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A MESSAGE TO THE NEW WORLD BANK PRESIDENT

INTRODUCTION

Lewis T. Preston, retired chairman of J.P. Morgan and Company, this spring officially was selected as new president of the World Bank, having been nominated by George Bush. The America nominee always has been made World Bank president. This September 1, Preston will succeed Barber B. Conable, who has headed the Bank since June 1986.

Preston takes command of the Bank at a time that may see the most significant global economic change in post-World War II history. The collapse of communism in Eastern Europe and the Soviet Union, and the election of reform-minded leaders in Argentina, Brazil, Mexico, and other developing countries have created accelerating momentum away from socialism and toward free markets. The question for Preston is will the World Bank, with its vast resources and enormous clout in the Third World, meet today's economic challenges?

Changing Course. If the Bank's record of the past quarter-century is any indication, it is doubtful that it will meet the challenge. In this period, Bank loans have propped up socialist economies and increased the debt for many less developed countries. To make matters worse, the Bank often has given bad economic advice to poor countries. Yet Preston need not become a prisoner of the Bank's immediate past. He can draw on the Bank's earlier good work and change the Bank's policies and lending practices. He can steer the Bank back toward being a free market champion and thus enable the Bank to spur economic growth in countries too long accustomed to stagnation or decline.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Faulty Loans. Formed in 1944 to lend money to war-torn European countries and Japan for public works projects such as roads, bridges, and power plants, the World Bank in the 1960s and 1970s shifted its lending to less-developed countries. It began in the 1980s to offer "structural adjustment loans" to countries with serious debt problems in exchange for what the Bank thought were positive economic reforms. In many cases, however, the Bank's project loans failed to improve economic conditions. The loans merely propped up money-losing state-run enterprises. In addition, the minor reforms made by recipient countries in exchange for loans frequently are more than offset by those countries' non-market policies. And many of the economic conditions that the Bank attaches to such loans, rather than helping these countries create growing, prosperous economies, end up strengthening the government officials and institutions that created the economic problems to begin with.

When Preston takes over, he will find a schizoid World Bank – part of it anchored in its past of failed policies and part of it encouragingly pulling in the free market direction which offers prospects of economic development to poor nations. The Bank's conflicting and contradictory directions are reflected in its two most recent annual reports. The *World Development Report 1989* stresses the need for private financial institutions, like banks, capital markets, and private enterprises. It points out that developing nations benefit from stable, non-inflating currencies, private banking, and legal protection for the rights of borrowers and lenders – all of which promote economic growth.

Contradictory Reports. The 1989 analysis, however, seems contradicted by the Bank's *World Development Report 1990.*[1] The 1990 report suggests that, to deal with poverty, governments of less-developed countries should adopt the kind of welfare state and socialist policies that have led to economic disaster in the past. The 1990 report advises, for example, that government-directed credit and lending programs, re-distributive social welfare policies, transfer payments and public employment schemes are necessary to alleviate poverty. The report fails to mention that the sort of extensive levels of government regulation and taxes needed to carry out these policies cause many of the problems they are meant to cure.

Preston should study both reports carefully. His experience at one of the West's most successful and respected financial institutions will tell him that the 1990 report represents the failed thinking of the past and of too many of the Bank's staffers. He will know that the 1989 report is a much better guide for future Bank policy.

[1] *World Development Report 1990* (Washington, D.C.: The World Bank, June 1990). Hereinafter referred to as the World Bank Report.

As he settles into his important new post, Preston should announce his intention to endorse the free market approach to economic growth and to reform the World Bank to enable it to become an agent of such growth. Specifically, he should:

1) Develop an index of economic opportunity or freedom to embody free market goals to guide the Bank's structural adjustment lending. The U.S. Congress is considering such an index to guide American foreign assistance. With this index, the World Bank would declare that the best use of World Bank funds would be made by those countries that:

- ♦ legally protect the private property rights of all citizens;
- ♦ insure that prices for all commodities, products, and services are set by voluntary agreement of buyers and sellers;
- ♦ keep tax rates low and stable;
- ♦ establish a private agricultural sector without government control of production, distribution, and pricing of farm commodities;
- ♦ limit government regulation of businesses;
- ♦ establish private banking and financial institutions;
- ♦ endorse free trade with low or no tariff and non-tariff barriers to imported good and services; and
- ♦ impose no restrictions on foreign investments;

2) Create guidelines to ensure that World Bank structural adjustment loans go only to countries instituting consistent and comprehensive economic reforms.

