

A stylized world map in a light teal color serves as the background for the cover. The map is centered and shows the outlines of continents. Overlaid on the map is the title 'jipia' in a large, dark teal, cursive font. The letters 'j' and 'i' have large, solid black dots above them. Below the main title, the subtitle 'Journal of Public & International Affairs' is written in a smaller, dark teal, serif font. At the bottom right, the year '2013' is displayed in a large, dark teal, serif font.

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## Foreword

At the Woodrow Wilson School, we believe that human interactions and interchange can create the intellectual spark and momentum for ideas that positively change the world. Our faculty members regularly leave the proverbial ivory tower to work in public service, bringing back with them practical experience that often transforms their own research and teaching. For me, working at both the National Economic Council and the Council of Economic Advisers highlighted how well-designed, cutting-edge research can make a powerful impact on public policy while also reminding me that, to break through, the research needs to be shared in an accessible form. Further, I saw how critical it is for decision makers to know how to understand both the strengths and weaknesses of research in order to make more informed decisions. While at the Woodrow Wilson School, our students develop those critical analytical tools that are so important for effective public sector leadership and also engage classmates with diverse professional and personal experiences to broaden their own understanding of the issues. These exchanges are central to our mission, “Princeton in the nation’s service and the service of all nations.”

The *Journal of Public and International Affairs* is the perfect demonstration of how interaction and exchange can generate ideas of great value for the world. Students from schools across the Association of Professional Schools of Public and International Affairs (APSIA) on four different continents submitted papers to this year’s volume. These submissions clearly demonstrated the importance of the marriage of scholarly research and practical considerations in creating new policy initiatives. After papers were selected from an impressive list of submissions, Princeton editors worked with the authors to further develop each essay’s policy ideas. The Princeton students found the experience of working with dedicated and intelligent authors to be extremely rewarding; I hope the authors felt the same. Most importantly, the outcome of those interactions, found in the following pages, are a rewarding read for anyone interested in sound ideas for serving this nation and all nations.

It is my pleasure as the Dean of the Woodrow Wilson School to support the publication of this Journal. To the many students who participated in this year’s edition, congratulations. To the reader, enjoy!

Cecilia Rouse,  
*Dean, Woodrow Wilson School of Public and International Affairs*

## Letter from the Editors

Forged in the wake of a record-breaking snowstorm in the Northeastern United States, the 24<sup>th</sup> edition of the *Journal of Public and International Affairs* showcases the academic work of scholars spanning the entire globe. The snow presented a challenge to JPIA as we readied for our annual “Reading Weekend,” a three-day event in which our Contributing Editors travel to Princeton University from their home schools across four countries to democratically select the best essay submissions for publication. Luckily, most editors were able to catch their flights before the blizzard closed down regional airports, and we proceeded to choose the articles—through vigorous and cheerful debate—that fill the following pages.

This year’s edition of JPIA continues the tradition of giving voice to promising young scholars from diverse policy fields on issues that traverse international borders and academic disciplines. As a joint collaboration of schools comprising the Association of Professional Schools of International Affairs (APSIA), JPIA receives graduate student submissions from a wide swath of global universities that are training the next generation’s leading policymakers and scholars.

The nine articles in this volume were chosen from over 150 submissions through a blind-selection process in Princeton. After individually reading a large number of submissions, attending editors first voted for their favorite papers via secret ballot, and we then facilitated an open debate to winnow down these choices to the cream of the crop. In the intervening months before publication, editors in Princeton from relevant policy areas worked with the authors to fact-check their work and fine-tune their arguments.

While their geographic foci and policy subjects are multifarious, all the authors in this edition share a passion for changing the world through better policy. Whether it is women’s health issues in Tanzania, banking regulation in the European Union, diplomacy with Iran over its nuclear ambitions, or immigration policy in the United States, the authors implore global policymakers to change course in order to remedy contemporary problems in public affairs. This dedication to making the world a better place through public policy, in addition to demonstrating first-rate scholarship, make us proud to showcase these articles.

We would like to express our gratitude to all the individuals and organizations that made this publication possible. First and foremost, thanks to the Woodrow Wilson School of International and Public Affairs as well as APSIA for providing generous financial and logistical support. In particular, thank you to Melissa Lyles, the Director of Graduate Programs at the Wilson School, and Leona Rosso-Dzugan, Graphic Designer at Princeton University, for their important contributions to the journal’s publication. We would also like to thank all of the JPIA Contributing Editors, especially Princeton editors Daphne McCurdy and Chikara Onda, for their tireless work during the 2012-2013 academic year. Finally, we would be remiss to not also thank all of students whom submitted to JPIA last year. It is their ambition, passion, and determination to improving policies for the benefit of world citizens that give us faith in a better tomorrow.

Gregory Rosalsky and Sarah Schleck  
*JPIA* Editors-in-Chief

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## MISREADING MALI'S COLLAPSE: GOVERNANCE, FOREIGN AID, AND POLITICAL INSTABILITY IN EMERGING DEMOCRACIES

*Nathaniel D.F. Allen*

In this article, I examine the reasons why many in the international community, in particular Mali's foreign aid donors, did not anticipate Mali's political collapse. Although Mali's governance was quite robust by some measures, international donors were largely unaware and did relatively little to address the Malian government's lack of accountability, institutional weakness, and increasingly tenuous political stability. In the aftermath of Mali's crisis, the international community needs to be much more cognizant of the political risks faced by emerging democracies and adopt pro-active policy measures to address political and institutional fragility. I conclude with several policy recommendations which could have helped to strengthen Mali's institutions, address instability in the country's north, and avert the central government's collapse, several of which have broader implications for the region and for other emerging democratic regimes.

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*Nate is a graduate student at Princeton's Woodrow Wilson School of Public and International Affairs, where he focuses on cross-cutting international development and security issues. The author would like to thank Bruce Whitehouse, Nicolas Van de Walle, Richard Hinman, Conor Godfrey, Jonathan Speed Meyers, and Travis Sharp for their thoughtful, frank, and perceptive comments on drafts. He can be reached at [ndfa@princeton.edu](mailto:ndfa@princeton.edu).*



## INTRODUCTION

A sparsely populated, landlocked democracy in the heart of West Africa, Mali was until recently considered a model for successful partnership between poor governments committed to sustainable development and international aid donors. Ranked 175<sup>th</sup> of out of the 187 countries in the United Nations Human Development Index, Mali's GDP growth rate has nevertheless averaged close to 5 percent per year since its transition to democracy in 1991, 1.5 percent more than the average for Sub-Saharan Africa (UNDP 2011; World Bank Databank 2012). The World Bank's 2011 Country Brief declared Mali "one of the most politically and socially stable countries in Africa" (World Bank 2011). This assessment was shared by the vast majority of Mali's donors; as late as May 2012, for example, USAID heralded Mali "one of the most enlightened democracies in Africa" (USAID in Van de Walle, 2012).

In a span of just over two weeks from late March to early April 2012, Mali's "enlightened" and "politically stable" democracy disintegrated. A group of disgruntled military officers—motivated by what they saw as incompetent leadership in combating a long-simmering Tuareg insurgency in Mali's north—initiated a coup d'état against President Amadou Toumani Touré's Bamako-based democratic government. In the pandemonium that ensued, the Tuareg insurgents, who were affiliated with radical Islamic militants, pressed their advantage and captured a region the size of France in northern Mali. In the year since the coup, the situation deteriorated as the al-Qa'ida-linked Ansar Dine consolidated its power. In January 2013, a French-led international force intervened to support the Malian Government and succeeded in reclaiming the north's most populous areas. However, given the continued resistance of some militants in some areas and the tension that continues to persist between the Tuareg nationalists in the north and the Bamako-based government in the south, a return to relative stability is far from guaranteed.

Multiple explanations have been offered to account for why a country widely regarded as well-governed and stable disintegrated so quickly. An influx of heavily armed Tuaregs into Mali's north following the fall of Muammar al-Qaddafi in Libya as well as the March 2012 military coup contributed to Mali's collapse, but it has also become apparent that Mali's 20-year-old democracy was far more fragile than most Western donors and experts believed. Years of incompetent governance by Touré's democratic regime, which was strongly backed by international aid donors, almost certainly played a central role in facilitating the conditions that led to the

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government's abrupt demise and the division of the country in two.

In this paper, I assess why Mali's precipitous slide into political instability caught many in the international community by surprise. In addition, I show how widespread misperceptions of Mali's political integrity, quality of governance and the role that the international community itself was playing in Mali likely contributed to Mali's collapse. Other scholars have focused on the role of foreign aid in Mali's collapse (Van de Walle 2012) as well as the United States government's maladroit counterterrorism policy towards the region (Kisangani 2012; Archer and Popovic 2007). Yet no one has explicitly examined why so many outside observers overestimated Mali's political stability or traced how misguided assumptions about the politics of Mali and other emerging democracies led to flawed policy outcomes.

This paper proceeds as follows. First, I provide some background by discussing the role that poor governance played in precipitating the coup in Mali. Second, I examine the general logic applied by aid donors and discuss why the international community found it reasonable to assume Mali was relatively stable despite some indicators to the contrary. Third, I examine three flaws in the international community's logic by applying recent findings in aid effectiveness and democratization literature to the situation in Mali. In particular, I examine three commonly held assumptions – that democracy is associated with peace, that foreign aid has little effect on governance, and that foreign aid is an appropriate response to insurgency – to demonstrate how the international community's lack of understanding of Mali's political context may have contributed to the crisis. In the final section, I suggest several policy recommendations for international policymakers aimed at minimizing political risks to emerging democracies. These include making democratic governance initiatives a central component of all aid, increasing financial oversight of funds disbursed to recipients of foreign aid, and conducting a comprehensive review of U.S. counterterrorism policy toward the region to address the fundamental political drivers of the Tuareg insurgency.

## **BACKGROUND AND CONTEXT: A CRISIS OF GOVERNANCE**

There is widespread consensus that both the influx of heavily armed Tuaregs into northern Mali in late 2011 and the military coup in March 2012 each played immediate, proximate roles in fomenting Mali's crisis, which I refer to throughout this paper as the collapse of Mali's democratically elected government and the take-over of the country's north by

armed insurgents. As Libyan strongman Muammar al-Qaddafi's regime fell, several thousand heavily armed Tuaregs formerly allied with Qaddafi made their way into Mali to support their co-ethnics in a longstanding struggle for independence, which has simmered for decades across much of the region (Allen et al 2012).<sup>1</sup> Unlike its neighbor Niger, which faces a similarly restive Tuareg population, the Malian government did not disarm the Tuareg as they re-entered the country, and, in October 2011, they formed the National Movement for the Liberation of Azawad (MNLA; in French, *Movement National Pour La Liberation de l'Azawad*), one of the rebellion's key instigators. Already struggling to maintain law and order over the vast north, "Mali's ill-equipped, poorly trained government soldiers were no match for the battle-hardened Tuareg (Zoubir 2012)." The flow of experienced militants and weapons into Mali clearly helped instigate the rebellion.

