prospects for continuing rapid growth, given one-party rule. Grafted onto this is a somewhat less successful discussion of the advantages of economic and political pluralism.

Any reader seeking a clear and accurate explanation of China's economic successes and challenges would do well with the first half of this book. Hutton begins with a brief but lucid history of China and its interaction with the rest of the world. This covers the economic travails of the Chairman Mao years, including the early mass reorganization of the means of production, the Great Leap Forward, and the policy of radical egalitarianism. The profound failures of this period created the consensus that a reorganization of the economy was needed, and that reorganization was spearheaded in 1978 by Deng Xiaoping, the architect of modern China. A series of reforms dismantling central planning and allowing for market-based activity contributed to a surge in economic growth that has lasted 30 years. With the new century, China began liberalizing external trade with stunning success, and a flood of foreign investment helped turn the country overnight into the world's mass assembler of consumer goods.



Will Hutton

The Writing on the Wall

Why We Must Embrace China as a Partner or Face It as an Enemy

Simon & Schuster Trade, New York, 2006, 432 pp., $28 (cloth).

There are many insights in Hutton's narrative. In contrast to eastern tradictory viewpoints. At all times, he seeks to illustrate the issues rather than suggest "magic bullet solutions."

But there is a downside to this "survey" approach. Moss is not always critical enough of the various views in the literature, leaving the reader wondering what to believe. For example, why does the "natural resource curse" lead to conflict? Is it because of the struggle for rent, the lack of accountability, or weak institutions?

Moss also seems to contradict himself at times. For example, his discussion of ethnicity and conflict suggests that ethnicity is not a major contributor to conflict. But when discussing alternative forms of governance and their tensions with liberal democracy, he argues, in part, that "most of the past and current conflicts in Africa have had some ethnic or linguistic component."

It is surprising that the chapter on Africa's slow-growth puzzle does not explore the case of countries endowed with significant natural resources, such as crude oil and diamonds. This would have helped provide insight into the unique challenges that these countries face.

In discussing economic reform and the politics of adjustment, Moss is sometimes unsure what to argue. On the one hand, he asserts that conditionality (for instance, in connection with IMF loans) was a "near-total failure." On the other hand, he concedes that structural adjustment has visibly improved macroeconomic management across Africa. What is not clear is the role played by conditionality. Today, there is little debate in Africa among policymakers that first-generation reforms aimed, for instance, at achieving fiscal discipline and taming inflation helped created the conditions for the strong growth currently enjoyed by the region.

Role of trade

Moss makes a compelling case for further integrating sub-Saharan Africa into the global economic system. But his discussion of the potential benefits of intraregional trade is disappointing. He could have emphasized that the large number of regional trade arrangements has not succeeded in boosting trade within the region. Currently, there are over 30 such arrangements, with each country belonging to at least 4. The result has been overlapping and sometimes conflicting commitments. Complicated and restrictive rules of origin, together with other internal barriers, have kept intraregional trade relatively low compared with other developing regions.

Despite these shortcomings, the book is an excellent primer for students of African development, and the section on further reading that follows each chapter provides additional resources for those who want to delve more into the issues.

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Europe, there was no top-down big bang in the path to a market economy—rather, China pursued a pragmatic, gradualist, bottom-up (or as Hutton also argues, piecemeal and reactive) approach to reform, "crossing the river groping for stepping stones," as Deng put it, which continues to this day. Hutton also emphasizes the role of accidents in explaining much of the success, in particular the surprise boom in small rural manufacturers, the large pool of savings that allowed for sustained investment, and the growth in globalization.

If the successes of the reform period are sharply illuminated, so are the challenges China now faces. With its ideological basis eroded by its embrace of market growth, the Communist party is struggling for legitimacy and facing the social strains of rising income inequality, corruption, land theft, and environmental degradation. Economic strains are also emerging. Mounting protectionist pressures abroad threaten China's export expansion, while the scale of economic waste leaves output growth increasingly reliant on unsustainably high levels of investment rather than driven by efficiency gains.

"Hutton believes that the Communist party's balancing act cannot be sustained."

Given the current economic and political strains, can China's remarkable economic performance continue? Hutton's answer is, Not without sweeping political changes. Despite the market reforms, the Communist party still retains a spiderweb of control over all important levers of economic activity, ranging from the banking system—which props up investment to the large industrial sectors—to the private economy. Indeed, the party believes such control is necessary to guarantee the high near-term growth so critical to its legitimacy.

But the growth machine is running out of gas, locking China into a low-productivity, low-innovation economy. Refueling this machine will require the "soft" institutional infrastructure that accompanies successful capitalism: impartial courts, clear property rights, independent banks and auditors, a free press, effective corporate governance, and free intellectual inquiry. Hutton believes that the Communist party's balancing act cannot be sustained, and the necessary changes will have important implications for the party's ability to run China as a single-party authoritarian state. This in turn will determine how the world should respond to the Chinese century.

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