3) Freeze World Bank project lending and initiate a full investigation and public debate among the World Bank members over how countries can meet their finance needs without further addiction to borrowing.

THE WORLD BANK'S DISAPPOINTING RECORD

This September, Preston will find a Bank that has strayed far from its original purpose and is now struggling to become a constructive force in the world economy. Officially named the International Bank for Reconstruction and Development, the World Bank was founded in 1944 by the 44 nations who met in Bretton Woods, New Hampshire. Today, the Bank has 153 members; only about 18 nations are not members. The Bank was founded to provide money to the war-ravaged countries of Western Europe and Japan for such infrastructure projects as roads, bridges, electrical plants, and other public facilities and enterprises. The founders felt that commercial banks would be reluctant to lend to these countries, many of which had defaulted on World War I and post-World War I debts.

According to the original Articles of Agreement, the World Bank was to facilitate "investment of capital for productive purposes...to promote private foreign investment by means of guarantees...and when private capital [was] not available on reasonable terms, to supplement private investment..." all over the world.[2] Its loans, however, were directed to the more advanced developing countries where prudent banking practices could be applied.

Global Welfare Agency. In the 1950s and 1960s, the World Bank tended to follow established banking practices in determining which countries would receive funds and for what projects. But with the emergence of new, less developed countries from old colonial empires, and under the presidency from 1968 to 1981 of Robert S. McNamara, the World Bank was pushed on a new course. In retrospect, this was a disaster – mainly for poor recipient countries. McNamara correctly wanted the Bank to fight world poverty; he incorrectly did this by transforming the Bank into a global welfare agency, dispensing cash handouts which, by and large, increased the poor countries' dependency on foreign assistance and did little to strengthen their economies. The Bank, moreover, increasingly lent money to governments with little concern for whether the money would be used wisely. And the World Bank actively supported central economic planning and even socialist policies.

Typical is what happened to Tanzania. There the government confiscated lands, created Soviet-style collective farms and government marketing boards to set prices and distribute crops for export and domestic use. The World Bank supported these efforts with $261 million in loans throughout the late 1970s. The result: Tanzania's agricultural sector and economy were in ruins by the 1980s.

In the past couple decades, too, World Bank loans have gone to such activities as Hungarian government-owned railroads, Indian government-owned coal mines, Mexican government-owned steel companies, and to Peruvian government-owned gold mines.[3] These loans, and hundreds of others, not only supported destructive economic policies, they addicted many less developed countries to borrowing and helped precipitate the debt crisis in the 1980s.

Agonizing Reappraisals. During the 1980s, however, this debt crisis and the resurgence of free market policies in Reagan's America and Thatcher's Britain, prompted some agonizing reappraisals at the Bank. As a result, some of the worst policies were reversed. Most noticeably, the Bank put more resources into "structural adjustment loans" (SALs) to pay governments, so to speak, for reforming their economies. The problem is that the SALs typical-

[2] Reprinted in *IBRD, the International Bank for Reconstruction and Development, 1946-1953* (Baltimore: Johns Hopkins Press, 1954).

[3] Melanie S. Tammen, "World Bank Snookers U.S. Congress Again," Heritage Foundation *Backgrounder* No. 649, May 23, 1988.

ly push minor reforms while leaving in place the macro-systems that cause many of the problems. The Bank, for example, lends money to a government and, in exchange, the government instructs its marketing boards to bring the prices of its commodities closer to the free market level. The result: The Bank bolsters the very government institution that should be abolished. Meanwhile, the small benefits from SAL-driven reforms often are more than offset by the other problems with the economy. Where a market system is not already in place, or where comprehensive and consistent reforms are not currently underway, SALs do little good.