Figure 1: Map of Mali and Historically Tuareg Areas



Source: Allen, Alikinoff, Godfrey, McDougall, Ramey, and Ross 2012

There is also little doubt that Mali's ill-timed military coup allowed the Tuareg rebels to conquer close to two-thirds of Mali's territory, including Northern Mali's three key cities. As confusion spread in Bamako in the days immediately following the coup, the MNLA seized an opportunity

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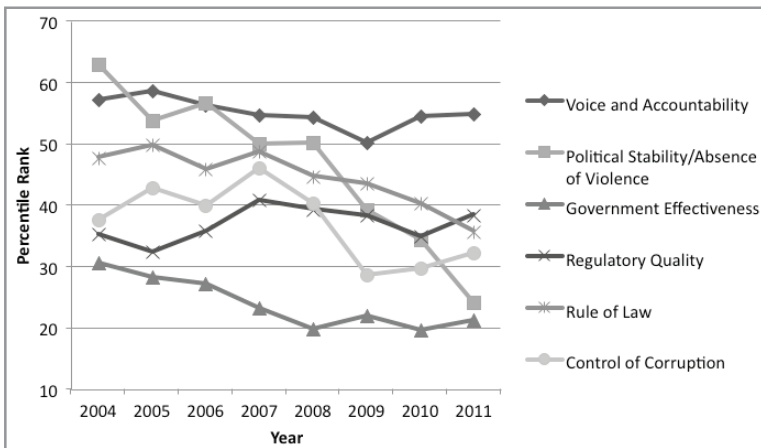
to advance south and occupy positions abandoned by government forces (Lewis and Diarra 2012). While the international community condemned the coup, insisted on the re-instatement of Mali's democratically elected government, and imposed sanctions on Mali's coup leaders, the MNLA, supported by the al-Qa'ida-affiliated Ansar Dine, advanced and captured the northern cities of Kidal, Gao, and Timbuktu on three consecutive days between March 30<sup>th</sup> and April 1<sup>st</sup>. By the time the coup leaders agreed to transition power on April 6<sup>th</sup>, control of Mali's north had been lost to the MNLA.

Beneath these two proximate causes, however, Mali's incompetent management of the Tuareg rebellion and deeper governance issues festered as contextual, symptomatic drivers of the crisis. Since 2005, Mali received at least \$60 million in funds from the \$700 million Trans-Saharan Counterterrorism Partnership (TSCTP), the U.S.'s signature counterterrorism program in the region, earmarked for the purpose of combating extremism in Mali's north.<sup>2</sup> However, Mali's corrupt armed forces, where officers often skim off their soldiers' ammunition and salaries, never seriously engaged al-Qa'ida in the North (Whitehouse 2012). Mali's mismanagement of its Armed Forces was just one symptom of a broader governmental malaise that had fallen over Mali in the years prior to the coup. Bruce Whitehouse observed that the coup leaders "could never have hoped to overthrow Touré ... had the country's core institutions – the policy, the courts, and the electoral process – been sound" (2012). In addition to mishandling the Malian Army, Touré has been accused of presiding over the embezzlement of donor funds to fight malaria and AIDS, subtly rigging both the 2002 and 2007 presidential elections, and contributing to a general breakdown of law and order such that vigilantes' revived an old practice of taking accused thieves, dousing them with petrol, and burning them alive (Whitehouse 2012).

Since at least 2007, the Malian government became increasingly corrupt and ineffectual, resulting in a widespread loss of public legitimacy. The World Bank's World Governance Indicators, which attempt to objectively measure varying aspects of governance drawing on a variety of independent sources, paint a picture of stagnation or decline throughout Touré's Mali in all but one indicator group: Voice and Accountability. By 2011, Rule of Law, Government Effectiveness, and Control of Corruption all declined by about a third from their highs during the previous decade; Political Stability declined by more than half (Figure 2; Kaufman et al. 2011). Available public opinion polls captured public sentiment with regard to the Malian government's decline. A public opinion survey conducted in 2008 showed

that while close to 60 percent of the Malian public disapproved of their government's handling of corruption and three-quarters believed that the government's economic policies had hurt most people, President Touré nevertheless retained majority approval ratings (Afrobarometer 2008). Yet in May 2012, another public opinion poll of Bamako residents revealed that more than half of all respondents blamed the Touré government for the loss of the North, and that, in contrast to international sentiment, close to two-thirds supported Mali's coup leaders (Guindo 2012).

**Figure 2: Mali's Percentile Rank In World Bank's Governance Indicators, 2004-2011**



Source: World Bank World Governance Indicators

### *The donor perspective*

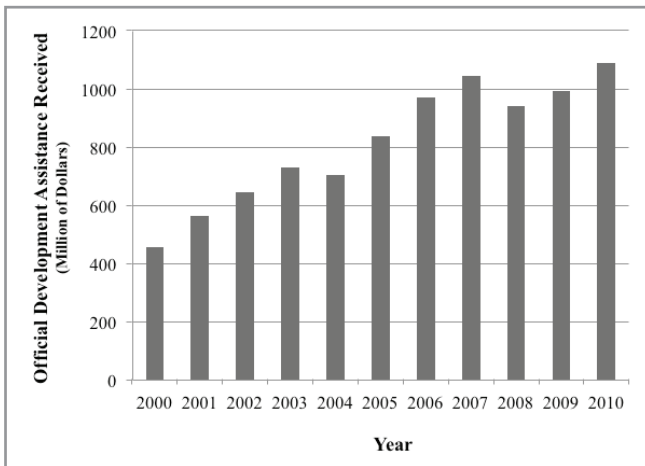
Given the importance that the international community typically places in promoting democratic governance, it is difficult to account for why so many Malians have rejected the country's democratic institutions in support of the coup leaders. To explain this disconnect, I examine why international aid donors maintained faith in a regime that was clearly viewed with increasing acrimony among Malian partisans. I focus here on aid because aid from international donors constitutes around 12 percent of Mali's GDP, was a central element of the U.S. strategy to combat criminality and terrorism in Mali's north, and thus probably constitutes the international community's principal interaction with Mali prior to the coup.

First, I examine the logic of what is perhaps the dominant theory among

scholars and practitioners of international aid: the theory of aid selectivity. In the late 1990s, a study by economists Craig Burnside and David Dollar found that aid was far more effective in generating economic growth when given to governments with good fiscal, monetary, and trade policies (Burnside and Dollar 2000). In light of these findings, many donors began to shift their aid allocations to poor countries that were also considered to be well governed. Donors such as the World Bank now allocate aid based on the two central criteria of poverty and governance, giving preferential treatment to poor but well-governed countries (Collier 2004). The standard assumption is that aid given to such states is most effective at reducing poverty and increasing economic growth.

Under these criteria, Mali, one of the poorest democracies on earth, quickly became an attractive candidate for international aid. Figure 3 shows that foreign aid to Mali rose from about \$500 million inflation-adjusted dollars in 2000 to almost \$1.1 billion by 2010. Further evidence of Mali's attractiveness as a candidate for international aid include its high aid/GDP ratio and its early selection for a compact with the United States Millennium Challenge Corporation, which explicitly bases its selection criteria on countries who are poor and well governed.

**Figure 3: Mali's Net Official Development Assistance and Official Aid Received, 2000-2010**



Source: World Bank Databank; Figures in Constant 2010 USD

Perhaps in large part due to its democratic institutions, Mali's relative deterioration in governance over the course of the Touré presidency is

belied by the fact that, compared to many peers in its region and income group, Mali's institutions still appeared relatively robust. Rule of Law and Regulatory Quality remained at or above regional averages and within standard errors of previous years laid out by the World Governance Indicator methodologies, and the decline in Government Effectiveness was marked but also within the standard error (World Governance Indicators 2012). Mali's continued strong performance in Voice and Accountability, as a result of its free press and vibrant community of NGOs, certainly gave the impression of a country acceptably committed to governing openly and effectively to warrant donor attention. Under these conditions, the moderate declines in certain areas of governance were easily dismissed by donors vested in Mali's growth and democratic success.

Secondly, there is the fact that, at least outwardly, the efforts of Mali's donors seemed to be paying off. The core objective of most development assistance is to reduce poverty and to increase economic growth. By both of these standards Mali seemed to be a success. As mentioned earlier, Mali's 5 percent growth rate made it one of the fastest growing countries in the region, although economists have speculated that much of Mali's economic growth has been driven by the devaluation of the West African Franc and the rise in gold exports (Van de Walle 2012). From 2000 to 2010, gross primary school enrollment increased from 55 percent to 80 percent and life expectancy increased from 47 to 51 years; the percentage of the population in poverty declined from 56 percent in 2001 to 44 percent in 2010 (World Bank 2012; ELIM Survey 2010). These gains are at least partially attributable to international aid. Declines in some governance indicators during the past decade, while worrying, did not appear to merit serious cause for concern among donors because Mali's overall governing performance relative to its peers in the region remained acceptable and its economic performance strong.

The collapse of Mali's government despite maintaining stable economic growth and consistent reductions in poverty poses a challenging paradox that is difficult to easily explain. A close examination of the scholarly literature reveals the relationship between democracy, foreign aid, governance and political stability is complex and at times conflictual. Recent scholarship in particular suggests ways in which the Malian government could have been simultaneously effective at reducing poverty as well as corrupt, illegitimate, and unstable. Here, the general literature is backed by ample scholarship concerning Mali itself.