THE POVERTY REPORT

In its *World Development Report 1990: Poverty*, the World Bank estimates that 1.2 billion people were living in poverty in the developing world in 1985, with the greatest proportion in sub-Saharan Africa.[4] It identifies as characteristics of the poor in less developed countries lack of assets and limited sources of income. It states, correctly, that "low GDP [gross domestic product] growth makes it difficult to reduce poverty" and that "raising the incomes of the poor requires broadly based economic growth."[5] Then, however, the Bank stumbles in its conclusion, suggesting that "a comprehensive approach to poverty, therefore, requires that the basic strategy be supplemented by a system of well-targeted transfers and safety nets."[6]

The World Bank's Poverty Report offers a menu of welfare state policies that have been tried and failed in the past. These include the following:

1) Subsidized Credit.

The poverty report calls attention to the benefits of government-subsidized credit for loans to small groups of the poor in less developed countries in contrast to loans to individuals. The report states that "well-designed [credit] programs can give disadvantaged groups access to credit and still remain financially viable. Institutions of this kind should be supported with limited subsidies to help cover their initial administrative costs."[7] Here the report points to the Bangladesh Grameen Bank. With government funds, local villagers operate small branches of the Grameen Bank throughout the country. These branches grant small loans to groups of the poorest Bangladeshis. Between 90 and 95 percent of these loans are repaid.

The Grameen Bank indeed is an example of how the poor, when given an opportunity, can manage their own economic affairs. It is also a credit to the energy and commitment of its founder, Muhammed Yunus. Yet the World

[4] World Bank Report, p. 28.

[5] World Bank Report, p. 51

[6] *Ibid.*

[7] World Bank Report, p. 69.

Bank report misses the major lesson to be learned from the fact that the Grameen Bank needs foreign aid funds. Bangladesh government regulations and an army of bureaucrats prevent businesses from expanding beyond a certain size. This means many small enterprises compete for the same market, with few able to make the profits or savings needed to expand. In an economy with a stable currency, private banking, and minimal government regulations, government capital for banks usually is not necessary. Small-scale entrepreneurs use their own savings to fund their businesses, and their profits to expand them. In most less developed countries, government interference with the same market hinders this growth process.

Another problem is that credit subsidies require government-operated banks or government selection of private banks to receive and pass along subsidies. With such subsidies inevitably come government regulations, fraud, and red tape. There is no evidence that governments, especially in less developed countries, can pick the best banks for the subsidies. To the contrary, in the highly politicized environment of such countries, politics typically determine where the subsidies go.

This, in fact, is recognized by the World Bank's 1989 report. It points out that government-subsidized financial institutions have had a very poor history in maintaining stable lending policies. These institutions tend to lend to inefficient public-owned companies, while using the printing press to increase the money supply to cover the bad loans.[8] One year earlier, in the World Bank's *World Development Report 1988*, a similar lesson is drawn. This report finds that subsidized credit in Latin America, which has been used to support massive and inefficient state-owned enterprises, has been a major factor in many of those countries remaining underdeveloped.[9]

2) Government-Controlled Agriculture.

With the stark evidence of Africa and the Soviet Union, no one today can dispute the fact that government-run agriculture has been a catastrophe. Yet the 1990 World Bank report advocates "various forms of food subsid[ies]: general food price subsidies, food rations, food stamps, food distribution policies, and food supplementation schemes. These policies can be used to raise the real incomes of the direct beneficiaries, and they provide a safety net to protect a wider group of the poor against collapses in their real incomes."[10]

[8] See *World Development Report 1989* (Washington, D.C.: The World Bank, 1989); and Edward L. Hudgins and Bryan T. Johnson, "Why The World Bank Should Read Its Own Report," Heritage Foundation *Backgrounder* No. 727, September 22, 1989.