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## THE FLAWS IN DONOR LOGIC: APPLYING THEORIES OF DEMOCRACY, POLITICAL VIOLENCE, AND FOREIGN AID TO MALI'S COLLAPSE

In this section, I apply recent scholarly findings regarding the relationship between democracy, foreign aid, governance, and political violence to explain why donors' assumptions about Mali were misguided and show how these assumptions may have led the international community to miss opportunities to prevent or mitigate Mali's collapse. First, despite the widely held belief that democracy is an inherently peaceful form of government, recent scholarship shows that democratization in poor, weakly governed countries tends to be destabilizing. Second, while it is commonly understood that aid has little relationship to governance, empirical research is starting to show that while aid may exert little *net* effect on overall governance, aid can have strong effects in both positive and negative directions; these effects are particularly marked in aid-dependent countries such as Mali. Finally, while there is very little research about the effectiveness of aid in ungoverned, contested spaces such as Mali's north, the aid that was given as part of the TSCTP was clearly inappropriate to the task of addressing deep regional grievances, which demanded a primarily political solution.

### *Democratic peace theory and Mali's unstable democratization process*

One of the United States' fundamental national security goals is the promotion of democracy; the White House's 2010 National Security Strategy maintains that governments who embrace democratic values are "more just, peaceful, and secure" (White House 2010). Even as of December 2012, the State Department's background note on the U.S. relationship with Mali praised the country for having a "stable, democratic" government prior to the coup and stated that its core goal prior to the crisis was "based on shared goals of strengthening democracy and reducing poverty through economic growth." The idea that democracies are more peaceful and secure than non-democracies originates with Immanuel Kant (1795), who argued in *Perpetual Peace* that it was possible to escape from war via the creation of a league of free, democratic states. Democratic peace theory, as it has come to be called, became a mainstream theory in the social sciences in the 1970s and the early 1980s. To date, there is not a single clear-cut case where constitutionally secure liberal democracies have gone to war with one another (Doyle 1983a), and robust correlations between democracy and peacefulness have held up in spite of numerous



challenges (Oneal and Russett 1999; Moaz 1998). The scholarly debate has since moved towards debating the reasons for democratic peace as opposed to its existence.

Although these findings have led the United States and its allies to relentlessly promote democracy in all guises and by essentially whatever means, recent scholarship shows the democratic peace theory comes with two significant caveats: it appears only to apply to mature democracies, and it only deals with war *between* as opposed to *within* states. With regards to the former, political scientists Edward Mansfield and Jack Snyder find that states undergoing transition to democracies are more likely to go to war with other non-democratic states before democratic institutions are fully established, which sparked a wave of additional research (Mansfield and Snyder 1995; 2005). With regards to the latter, few have argued that poor and young democracies are less prone to internal conflict; one need only look at the United States' own troubled path to democracy to understand that the unfortunate reality is that transitions to mature democracy take place only haltingly and over long periods of time. Paul Collier and Dominic Rohmer find that, below an income threshold of USD 2750 per capita, democracy makes developing countries more prone to many forms of political violence, including rebellion (2008).

While Mali was at relative peace with neighboring countries, Mali's lack of fully developed democratic institutions and GDP per capita of just USD 650 both theoretically and practically put the country at elevated risk for political violence. The vast majority of Mali's donors were sanguine about Mali's prospects, but there was also considerable angst in some quarters about the ongoing violence in Mali's north, particularly during Touré's second term. While USAID was praising Mali's central government for its enlightened leadership, the State Department had issued travel restrictions due to concerns about banditry and kidnapping in Mali's north as far back as 2007. By the mid-2000s, the government could claim little sovereignty over its territory in Mali's north (Van de Walle 2012), and attempts to adequately cope with northern lawlessness were hampered by the Malian state's fragility (Sidibe 2012).

Although Mali may have been on a democratic path, the relative youth of its democratic institutions and its extreme poverty meant that Mali was at substantial risk for political violence. Donors were right to praise some of Mali's democratic gains, yet they were wrong to regard Mali as among Africa's most stable countries.

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### *Aid and governance in Mali's aid-dependent regime*

Secondly, few scholars and fewer practitioners appreciated the complex interaction between foreign aid and governance in Mali's largely aid-dependent political system, which means there has been little examination of the role that foreign aid may have played in Mali's collapse.<sup>3</sup> Broadly, this is because most research finds little *prima facie* evidence for any direct relationship between aid and governance. In their study, Burnside and Dollar find no systematic relationship between aid and recipient country policies, although they find ample evidence that policy influences the effectiveness of aid (2000). Collier and Dollar likewise note that donors tend to exaggerate their influence over policy (2004).

Yet the literature also points to many particular situations in which aid may affect the policies of recipient nations. Collier and Dollar describe both a substitution effect, whereby governments agree to reforms in exchange for more aid, and an income effect, whereby the more aid a government receives, the less likely a government is to implement politically costly reforms, to illustrate that in fact causality can flow in multiple directions and is often case dependent (2004). Therefore, while aid might have no net effect on overall governance, it may have marked *conditional* effects on certain elements of governance and certain types of governments. Scholars are just beginning to closely examine these effects and, importantly, trying to test distinct claims about *causal mechanisms* by which aid is linked to economic growth, governance, and other outcomes such as health and education (Wright and Winters 2010).

Several of these conditional effects—both positive and negative—are pertinent to the Malian case. On the positive side, Montinola (2010) finds that the substitution effect mentioned by Collier and Dollar is effective, but only in democracies. Her results here are specific to fiscal reform, which Dollar and Burnside (2000) find critical to aid effectiveness and highly correlated with economic growth. With regards to Mali, it is unclear to what extent aid “bought” reform, but it is certainly clear that Mali maintained solid fiscal, monetary, and trade policies. These policies were critical in helping Mali maintain strong economic growth.

Secondly, beyond being broadly useful as a tool for fiscal reform, recent studies show that aid intended to promote democracy is effective at doing so, especially among democratic regimes. Finkel et al. find clear and consistent impacts of USAID democracy assistance on democratization in recipient countries, with Elections, Civil Society, and Free Media campaigns exhibiting the largest impacts (2007). Dietrich and Wright similarly find that democracy aid has a positive effect on democratic consolidation, while economic aid has no effect (2012).

In his study of the role of foreign donors in the collapse of Mali's government, political scientist Nicolas Van de Walle finds strong evidence for the success of Mali's democratic governance programs. He finds the role of foreign aid in promoting the expansion of Mali's civil society incontrovertible, and "donor money directly encouraged the emergence of local associations" (2012). While direct foreign aid for the expansion and consolidation of Mali's democracy is small, such aid does appear to have been effective.

Yet aid can have pernicious effects on governance as well. A 2006 review finds that "states which raise a substantial portion of their revenues from the international community are less accountable to their citizens and under less pressure to maintain popular legitimacy" (Moss, Petterson and van de Walle 2006). Brautigam and Knack (2004) find that high levels of aid over long periods of time are correlated with deteriorations in governance and lower tax revenues as a share of GDP, advancing quantitatively long-held theories of aid dependency. They further find that the mechanisms by which such aid can undermine governance are manifold, including high transaction costs from aid fragmentation, competition for an aid-dependent government's low reserve of skilled workers, and the fostering of perverse incentives that create moral hazard problems for aid agencies.

In Mali, the political economy of foreign aid undermined governance in two critical ways: by weakening the integrity and authority of its institutions and by indirectly contributing to widespread public corruption and lack of accountability. Mali is a highly aid-dependent country that, depending on the year, receives between 80-100 percent of government expenditures in foreign aid (World Development Indicators 2012).<sup>4</sup> There is exhaustive qualitative evidence documenting the harmful effects of Mali's status as an aid dependent country. One high-ranking donor official I interviewed in 2007 admitted that the Malian government was in an extremely weak negotiating position relative to its donors, who were the primary drivers of Mali's development process (Allen 2008). Isaline Bergamaschi (2008) attributes the weakness of Mali's civil service sector to agreements with the IMF limiting the amount of the national budget going to public salaries. And according to Van de Walle, "a plethora of poorly coordinated donor-driven decision and policy-making mechanisms dominate and in some cases have largely replaced domestic governing institutions," exacerbating the Malian government's extremely weak capacity to independently plan and implement policy (2012).

This weakness in central government capacity lowers accountability and fosters perverse incentives which facilitate corruption. Bergamaschi

finds that Mali's strategy of compliance vis-à-vis its donors is actually quite deliberate and intended for political gain; one of her government informants observes "leaders in this country want assistance, not ownership because ownership means responsibility, transparency, accountability, and possibly even sanctions" (2008). Van de Walle (2012) bemoans the fact that foreign aid's focus on the executive branch has severely undermined its "horizontal accountability" to other branches of government as well as its citizens. In spite of some action by donors to combat corruption, such as suspending health aid after the health minister was implicated in embezzling funds from the Global Malaria Initiative, the corruption in Mali's public sector—much of which was financed by international aid money—remains deeply systematic and ingrained. Donors appeared to some extent aware of some of the direct and indirect negative effects of aid, but also felt little need to urgently redress them given the perception that Mali's overall trajectory appeared positive.

### *Mali's insurgent politics and the effectiveness of aid in contested spaces*

Finally, even donors who proactively combated the rebellion appear to have deeply misunderstood the insurgent politics in the north. In part, this is because policymakers attempting to bring stability to ungoverned spaces and contested regions are hampered by a lack of systematic research on the effectiveness of aid in ungoverned spaces or aid given during active conflicts. General studies of U.S. military aid, however, have broadly shown that it is not a useful tool in compelling the recipient state to comply with U.S. foreign policy objectives (Sullivan et al. 2011). Studies of development aid during periods of insurgency or civil war show mixed results; in Afghanistan, for example, a recent impact evaluation of Afghanistan's National Solidarity Program shows highly positive results (Beath et al. 2010), whereas other studies document how Western aid has fueled the insurgency in areas with little government control (U.S. House of Representatives 2010). John Speed Meyers and Todd Harrison note the lack of solid empirical research in the general area of "expeditionary economics" concerning the stabilization and reconstruction of societies during conflict, calling for the field to adopt more empirical methods, including randomized field experiments (Speed Meyers and Harrison 2012).

In Mali, the United States TSCTP initiative failed to increase the capacity of the Army to better control its territories or bring stability to the north. Kisangani (2012) notes that the performance of Malian soldiers actually declined since the TSCTP was expanded in 2005, and Todd Moss

observes “Mali’s army was losing badly to Tuareg rebels prior to the coup and then nearly crumbled overnight” (2012). The *New York Times* recently reported in January 2013 that the coup leaders were trained by U.S. forces, and many of the U.S.- trained Malian forces defected in the heat of the conflict. Moss, a former Deputy Assistant Secretary for African Affairs at the U.S. Department of State, has called for a fundamental revisiting of the U.S. approach to counterterrorism cooperation.