[9] See *World Development Report 1988* (Washington, D.C.: The World Bank, 1988).

[10] World Bank Report, p. 92.

Here, apparently, the World Bank ignores the evidence so clear to everyone else and continues to endorse state control of agriculture as a means to help the poor. To make matters worse, the 1990 report balks at strongly endorsing the policy that most would help farmers and consumers in poor countries: abolition of government marketing boards and establishment of private ownership and control of all farms and food distribution.

In most African countries and in many other poorer nations, individual ownership of farms is restricted if not prohibited. Governments require all crops to be sold to state-owned marketing boards, which set the price for crops. The government usually pays farmers below market prices for their crops and then either distributes the cheap food in urban centers where most government employees and political supporters live or exports the food and pockets the profits. African governments even require farmers to use government transportation to send their crops to market.

Food Production Decline. When governments offer below market prices to the farmer, farmers typically produce only what is necessary for the needs of their immediate families. Those who produce more, usually do so to sell their goods in the informal sector or black market. As a result of these economic policies, sometimes backed with World Bank loans, Africa's per capita food production declined 25 percent between 1960 and 1985.[11]

What the World Bank's 1990 report ignored is what some African countries have begun doing on their own. Between 1985 and 1987, for example, Nigeria decided to come to grips with its failed policies. It shunned new World Bank loans and instead abolished all of its marketing boards. Nigeria also ended some restrictions on foreign investment. As a result, Nigeria's gross domestic product grew 5.2 percent in 1988 and 8 percent in 1989.[12] By comparison, between 1980 and 1987, the GDP shrank an average of 1.6 percent annually.[13] Agricultural output grew almost 4 percent in 1988, after the marketing boards were abolished. Production of cocoa, the country's second highest export crop, which had been declining, increased almost immediately by one-third after the boards were abolished.[14] The lesson of this for the World Bank should be clear: freeing markets, not government control of agriculture, is the best way to aid the poor.

[11] Melanie S. Tammen, "The Failure of State Agriculture in Sub-Saharan Africa," Foundation for Africa's Future, Alexandria, VA, 1988, pp. 17-20.

[12] *Ibid.*

[13] *Trends in Developing Economies 1990* (Washington, D.C.: The World Bank, 1990), pp. 395-403.

[14] See Michael Johns, "A U.S. Policy for Nigeria: Supporting Political and Economic Freedom," Heritage Foundation *Backgrounder* No. 730, October 13, 1989.

3) Black Market Crackdown.

All less developed countries have extensive informal sectors or black markets for clothing, furniture, housing construction, transportation and almost all other goods and services. These informal markets sprout when government regulation and taxes become so oppressive that individuals must evade the system to survive. Rather than recognizing and treating the cause of black markets, the 1990 World Bank report treats the symptoms. It advocates stricter law enforcement against free market entrepreneurs.

It is the poor, of course, who suffer most from tight government control of the economy. The elites can afford to pay the bribes to the politicians and bureaucrats to obtain the permits to do business or to obtain the access to scarce goods. But the poor usually cannot and thus suffer. In Peru, for example, economist Hernando De Soto found that to obtain a license for a small business, legally and with bribes paid only to keep the process from stopping completely, took 289 days of full-time efforts. To obtain a piece of abandoned government land and permission to built would take six years and eleven months.[15]

In most less developed countries, informal sector activities account for between one-third and one-half of the GDP. Workers in this sector are the true entrepreneurs who, to survive, must evade state economic regulation. The World Bank's call for stricter law enforcement against the informal sector ignores the honest efforts of entrepreneurs.

4) Social Welfare.

The World Bank Report for 1990 contends that a strategy for fighting poverty should be supplemented with "a system of well-targeted transfers and safety nets."[16] The report adds: "Public spending that is well designed and accurately targeted can play an important part in the fight against poverty."[17] The Bank in effect advocates a welfare state with government spending on health, education, income transfer, and population control.

Though surely well intended, this policy prescription is deeply flawed. Most developing countries simply do not have the resources for such a welfare state. History teaches that wealth first must be created before it can be distributed.

[15] Hernando De Soto, *The Other Path* (New York: Harper and Row, 1989).

[16] World Bank Report, p. 51.

[17] World Bank Report, p. 4.

The Bank report suggests more public sector employment, especially in rural areas.[18] But a major problem in most less developed countries is bloated public payrolls. The Bank ignores the best source of job creation: the free market.

Further, public employment schemes, as well as any social welfare program, require government spending. This usually means higher taxes, which hinders the creation of jobs and businesses in the private sector. In the end, economic growth is stifled.[19]

5) Land Reform.

The World Bank's 1990 report supports efforts to seize property from the "rich" and redistribute it to the "poor," arguing that "individual land registration and titling may be undesirable," and that "common pasture and forest resources are important for poor rural households."[20] This ignores the near-universal evidence that when land is the responsibility of individuals, the land tends to be better cared for, because it is the individual who profits from its best use and who suffers if the land is abused.

This point is demonstrated graphically by a photograph of Africa's Sahel desert taken in the early 1970s from a U.S. satellite. It shows a 400-square-mile dark green pentagon-shaped area standing out clearly against lighter surrounding sand and shrub. The dark green area is lush vegetation; the surrounding area is barren. The distinctive differences between the two areas are not geography or climate. The differences are legal. The large, lush green area is private property on which the owner raises cattle and makes certain that grazing from one year to the next rotates from one part of the land to another so that the vegetation is not depleted. The surrounding area is common property. As such, no individual has the incentive or the authority to care for the resources in this area.[21]

6) Foreign Aid Supports.

The World Bank concludes its 1990 report with a call for increased support for poor countries from the Bank, the International Monetary Fund, the U.S. Agency for International Development and other nations. The Bank ignores the fact that no link has been found between increased foreign aid and increased economic growth. Rather, existing evidence proves the opposite. Tanzania, for example, has received more foreign assistance per capita over the past quarter-century than nearly any other country. Yet it is one of the poorest countries in the world. By contrast, Asian countries such as the

[18] World Bank Report, p. 97.

[19] See Bruce Bartlett, "The State and the Market in Sub-Saharan Africa," *The World Economy*, September 1989.

[20] World Bank Report, p. 65.

[21] Cited in *Access to Energy* newsletter (Boulder, Colorado), January 1990, p. 2.

Republic of China on Taiwan received little or no assistance. Today, they are prospering.

RECOMMENDATIONS

When Lewis Preston takes over as World Bank president in late summer, he will face the twin challenge of dealing with countries desperately seeking free market solutions to their economic problems and with a Bank staff often mired in the failed policies of the past. Preston can transform the bank from an institution that often has been the cause of economic stagnation to one that helps spur economic growth. To do this, he should instruct his staff of World Bank experts to:

1) Develop an index of economic opportunity or freedom to embody free market goals to guide the Bank's structural adjustment lending.

Preston should recognize that institutionally there is little to keep the World Bank from repeating past mistakes. An index by which loan requests would be judged would create such an institutional force. Countries would receive World Bank loans if they received a passing score on an index measuring the extent to which the count grants economic opportunity or freedom.

The index would measure:

♦♦ **Protection of private property rights.** A fundamental ingredient for economic growth is the right of individuals to own, use and dispose of goods and services as they see fit, without (or with minimum) interference from government or other individuals. Property gives individuals the material means to support themselves without government handouts and to establish enterprises. When property is owned by individuals, they have a strong incentive to put it to its most profitable use. Where property rights are denied, or their protection is not ensured, individuals have little incentive to engage in productive activity.[22]

♦♦ **Free pricing systems.** Governments in many less developed countries impose price controls. These distort markets, creating shortages when prices are kept below the market level or a surplus of goods that no one can purchase when prices are kept above the market level. Resources are wasted and inefficiencies created. As a result, growth falters or halts.