The TSCTP claims to be an initiative with broad goals beyond combating terrorism, including “promoting democratic governance” and “enhancing and institutionalizing cooperation among the region’s security forces” (U.S. Africa Command 2012). Yet aid to Mali’s north was mostly “too little and too late” (Kisangani 2012), hampered considerably by concerns for the safety and security of Western aid workers. A mid-term evaluation conducted by USAID in 2011 of its component of the TSCTP noted that in spite of limited success in changing the attitudes of program beneficiaries towards extremism, TSCTP was unlikely to achieve its goals if present trends continued due to the fact that extremist elements enjoyed “a complicit population in an increasingly ungoverned space.” Efforts by donors to provide assistance through the Malian government also failed, with a donor-funded northern development agency being deployed by authorities in Bamako primarily as a vehicle for the clientistic co-optation of northern elites (Management Systems International [2009] in Van de Walle 2012).

Fundamentally, the failure of the U.S.-led counterterrorism policy towards Mali was because Western donors failed to understand the nationalist nature of insurgent politics in the county’s north. In spite of the initiative’s broad rhetoric, analysts have noted the TSCTP’s strict focus on non-state actors in the area rather than on the activities of the states themselves that comprise the region; these same states have “readily accepted U.S. offers of military assistance, often with motives other than assisting in the ill-defined struggle against global terrorism” (Archer and Popovic 2007). The TSCTP appears to have largely ignored much deeper, more widespread and older grievances driven by Tuareg demands for regional and cultural autonomy (Kisangani 2012); it is largely as a result of these grievances that the Tuareg nationalists chose to resort to arms in the first place and tactically ally themselves with al-Qa’ida- affiliated extremist militants.

Certainly, the Tuareg did themselves no favors by agreeing to such a relationship, particularly now that it appears that the Ansar Dine and other extremist militant groups manipulated nationalist sentiments to-

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wards their own ends of attempting to create an unpopular and largely illegitimate Islamist state. Yet with the region becoming untenable for Western aid workers in recent years, it seems likely in retrospect that only a political solution administered by the government in Bamako could have adequately addressed nationalist concerns. It appears that in its desire to be seen as cooperating with the Malian government in combating terrorism, U.S. policy makers overlooked or ignored the Malian government's own contribution to the region's conflict via a history of neglect, apathy, and racism towards Mali's marginalized Tuareg populations.

## CONCLUSIONS AND RECOMMENDATIONS

The crisis in Mali indicates that the international community, and in particular Mali's international aid donors, deeply misunderstood the local political context in which they were working. In hindsight it is clear that Mali's consolidation of procedural democracy, declining poverty, and robust economic growth existed concurrently with a weak central government, rampant corruption, and an increasingly untenable security situation in the north. As stated by Van de Walle (2012), the central blame for Mali's present predicament rests with the Malian government, but the international community, given its strong financial, moral, and rhetorical support of the Malian government, is also culpable to varying degrees for the crisis. Foreign aid may have helped to strengthen Malian civil society, decrease poverty, and increase economic growth, yet it also appears to have played a role in Mali's destabilization by weakening the integrity of Mali's institutions and indirectly sanctioning a lack of accountability and corruption in Mali's executive branch.

For scholars, the key lesson to emerge from the Mali crisis is that much more research is needed to elucidate the specific causal pathways between foreign aid and governance, particularly in weakly governed spaces and in the middle of low-to-medium intensity conflict. While studies of the overall effect of aid on governance do show a relatively benign relationship, it is becoming evident that this is because the interaction between aid and governance is complex and that aid has a variety of effects in both *positive* and *negative* directions. The focus of empirical research going forward needs to reflect a more nuanced approach, focusing on the conditional effects of various types of aid, policy characteristics, regime types, and stages of development.

It is also incumbent upon donors to better mitigate the political risks of foreign aid, regardless of to what extent foreign aid reduces poverty or raises economic growth. This is particularly true of aid given to weakly

governed and conflict-prone countries – and especially, if Mali is any indication—to emerging democracies. It is becoming clear that aid can have quite pernicious effects on governance, some of which are known, some of which probably are not, and many of which require further research to confirm more definitively. The fact that aid appears to have positive effects on governance in some situations does not absolve donors from doing what they can to reduce potentially harmful effects.

Several policy recommendations emerge from this analysis. First, institutional capacity building must be made a central theme of international engagement with nations in the process of democratic transitions. Just as important as the aid specifically intended for institution building is understanding the importance of *aid politics*, which, if not managed carefully, might actually do more to harm governing institutions than to help them. To mitigate both qualitatively and quantitatively documented impacts of aid dependence, donors should:

- *Significantly expand democracy assistance to emerging democracies.* As mentioned by Van de Walle (2012), democracy assistance seems to have been an unequivocally positive influence in Mali and should be expanded to focus on strengthening horizontal accountability mechanisms such as the courts and the legislature. It is important to note here that such initiatives depend on the compliance of emerging democracies themselves, which is why they might not be broadly applicable outside of democratic contexts.
- *Make democratic governance a core component of all multilateral and bilateral aid.* As also recommended by Van de Walle (2012), rather than being seen as a sector-specific, separate development activity, democratic governance needs to become a core theme of all development assistance to emerging democracies. This exercise should at least force donors to attempt to confront and mitigate the risks of aid programs that have the potential to undermine recipient government institutions.
- *Insist on the toughest possible financial oversight of aid given by donors to recipient governments.* If recipient governments lack financial oversight capacity, then such capacity should be structured into the aid disbursements themselves. Donors could also consider cash on delivery or increasing budget support provided certain oversight-related benchmarks are met. A lack of sufficient financial control should be recognized as a strong disincentive to lend money to recipient governments; in such cases, donors might consider channeling aid through other organizations and institutions.

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- *Create incentives for recipient governments to increase their tax revenue base.* Donors might consider offering in-kind aid contributions or conditioning aid based on government progress in expanding its tax-revenue base. A key feature of aid dependent countries is that much or most of their public spending is financed by aid, which in turn reduces government incentives to generate tax revenue and makes the government less accountable. Donors must make increasing recipient ownership tax-revenue generation capacity a central part of their aid programs.

Secondly, the U.S. strategy to combat terrorism in Mali appears to have been too narrow and ill equipped to address the deep-seeded political drivers of the conflict. Instead of helping to combat terrorism and decrease violent extremism in Mali's north, the U.S. government appears to have inadvertently empowered elements of Mali's military which subsequently ousted its civilian leadership and defected to insurgents. Given the leverage of Mali's donors, it at least seems plausible that the international community, working in concert with regional organizations, could have done much more. The international community might have positively influenced the Malian government by:

- *Making some counterterrorism/development aid conditional on Mali fulfilling its development and treaty commitments to the north.* Much of the conflict in the north is driven by a centuries-old distrust that certain Tuareg have of the Malian government, which has consistently failed to deliver on its promises to develop the north. Notwithstanding the deep tensions that exist between Mali's northern and southern populations and even within the north itself, donors might have more effectively used their aid money to pressure the Malian government into treating marginalized Tuareg groups more fairly.
- *Separating the moderates from the extremists.* In working with the Malian government to combat terrorism in the north, the United States appeared (possibly inadvertently) to have chosen sides in a long-simmering ethnic conflict. By recognizing the legitimate demands of the more moderate Tuareg elements while strongly discouraging extremism and violence, the international community might have been viewed as a more honest broker.<sup>5</sup>

Finally, the failure of the U.S. government's counterterrorism training in Mali also calls into question the U.S. Department of Defense's larger emphasis on building partner military capacity across the rest of the world, particularly as the war in Afghanistan winds down. It is not clear to what extent the Malian case may be broadly generalized, but at the very least it suggests that the Department of Defense might want to think twice about



investing heavily in building up the military capacities of fragile states. On a broader level, the United States should:

- *Conduct a comprehensive review of the U.S.'s counterterrorism policy towards the Sahelian region.* At the very least, it is clear that the Trans-Sahel-Counterterrorism Partnership needs to be heavily modified or revamped to better integrate with other U.S. foreign policy objectives. The reasons behind the Malian army's poor performance against the Tuaregs in spite of substantial U.S. assistance also need a thorough accounting.
- *Have the President or Congress direct relevant bureaucracies to prepare a lessons-learned report from Mali.* The purpose of such a report should be to assist U.S. policy makers in preventing similar crises, which remain a significant possibility in the aftermath of the Arab Spring and continued unrest in the Sahel.

The international community is neither omniscient nor omnipotent, and, again, it is possible that in reality very little could have been done to avert Mali's crisis. Nevertheless, had the donor community been more aware of the political risks inherent in young, impoverished democracies, donors may have been able to exercise more leverage than they did to cope with the urgency of the situation. While Mali appeared to be a relatively successful case of democratic development, the international community, and in particular aid donors, were wrong to ignore the popular discontent and excess that plagued the final years of the regime of Amadou Toumani Touré. The sudden collapse of the Malian regime, after years of slow deterioration, should serve to remind the international community that the politics of poor democracies are as just as important as their economics, and donors ignore the political implications of their support at their own peril.

## NOTES

<sup>1</sup> The Tuareg are a specific community of Berber peoples who have historically inhabited much of the semi-arid Sahel and the Saharan desert throughout Northern and Western Africa. The Tuaregs are the principle ethnic group in the northern, desert regions of Mali and similarly large portions of the population in Niger and Algeria.

<sup>2</sup> Gwin (2012) puts the amount of U.S. counterterrorism assistance to Mali at \$1 billion, which could either represent unofficial funding or the total amount given to the general region

- <sup>3</sup> Nicolas Van de Walle's "Foreign Aid in Dangerous Places: the Donors in Mali's Democracy" (2012), which has been previously cited in this paper, is an important exception; he does conclude that international donors could have done more in various ways to prevent Mali's collapse.
- <sup>4</sup> There is an important caveat to be made here in noting that, although Mali may receive 80-100 percent of the amount its government spends in foreign aid every year, not all of this aid goes to directly to government spending. Bergamaschi (2008) states that between 1996 and 2005, aid made up an average of three quarters of Mali's investment special budget and 27.6 percent of the general government budget.
- <sup>5</sup> It appears that the international community may have realized this lesson in hindsight given their willingness to work with the MNLA to take back the country's north from the Islamic extremists.

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## FEDERAL STIMULUS IN TEXAS: A CASE STUDY IN UNIFIED GOVERNMENT AND ADVERSARIAL FEDERALISM

*Ezra Levin*

Can a unified federal government ensure that federal funds are used as intended within states? In addressing this question, this paper expands on existing literature with a case study on federal stimulus funds in Texas that illustrates the adversarial relationship that can characterize modern interactions between politically polarized state and federal governments. These dynamics are shown to be the product of long-term political trends that have produced an ever-growing number of increasingly polarized states that are opposed to federal policy agendas. Furthermore, in contrast with the popular image of weak states and a powerful federal government, the case study reveals two well-matched adversaries, each with political goals and tools they manipulate to achieve those goals. The paper concludes with federal policy prescriptions for achieving local policy objectives in this environment.

### INTRODUCTION

Can a unified federal government ensure that federal funds are used as

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*Ezra Levin is a 2013 graduate of the Master in Public Affairs program at Princeton University's Woodrow Wilson School of Public and International Affairs, where he focused on domestic poverty and economic mobility. He can be reached at [elevin@cfed.org](mailto:elevin@cfed.org).*

intended within states? In answering this question, this paper reviews the academic literature on unified government and federalism; expands on this literature with a case study that illustrates the adversarial relationship that can characterize modern state-federal relations; explores how these state-federal dynamics have grown out of decades-long political trends; and concludes with policy prescriptions that adapt to this state of adversarial federalism.

Two significant political developments over the past forty years have greatly affected the answer to the question posed above. The first is the federal government's growing reliance on flexible grants to states in order to implement a diverse array of policies. As Figure 2 in this paper shows, federal grants to state and local governments increased more than 330 percent between 1970 and 2011, from \$123.7 billion to \$532.7 billion. The second development is the increasing political polarization at both the state and federal level, which has driven state-level partisans farther apart ideologically from opposing federal-level partisans.

In the last forty years, since the early developments of these two trends, six short periods of unified federal government have punctuated longer periods of split federal government. While these unified periods may represent brief opportunities for the majority party to enact new federal grants, federal enactment is only the first step in a multistep process in which states play a crucial part. Much research has explored the role of state-federal relations in the administration of federal grants, but there is little literature on the effect of growing political polarization on these relations. This paper examines the current state of federalism by focusing on the administration of two federal stimulus grants in Texas during President Obama's period of unified government from 2009 to 2011.

The case study illustrates the adversarial nature that can characterize state-federal relations. While elements of the case fit within the previously researched "Opportunistic Federalism" framework, the case contradicts descriptions in the literature of weak states, growing executive branch pre-eminence, and synergistic state-federal collaboration. The state is revealed to be a worthy adversary of an active Congress, an adversary that twice defeats federal attempts to ensure funds are used for federally intended purposes.

Examining historical data, Texas appears not as an outlier, but rather as the most recent product of a forty-year trend: a steadily growing number of increasingly polarized states controlled by a party opposed to the unified federal government's party (e.g. unified Republican state governments during periods of unified Democratic federal governments). While these "adversarial states" have grown in number, congressional members from

these states who belong to the federal majority party have also multiplied. These “embattled members,” isolated ideologically from their home-state governments, are sensitive to local interests but opposed to empowering their adversarial state governments.

The Texas case presents an example of embattled members attempting to assert control and of the state’s effective, adversarial response. The case suggests that even state-level, tailored legislative language is inadequate to ensure federal funds are administered within states that have divergent policy priorities.

The paper concludes with reflections on possible policy prescriptions. Future federal lawmakers interested in translating lofty vision into local policy change may increasingly turn to strategies that eschew flexible state administration, that empower localities, or that require state policy action as a prerequisite for eligibility.

## LITERATURE REVIEW: UNIFIED GOVERNMENT AND STATE-FEDERAL RELATIONS

In 1992, Fiorina concluded in the *Political Science Quarterly* that “we seem to have settled into a persistent pattern of divided government” (Fiorina 1992). But months later, elections broke Fiorina’s pattern and produced a unified Democratic government. As *Figure 1* shows, six of the past eighteen congresses have been unified with a president of the majority party. While divided government may be the norm, unified federal governments occur regularly.

**Figure 1: Unified and Divided Government since Carter**

Year	Congress	President’s Party	House	Senate	Government
1977	95th	D (Carter)	D+149	D+24	D-Unified
1979	96th	D (Carter)	D+119	D+18	D-Unified
1981	97th	R (Reagan)	D+51	R+6	Divided
1983	98th	R (Reagan)	D+103	R+8	Divided
1985	99th	R (Reagan)	D+71	R+6	Divided
1987	100th	R (Reagan)	D+81	D+10	Divided
1989	101st	R (Bush)	D+85	D+10	Divided
1991	102d	R (Bush)	D+101	D+12	Divided
1993	103d	D (Clinton)	D+83	D+14	D-Unified
1995	104th	D (Clinton)	R+27	R+4	Divided



Year	Congress	President's Party	House	Senate	Government
1997	105th	D (Clinton)	R+21	R+10	Divided
1999	106th	D (Clinton)	R+13	R+10	Divided
2001	107th	R (Bush)	R+11	R+0	Divided*
2003	108th	R (Bush)	R+26	R+2	R-Unified
2005	109th	R (Bush)	R+31	R+10	R-Unified
2007	110th	R (Bush)	D+31	D+2	Divided
2009	111th	D (Obama)	D+78	D+18	D-Unified
2011	112th	D (Obama)	R+49	D+6	Divided

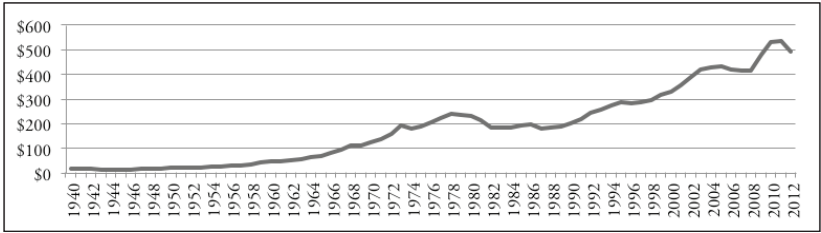
*Source: Compiled using data from the 1979 and 2012 Statistical Abstract of the United States. Members not formally belonging to the Republican or Democratic parties were categorized according to the party with which they caucused.*

*\*The 107th Congress became a split-government period following Senator Jim Jeffords' defection from the Republican Party in June 2001.*

While unified government may increase the majority party's ability to enact its agenda at the federal level<sup>1</sup>, the American system of federalism does not provide the federal government dictatorial power in implementing its agenda within states. And much has changed since President Madison vetoed a public works bill, stating, "the permanent success of the Constitution depends on a definite partition of powers between the General and the State Governments" (Madison and Ketcham 2006). In the 20<sup>th</sup> Century, state and federal government responsibilities became closely intertwined.

*Figure 2* shows that federal grants to state and local governments have increased precipitously since 1940. Between 1970 and the peak in 2011, these grants increased by more than 330 percent, from \$123.7 billion to \$532.7 billion. State governments now spend roughly 41 percent of their budgets on education, 22 percent on healthcare, 8 percent on transportation, and the remainder on corrections, public assistance, and other programs (Sigritz 2010). More than a third of the funding for these programs, \$411 billion, comes from the federal government (Sigritz 2010).

**Figure 2: Growth in Federal Grants to States and Local Governments Since 1940**



*Note: Years are federal fiscal years and amounts are in billions (constant 2005 dollars).*

*Source: Compiled using data from Office of Management and Budget's Budget of the U.S. government, fiscal year 2012, historical tables.*

With Madison's definite partition all but eliminated, the federal government now depends on the state to administer federal funds. In a seminal work in 1970, Martha Derthick describes a federal-grants system in which "the state government becomes, for the purposes of the grant program, a federal agent, and the federal government accordingly seeks to ensure that it will spend funds solely for federally approved purpose." The system, she writes, "entails the achievement of federal purposes by proxy" (Derthick 1970).

But the state is not a perfect proxy. States have different policy priorities, and in Derthick's case study of Massachusetts' welfare program, "federal conditions conspicuously fail to cover the questions of major substantive importance" (Derthick 1970). This lack of federal specificity, she argues, is necessary both to avoid highlighting differences in values within the federal government and also to ensure that states do not reject funds that come with burdensome requirements (Derthick 1970). And so, federal legislative language on grants to states is often vague, allowing states a great deal of administrative flexibility.

Flexibility, however, does not mean complete freedom. The federal government maintains some amount of power to ensure funds are administered as intended. While the main formal tool of compliance— withholding federal funds from states—is of limited direct use, this power "is in fact one of the major resources of federal influence... It lies at the foundation, as a weapon in reserve, of all federal enforcement activity" (Derthick 1970). Enforcement of federal priorities within states thus becomes a "diplomatic process" in which the federal government tries "to obtain as much conformance as can be had without the actual withholding of funds" (Derthick 1970).

Developing this idea of intergovernmental bargaining, Bardach explores a number of “games” that state implementers of federal policies play during the implementation process (Bardach 1977). Among others, Bardach describes the “tenacity game,” in which implementers delay implementation until their own preferences can be satisfied, and the “resource diversion game,” in which implementers divert funds to other purposes.

A common cousin of the “resource diversion game” in state-federal relations is the “supplanting game,” in which states replace (i.e., supplant) their own funding for an activity with federal funds. For example, when a state receives new federal funding for education, the state may reduce its own level of funding for education simultaneously. Doing so allows the state to eliminate *additional* support for education while essentially converting federal education funds into unrestricted state funds for other policy priorities.

The supplanting game is not confined to education funds. The U.S. Government Accountability Office (GAO) reported that federal highway funds are widely used by states to reduce their own funding for highway projects (U.S. Government Accountability Office 2004). Similarly, states often play the supplanting game with Medicaid, the largest federal grant to states, in order to reduce state funding of healthcare services. The Urban Institute reported that “shifting services into Medicaid, states can get federal dollars to help pay for the services that previously had been financed just with state funds” (Coughlin and Zuckerman 2002).

A common federal response to supplanting is the Maintenance of Effort (MOE) provision. These provisions require grant recipients to maintain a certain level of funding in order to receive federal funds. The purpose is to prevent state government recipients from replacing their own funding for an activity with federal funds. The MOE provision is quite common in federal grant programs. The Congressional Research Service (CRS) reports that “an examination of grants-in-aid listed in the *Catalog of Federal Domestic Assistance* revealed that 33 federal grants to state and local governments have state spending [MOE] requirements” (Dilger and Boyd 2011). Notwithstanding these and other federal responses, states often have ways to get what they want, using “creative and often aggressive tactics” to supplant state funding with federal funds (Wintson and Castañeda 2007).