♦♦ **Low, stable tax rates.** High taxes punish individuals for being productive. Low taxes allow maximum economic output and usually bring in more revenues to treasuries than higher taxes. Stable tax rates allow businesses to plan ahead.

[22] See Edward L. Hudgins, "Private Property: The Basis of Economic Reform in Less Developed Countries," Heritage Foundation, *Backgrounder* No. 770, May 24, 1990.

♦♦ **Private agricultural sectors.** The public marketing boards of sub-Saharan Africa have been a failure. By contrast, countries with private sector agricultural markets, such as Mainland China and South Korea, have increased agricultural production. Freeing farmers from government control gives them the power and the incentive to meet their countries' agricultural needs.

♦♦ **Limited government regulation of the economy.** Government regulators in less developed countries make it difficult and costly for entrepreneurs legally to start businesses. Lengthy delays in issuing licenses, confusing and contradictory application procedures, and the arbitrary power of government officials to control businesses hinder the creation and expansion of many businesses and force others into the informal sector. Regulatory reform in less developed countries would help channel the energy of entrepreneurs into its most productive use.

♦♦ **Private banking and financial institutions.** Private banks, free from political pressure, tend to channel funds to the most promising enterprises, Small, local banks especially give small-scale businesses a ready source of capital.

♦♦ **Free trade policies.** When governments in less developed countries restrict imports to protect certain industries and privileged workers, they deprive other sectors of their economies of capital and necessary imports. This creates even more unemployment and damages other industries. Further, such protected industries, because they need not compete with foreign firms, usually produce poorer quality products that lose money. Free trade would allow resources in these countries to go to the industries that are most competitive and increase economic growth.

♦♦ **Encourage foreign investment.** Foreign aid often takes the place of foreign investment. Governments that restrict or prohibit investments from other countries cut their citizens off from a crucial source of funds which can be used to build factories and infrastructure. Such governments usually must turn to borrowing, often from the World Bank, to cover investment costs. Such borrowing in the past has been a major cause of the debt crisis. Removing all restrictions on foreign investments would open the doors of most less developed countries to needed capital.

2) Create guidelines to insure that structural adjustment loans go only to countries instituting consistent and comprehensive economic reforms.

The World Bank has a history of throwing good money after bad. Policy changes attached to loans, even if sound, usually are more than offset by other economic policies of the recipient countries. Governments that are not willing to commit themselves fully to comprehensive and consistent free market reforms should not qualify for loans. Such loans do not help their economies and often remove pressure to make fundamental changes. The World Bank especially needs new guidelines as the Soviet Union and other socialist countries seek assistance in exchange for promises that they will reform their economies. By establishing such guidelines, Preston would help the Bank itself to avoid promoting contradictory policies.

3) Freeze project lending and initiate a full investigation and public debate among the World Bank members over how countries can meet their finance needs without further addiction to borrowing.

World Bank project lending in the past has allowed countries to cut wasteful spending, privatize money-losing state enterprises, and adopt growth-oriented market reforms. In addition, such loans have drowned countries in a sea of debt. The World Bank must re-evaluate its basic purpose. If its project lending is to continue, it must show why no other means is available to less developed countries and establish strict guidelines to avoid the errors of the past. Preston should initiate a complete review of the Bank's purpose and a public discussion among the members concerning the Bank's future.

CONCLUSION

Lewis T. Preston takes command of the World Bank at a time of worldwide economic and political change. Socialism and government direction of economies have ruined one country after another and led to political revolutions. Such countries now look to the West for guidance and assistance. In the past, the Bank has been giving bad advice to less developed countries. As a result, many poor countries became addicted to loans and aid, while refusing to reform their own economic environments. Preston has an opportunity to change the Bank's course by rejecting the philosophy found in the latest World Bank report.

Global Transformation. Western governments and international institutions such as the World Bank have an opportunity to transform the global economy. It would be a tragedy if the Bank failed those people who genuinely want to replace stagnant, socialist economies with dynamic free markets. Lewis Preston has the chance to make the World Bank the means of placing prosperity in the reach of all individuals and in all less developed countries.

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