While negotiations over supplanting and other games can be contentious, Derthick concludes her analysis positively on the mutually beneficial relationship between federal and local governments. Conlan summarizes, “government is good at setting lofty policy goals and objectives, but federal officials lack the detailed local knowledge that often is necessary for effec-

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tive implementation” (Conlan 2010). According to Derthick, federal and state governments benefit from a relationship that allows vision, financing, and local expertise to come together to address “local and particular manifestations of nation-wide problems” (Derthick 1970).

Others have muddied this rosy picture of state-federal synergy, describing the transition of American federalism from good-faith cooperation to coercion, opportunism, and collaboration. Kincaid describes a late-1970s shift from fiscal-based intergovernmental cooperation to “coercive federalism,” which entails increased reliance on federal regulatory policy to coerce state policy action (Kincaid 1990). Conlan expands Kincaid’s “coercive federalism” into “opportunistic federalism,” which includes coercive elements as well as those that “are more seductive, dismissive, or co-optive than openly coercive” (Conlan 2006). Instead of opportunism or cooperation, McGuire focuses on an easier-to-meet standard, intergovernmental *collaboration*, which simply assumes that “governments are interdependent and that they need each other to successfully carry out particular policy-making and administrative functions” (McGuire 2006).

Whether the state-federal relationship is characterized by cooperation, collaboration, coerciveness, or opportunism, the literature remains somewhat mixed on who holds the power during state-federal negotiations. Kincaid argues that state governments “may not possess sufficient constitutional or political leverage” to resist coercive federal behavior (Kincaid 1990). In contrast, Conlan observes that state and local governments also practice opportunism “when they direct federal grants away from their intended purposes to serve strictly parochial ends” (Conlan 2006).

To the extent that the federal government does hold the power, Gais and Fossett argue that it is the executive branch, not Congress, which has played an increasingly dominant role in American federalism because federal administrators are better equipped to adroitly exert power during state-federal interactions (Gais and Fossett 2005). This analysis essentially extends Derthick’s analysis of Congress’ role in intergovernmental grants. She observes that because “Congress is highly sensitive to state and local interests...the [grant] terms it settles on are in important respects highly permissive ones” (Derthick 1970).

In summary, while scholars disagree on the precise current state of intergovernmental grants, there are a few common threads: the ability of the federal and state governments to coerce, cooperate, or collaborate their way to mutually beneficial implementation of federal grants; the importance of bargaining and negotiation to this process; the trend of increasing power in the hands of the federal government at the expense of state and

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local governments; and the growing preeminence of the executive branch, rather than Congress, in asserting this federal power.

## CASE STUDY PART I: 2009 ARRA STIMULUS AND TEXAS

Inheriting the grimmest national fiscal situation since the Great Depression and facing great demand to create jobs, President Obama's first priority was stimulating the economy. His response was to oversee the largest increase in federal grants in over forty years. Of the programs in his near \$1 trillion economic stimulus bill, the American Recovery and Reinvestment Act (ARRA), more than one-third were grants to states and local governments, "making the success of this broad initiative heavily dependent on effective intergovernmental implementation" (Conlan 2010).

Because of the administration's reliance on state governments to administer these grants, "it was in their interest to make sure that grants and contracts were spent expeditiously on activities that were beyond reproach" (Conlan and Posner 2011). One of the legislative tools employed to ensure that stimulus-funded activities were beyond reproach was the MOE provision. The single-largest grant to states in ARRA—the near \$40 billion education-focused State Fiscal Stabilization Fund (SFSF)<sup>2</sup>—required states to maintain their own education funding at fiscal year 2006 levels.

The program directed states to restore any cuts made to state support for education since 2006, restoring state education funding to the Fiscal Year 2008 or 2009 levels, whichever was greater. If, after restoring funding to recent highest levels, additional SFSF funds were still available, those funds were to be distributed to school districts based on the federal Title I formula, which targets low-income school districts.

While Conlan and Posner observe that some states facing budget shortfalls found the MOE requirement difficult to meet, they fail to note that other states were able to supplant state funding for education despite the MOE requirement. States with current funding of education significantly above 2006 levels viewed SFSF as an opportunity to reduce state support to 2006 levels, using SFSF funds to fill in the newly created shortfall. Doing so, they effectively converted the SFSF funds earmarked for education into state funds that could be used for any purpose. A September 2009 memorandum from the U.S. Department of Education's (ED) Office of Inspector General identified this problem. The memo is worth quoting at length:

*"Some States' budget proposals would reduce State support for public education back to the FY 2006 levels and replace the State*

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*funds with their SFSF allocation to free up State resources for non- education budget items...Although this reduction may be allowable under the law, it may adversely impact the achievement of the education reforms of the SFSF program” (U.S. Department of Education 2009).*

Indeed, describing the problem as limited to only “some states” may have understated the problem. A Columbia University review of 20 states’ use of SFSF funds found that “*all* of the states explicitly or implicitly ‘backfilled’” (Rebell et al. 2010). That is, *every* observed state exploited flexibility in the legislative language to reduce state funding in order to avoid distributing leftover SFSF funds to school districts by Title I formula.

Some states went further. Texas reduced state funding for education by the full amount of their SFSF grant, \$3.25 billion, the second largest such grant in the country. Doing so not only eliminated leftover SFSF funds, it effectively converted all Texas SFSF funds into newly freed state revenue that the unified conservative Texas government could use for any purpose, economically stimulative, progressive, or not. The state did so while maintaining a multi-billion dollar “Rainy Day Fund,” essentially a state savings account.

The 12-member Texas Democratic congressional delegation was vocal in responding to what they perceived to be inadequacy in the MOE provision. In a March 2009 letter to the U.S. Secretary of Education, the delegation requested assistance from the department and stated that “we believe the SFSF was not intended to allow Texas to maintain its Rainy Day Fund, but rather to immediately invest in our schools” (Texas Democratic Congressional Delegation 2009a). On April 16<sup>th</sup>, several Democratic Texas state senators sent a letter to the Secretary of Education as well, airing concerns that “the SFSF was used to supplant general [state] revenue...swapping out, dollar for dollar, state funds for federal funds” (Democratic Texas State Senators 2009). Also in April, the congressional delegation sent letters to the Texas Governor, Lieutenant Governor, and Speaker of the State House stating similar concerns that the state’s budget plan did “not comport with the intent of...ARRA” and that the funds “cannot supplant state funding for education, but rather must go towards increasing the support for local schools” (Texas Democratic Congressional Delegation 2009b).

But the delegation was incorrect—the legislative language did *not* prohibit states from supplanting state funding with ARRA funds, even if doing so would, as ED put it, “adversely impact the achievement of the education

reforms of the SFSF program.” The Texas delegation next attempted to change the legislative language by increasing the restrictions of the MOE requirement through amendment in May of 2009 (Doggett 2009). But the House failed to adopt the amendment.

The original MOE language remained law and Texas was able to proceed with its planned use of the funds. Representative Doggett, Chairman of the Texas Democratic Congressional delegation, would summarize the outcome on the House floor more than a year later: “When Texas received \$3.25 billion in education stimulus funds... [the state] played a shell game that left Texas schools not a dime better off than if no Federal aid had come in the first place” (Doggett 2011).

## **CASE STUDY PART II: 2010 EDUJOBS STIMULUS AND TEXAS**

As the economic recovery continued to lag, pressure mounted to delay or at least cushion the “funding cliff” caused by the exhaustion of SFSF and other ARRA funds. In April of 2010, Senator Harkin floated a \$23 billion Education Jobs Fund program (EduJobs) based on the SFSF program (Klein 2010). Opposition to deficit spending would eventually whittle the proposal down to \$10 billion, \$830 million of which would be earmarked by formula for Texas (U.S. Department of Education 2010a).

With the defeat over the \$3.25 billion in Texas SFSF funds fresh in their minds, the Texas Democratic congressional delegation came out opposed to any new program that failed to include a more stringent MOE provision for new Texas education funds. In July, the delegation released a press statement demanding that any new education job stimulus program include specific MOE language for the state of Texas to prevent “any further shell games with the federal education dollars at the expense of [Texas] schools.” Their MOE language, they noted, had been endorsed by “Texas statewide education organizations representing teachers, principals, school boards, school administrators, and nearly 40 superintendents” (Texas Democratic Congressional Delegation 2010).

In August of 2010, the Senate passed a version of the EduJobs bill with the Texas provision included, exactly as written by the Texas delegation. The Republican Texas Attorney General threatened a lawsuit if the Texas provision was enacted into law (Hamilton 2010). The EduJobs bill was in no danger of failing to pass the House—the final vote would be 247-161 in favor—but despite the threat of a lawsuit, the House maintained the Senate language and passed the bill, and President Obama signed it into law on August 10<sup>th</sup>.

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On August 13<sup>th</sup>, the ED released two applications for the EduJobs funds, one for Texas and one for all other states. The Texas application reflected the stricter MOE requirements for that state as required by the Texas delegation’s legislative language. On September 3<sup>rd</sup>, the Texas Education Commissioner submitted to ED an altered version of the federal application. Among other changes, the altered version removed the phrase “the state will comply with the additional MOE requirements” and replaced it with the much more vague assurance that “the state will prioritize public education funding” (Texas Education Agency 2010). ED refused to accept the altered application, noting in a September 8<sup>th</sup> letter that the department had already indicated to state officials that an application with alterations “such as those that were included in your September 3<sup>rd</sup>, 2010 submission, would not be consistent with statutory requirements” (U.S. Department of Education 2010b).

Texas refused to file an unaltered application and instead, as promised, filed suit against ED. The funds were now stuck in a political stalemate. The state argued that the Texas “state constitution precludes [the Governor]” from submitting the application (Gillman 2010). The Texas Democratic delegation, through Chairman Doggett, dismissed this as “an act of political theater,” and said that “the bottom line is this: Federal aid to education should actually aid education in our local Texas schools.” And ED maintained that it would send funds to Texas only when the state submitted an unaltered application meeting the statutory requirements of the Texas-specific MOE provision. The next several months would see plenty of political jabs between Texas Republican leaders and Texas Democrats, but there would be no significant developments on the application, the litigation, or ED’s stance on the Texas funds.

In the end, the impasse would be broken by larger events. The 2010 elections swept Republicans into Congress, giving them control of the House. Republican Texas Representative Michael Burgess (supported by each of the twenty-one other Texas Republican House members) quickly introduced a bill to repeal the Texas-specific MOE provision (Burgess 2011). In April of 2011, the House passed a stopgap budget bill and included the Burgess language as a small rider—just 16 words in a 176-page bill<sup>3</sup>—repealing the Texas-specific provision (Smith 2011). Days later, Texas submitted an application to ED, meeting the requirements of the laxer MOE provision, and ED soon accepted the application. On sending the \$830 million in EduJobs funds to Texas, Obama’s Secretary of Education issued a press release stating that “education dollars will help Texas keep teachers in the classroom working with our students this year”



(U.S. Department of Education 2011).

Whether or not the Secretary's optimistic statement rings true depends on one's perspective. Reviewing the Texas budget, the Center for Public Policy Priorities found a \$5.6 billion cut in state support for K-12 education, a number that factors in the additional \$831 million provided by federal EduJobs (Castro 2011). Though the state's Rainy Day Fund was tapped to close a \$3.1 billion shortfall in 2011, more than \$6 billion in the fund remained untouched to address the education funding shortfalls in fiscal years 2012 and 2013.

## REFLECTIONS: UNIFIED GOVERNMENT AND ADVERSARIAL FEDERALISM

What kind of federalism does the Texas case study exhibit? It is difficult to fit the events into McGuire's "collaborative federalism." With ARRA, the Obama administration sought to achieve economically stimulative policy throughout the country by relying on state administration of federal grants. But because the Texas state government showed no interest in using those grants for their federally intended purposes, the relationship was one-sided, not interdependent. The two governments lacked a unified interest in carrying out a particular policy, and so even McGuire's limited definition of "collaborative" does not capture the dynamics of the Texas case.

Nor does Gais and Fossett's description of "executive federalism" seem to apply. The executive branch did take official note of the problem with the SFSF MOE provision in its 2009 memorandum. But despite the fact that SFSF was the single-largest grant program in Obama's top-priority ARRA legislation, the administration was unable or unwilling to correct the problem. The executive branch displayed no use of the "diverse tools" that Gais and Fossett argue that the executive branch is uniquely adept at manipulating.

The source of conflict with Texas over EduJobs funds was not the executive branch's discriminating use of administrative tools, but rather the legislative language itself written by Congress. In three separate instances, the executive branch implemented federal stimulus programs based on close readings of legislative language: first by allowing diversion of SFSF resources due to a minimal MOE provision, then by withholding Texas EduJobs funds due to the Texas-specific provision, and finally by allowing the funds to flow to Texas upon repeal of the more stringent MOE provision.

The Texas case also fails to fully corroborate Derthick's observation of congressional permissiveness with regard to federal grant terms. While the Texas Democratic delegation displays sensitivity to *local* interests, it

reveals significant skepticism of and opposition to *state* interests. And the result of this sensitivity to local interests is not “highly permissive” grant terms, as Derthick argues, but highly restrictive ones.

Rather than collaborative or executive federalism, the Texas case study fits better within Conlan’s “Opportunistic Federalism.” In reviewing the Obama administration’s first two years, Conlan himself finds “a unique mix of cooperative, cooptive, and coercive federalism strategies” that exemplify “an opportunistic approach that viewed states as instrumental to more primary goals and programs” (Conlan and Posner 2011). This framework of opportunism applies well to the Texas experience with SFSF and EduJobs. Texas took advantage of the opportunity provided by the flexible MOE requirement to supplant state funding and free up state revenue. The federal government, through Congress, opportunistically used the authorization of a new grant program, EduJobs, to greatly constrain and coerce the state. And the state responded using its own tools in a Bardach-like “tenacity game” of brinkmanship and delay that eventually resulted in the state receiving the funds with fewer strings attached.

What is not exhibited in this case of “opportunistic federalism” is a weak and vulnerable state suffering at the hands of the federal government, a picture painted by both Kincaid and Conlan. Instead, we see two great adversaries, each with their own policy and political goals and each with tools they manipulate to achieve those goals. In the end, the state wins, subverting the purpose of the largest grant program in President Obama’s top legislative priority and eventually overcoming staunch opposition from Congress to do the same with the EduJobs program. In two head-to-head battles, the state revealed itself as a worthy adversary, fully in control of the “sufficient constitutional [and] political leverage” that Kincaid fears states lack. Against the most unified federal government in more than 40 years, the state won both a quick skirmish over SFSF and a more protracted battle over EduJobs.

## **LESSONS: POLARIZATION AND INCREASINGLY ADVERSARIAL FEDERALISM**

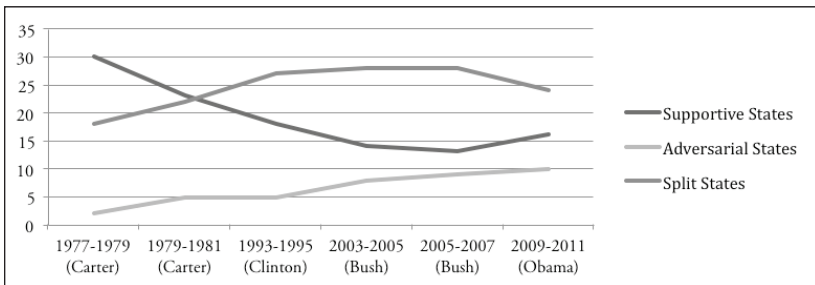
During Obama’s period of unified federal government, the Texas state government was unified and conservative, with the governorship and bicameral legislature controlled by the state’s Republican Party. In this respect, Texas can be considered an “adversarial state,” one with a state government unified under a party other than the unified federal government’s party.

Texas was not an outlier. As Conlan and Posner report, one of the no-

table aspects of Obama’s period of unified government was that “state and local elected officials became more strident representatives of the extreme ideological wings of their parties,” matching the political polarization that scholars have recorded at the federal level. The result was “a source of policy drag that would slow the pace of policy change, frustrating the policy ambitions of new federal officials” (Conlan and Posner 2011).

But while researchers have studied broadly how states can subvert the purpose of federal grants during implementation, there is little research on the effect of the partisan makeup of states on this feature of intergovernmental relations. Even in times of unified federal government, the fifty state governments remain a mix of divided and unified governments, with some unified by the federal majority party and others unified by the federal minority party.

**Figure 3: State Government During Unified Federal Government**



Federal Unified Period	Supportive States	Adversarial States	Split States
1977-1979 (Carter)	30	2	18
1979-1981 (Carter)	23	5	22
1993-1995 (Clinton)	18	5	27
2003-2005 (Bush)	14	8	28
2005-2007 (Bush)	13	9	28
2009-2011 (Obama)	16	10	24

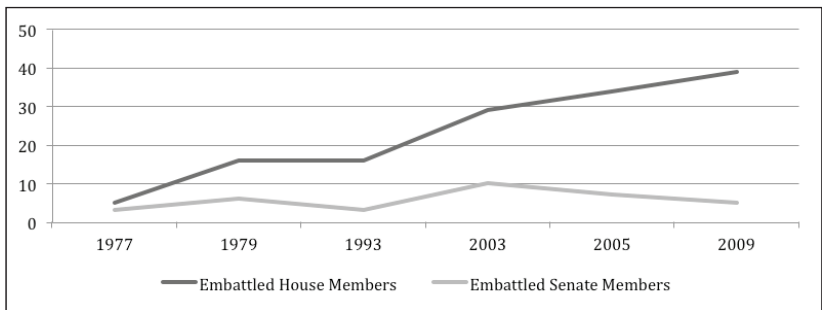
Source: Data from the National Governor’s Association, the National Council of State Legislatures, and the 1977, 1979, and 1993 Statistical Abstracts of the United States.

“Supportive States” are those with unified governments (legislature and governor) of the same party as the unified federal government. “Adversarial States” are those with a unified government of a different party than the federal government. “Split States” lack a unified state government. Given its nonpartisan state legislature, Nebraska is counted as “unified” based on the party of its governor.

This mix has been changing in a consistent direction over the past forty years. *Figure 3* shows a clearly increasing trend in the number of adversarial states since Carter’s unified government in 1971. Regardless of party, every successive period of unified federal government saw the same or greater number of adversarial states. In his first period of unified government, Carter faced only two adversarial states<sup>4</sup>, while Obama faced ten. In short, each president lucky enough to preside over a period of unified federal government has faced not only more vociferous opposition from increasingly ideologically distant adversarial states, but a greater number of these states as well.

Presidents are not the only federal lawmakers who confront adversarial states. Within every adversarial state is a delegation of “embattled representatives,” or federal representatives belonging to the federal majority party. The Texas Democratic congressional delegation is an example of embattled members. Because of polarization of political parties at state and federal levels, these members too are increasingly ideologically separated from their home states’ ruling party. As might be expected given the increase in adversarial states, the number of embattled members has also risen in the past forty years regardless of the political party in power at the federal level.

**Figure 4: Increase in Embattled Senators and Representatives Since Carter**



*Source: Data from the National Governor’s Association, the National Council of State Legislatures, and the 1977, 1979, and 1993 Statistical Abstracts of the United States.*

*\*Embattled members are defined as members of Congress representing states under unified control of a party not in control of the unified federal government.*

As *Figure 4* shows, every successive period of unified federal government saw the same or greater number of embattled members in the House of

Representatives. In Carter’s first unified period, there were five embattled members in the House; Obama’s period of unified government saw thirty-nine, a near sevenfold increase. The average number of embattled members per adversarial state also consistently rose, from a low of 2.5 to a high of 3.9 following the 2008 elections. As a result of these trends, the representation of embattled members in Congress has increased. Embattled members represented less than 2 percent of Carter’s Democratic House majority in 1977. In 2009, embattled members represented more than 15 percent of Obama’s Democratic House majority.

Thus, a motive and a means for legislatively affecting state-federal grant relations have been in development for at least forty years. The motive is the widening ideological gap between embattled members and their adversarial states. The means is embattled members’ growing representation in Congress. The Texas Democratic delegation in the 111<sup>th</sup> Congress represented, thus far, the pinnacle of this trend. Never before was a delegation of embattled members so large and so ideologically distant from its home state’s ruling party.

It is interesting the extent to which the embattled members’ political power went ignored or untapped during the passage of the ARRA and its SFSF program. As *Figure 5* shows, the ten adversarial states stood to receive \$9.1 billion from the SFSF education program, nearly a quarter of the entire program’s appropriation. In other words, not only did the single largest grant program in Obama’s first-priority legislation not include a strong MOE requirement to ensure faithful implementation of the federal agenda within all states, but nearly a quarter of the funds from that program went to states with vastly different policy agendas than that of Obama’s unified federal government.

**Figure 5: Allocation of SFSF and EduJobs Funds to Adversarial States**

Adversarial State	SFSF Allocation	EduJobs Allocation (estimated at enactment)
Arizona	\$831,869,331	\$211,824,489
Florida	\$2,208,839,244	\$554,821,008
Georgia	\$1,260,799,095	\$322,313,830
Idaho	\$201,699,682	\$51,641,026
North Dakota	\$85,644,337	\$21,517,716
South Carolina	\$567,741,302	\$143,700,517
South Dakota	\$104,292,688	\$26,292,261

Texas	\$3,250,272,133	\$830,820,460
Utah	\$392,581,821	\$101,303,951
Nebraska	\$233,955,926	\$58,890,974
<b>Total Adversarial</b>	<b>\$9,137,695,559</b>	<b>\$2,323,126,232</b>
<b>Total U.S.</b>	<b>\$38,994,382,141</b>	<b>\$9,769,628,903</b>
<b>As % of U.S.</b>	<b>23.43%</b>	<b>23.78%</b>

*Source: Allocation data for both SFSF and EduJobs from the Department of Education. Note that figure totals include allocations to the District of Columbia.*

It is possible that the speed with which ARRA was passed prevented embattled member opposition from coalescing. The House passed ARRA less than two weeks after the Appropriations Committee released its 258-page draft (and only three days after formal introduction of the near final legislation). And while SFSF was the single largest grant program within ARRA, it was one of only many grant programs, tax cuts, and other measures included in the final 496-page bill. By contrast, the 20-page EduJobs bill primarily focused on the EduJobs program itself, was months in the making from initial proposal to final bill language, and came on the heels of direct experience with SFSF. These factors may have made EduJobs an easier target for activist embattled members.

If the EduJobs battle in Texas is the natural result of the trend in adversarial states and embattled members, and if that trend continues as it has for the past forty years, we may see more conflict on three fronts during periods of unified federal government. The first is conflict between the federal executive branch and adversarial states. As adversarial states continue to become polarized and multiply, presidents seeking cooperation or even simple collaboration will increasingly find states uninterested in such partnerships.

A second area of conflict arises between embattled members and their adversarial states. The Texas Democratic delegation tried and failed to assert federal authority over their home state. If future unified congresses see even greater embattled-member representation, congressional attempts to constrain adversarial states may become more common. Lacking a cooperative or collaborative partner at the state level, embattled members may increasingly seek creative legislative devices to accomplish federal policy goals within adversarial states.

Third, conflict is likely to arise between embattled members and other federal policy makers. If future embattled members agree with Gait and Fossett that the executive branch is better suited to respond to adversarial

states with “an adaptive, selective application of diverse tools,” we may see a greater push by embattled members to give the executive branch flexible authority in enforcing the federal agenda. However, before such authority could be given, it would need to overcome likely opposition from non-embattled majority party members who may prefer to allow their home states flexible use of federal funds.

## CONCLUSION AND POLICY IMPLICATIONS

Conflict between federal and state governments over administration of federal funds is not new. Indeed, while Madison spoke of the need for a “definite partition” between state and federal governments, grants to states became “a major intergovernmental tool for the federal government” no later than the mid-nineteenth century (Gais and Fossett 2005). Negotiations, bargaining, coerciveness, collaboration, and opportunism have long characterized state-federal relations, and so the presence of such games in the Texas case should come as no surprise.

What may come as a surprise in the Texas case is the ferocity of state opposition to the unified federal government’s agenda and the power the state wielded in successfully resisting that agenda. While games have been a traditional part of intergovernmental relations, fierce, ideologically-based opposition has been less common in the late 20<sup>th</sup> and early 21<sup>st</sup> centuries. The level of skepticism of state power exhibited by Congress in the Texas case is reminiscent of the Great Society-era legislators who feared southern states in particular would divert funds away from federal goals and so sought to circumvent state governments in attaining those goals (Gais and Fossett 2005).

The Texas-specific EduJobs provision may be seen as the product of larger forces that for decades have been setting the stage for new policy and political battles in state-federal relations. Opposition to coercive federal power has grown and solidified in the form of increasingly numerous and polarized adversarial states, while a countervailing force has been growing within those states in the form of embattled-member delegations. The Texas Democratic delegation represented the largest block of embattled members from any state for any period of unified government since Carter’s administration, if ever. Perhaps as a result, the Texas EduJobs case reveals an instance in which Congress was highly sensitive to local interests, highly skeptical of state interests, and highly active in the realm of intergovernmental relations.

Future embattled members who are similarly sensitive to local interests but hesitant to empower ideologically opposed states can learn from the

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Texas case. Though the Texas delegation succeeded in amending the federal grant to prevent the federal funds from supplanting state funding, the strategy failed to achieve its intended effect because the State maintained its central role in administration of the funds. The lesson from the Texas experience is that even with state-level, tailored legislative language, it is difficult for the federal government to ensure that flexible federal funds are administered faithfully within unsympathetic states that have divergent policy priorities.

Given this difficulty, embattled members and other federal lawmakers have several options for achieving local policy objectives:

- *Provide support directly to individuals.* Programs administered through the tax code, such as the Earned Income Tax Credit and the Affordable Care Act's health insurance premium subsidies, and direct federal benefits, such as Pell Grants, allow the federal government to provide benefits directly to individuals without danger of adversarial states diverting funds away to other purposes.
- *Provide support directly to local communities.* Place-based initiatives like Choice and Promise Neighborhoods and locality-focused grant programs, such as the Early Learning Challenge grants, allow the federal government to provide support directly to localities. Similar to direct support to individuals, federal funds for local communities avoid the state-level supplanting problem.
- *Use new mechanisms to distribute funds to states after policy reforms.* The Obama administration's Race to the Top (RTT) program presents an innovative model for affecting statewide reforms *before* federal funds are distributed to states. While traditional federal grants to states fund future state action, the RTT model rewards a select group of states that have already implemented reforms. Furthermore, the competition model allows the program to have impact beyond the individual states that receive funds.

None of these policy prescriptions is a silver bullet and each has its own unique limitations. But if the Texas case represents the most recent product of a continuing trend, future federal policymakers may increasingly find themselves eschewing the administrative tools of states in favor of other methods of translating lofty vision into locally implemented policies.

## NOTES

<sup>1</sup> The literature is somewhat unsettled on the effect of unified government on legislative productivity. Mayhew argues that if you “peer through a Capitol



Hill haze that can feature delay, suspense, party posturing, ugly wrangling, and other presentations,” you will find a similar pattern of legislative accomplishment during periods of both unified and divided government (Mayhew 1991). But others disagree. Edwards et al. argue that “much more important legislation fails to pass under divided government than under unified government” (Edwards et al. 1997), and Binder argues that “divided party control does appear to [negatively] affect the broader ability of the political system to address major public problems” (Binder 1999).

<sup>2</sup>Nearly \$9 billion in additional, more flexible SFSF funds were provided to states to support public services more generally—education and otherwise—but the remainder of this paper uses the term “SFSF” to refer to the \$39 billion in education-specific SFSF funds.

<sup>3</sup>The repeal language was simple: “Section 101 of Public Law 111–226 (124 Stat. 2389) is amended by striking paragraph (11).” Public Law 111–226 being the EduJobs bill, and paragraph (11) being the Texas-specific MOE provision.

<sup>4</sup>Even in these two adversarial states, the margins were quite small in 1977. Both states had one chamber of the legislature evenly split between Republicans and Democrats (Vermont’s House and New Hampshire’s Senate).

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## H-2A GUESTWORKER VISA PROGRAM: FACILITATOR OF EXPLOITATION AND LABOR TRAFFICKING IN THE U.S. RANCHING INDUSTRY

*Alex Penwill*

Born out of the Bracero system of the post-World War II era, today's H-2A guestworker visa program facilitates the exploitation of foreign sheep, goat, and cattle herders in the United States by binding them to a single employer, subjecting them to labor abuses, and exempting them from legal protections provided to other workers. In some cases, guestworker maltreatment escalates from exploitation to criminal abuse. As comprehensive immigration reform comes to the forefront of the American political agenda, it is more crucial than ever to take a hard look at the H-2A visa system. This article examines the legislative history of the H-2A ranching program, its exemptions from federal labor laws and other protections, and the abuse guestworkers suffer as a result. The article argues that, in some cases, this abuse rises to the level of human trafficking, debt bondage, forced labor, and indentured servitude—serious violations of national and international law. Finally, the

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*Alex Penwill is a 2014 International Organization Administration MA candidate at the Josef Korbel School of International Studies at the University of Denver, with concentrations in Latin America, technology and sustainable development, and market-based social enterprises. He can be reached at [cpenwill@gmail.com](mailto:cpenwill@gmail.com).*

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article makes policy recommendations for reforming the H-2A program and amending state labor codes to fortify America's commitment to human rights and equal justice.

## INTRODUCTION: THE LANDSCAPE OF LABOR TRAFFICKING

Globally ubiquitous but widely overlooked, unrecognized, or ignored, modern slavery is difficult to see and even more difficult to combat. Deliberately designed to go unnoticed from the outside, or inherently hidden beneath a patina of legal legitimacy or social custom, modern iterations of slavery—human trafficking, forced labor, debt bondage, and involuntary servitude, among others—are initiated and maintained by fraud and deception; control of free will and free movement; geographic, cultural, and linguistic isolation; and physical and psychological intimidation, coercion, and violence which breed compliance, fear, and silence in its victims.

One such iteration of modern slavery exists in the Western United States: the legal exploitation of foreigners employed on a temporary and expendable basis as sheep, goat, and cattle herders via the U.S. Department of Labor (DOL) H-2A guestworker visa program. Born out of the post-World War II era *Bracero* system, today's H-2A program facilitates the exploitation of herders by binding them to a single employer, subjecting them to labor abuses, and exempting them from legal protections provided to other workers. As a consequence, the treatment of H-2A herders escalates from exploitation and abuse to circumstances tantamount to human trafficking, debt bondage, forced labor, and involuntary servitude.

Approximately 1,600 migrant sheep, goat, and cattle herders enter the United States every year on H-2A visas issued by the Department of Labor for temporary agricultural work (Lee 2012), most brokered by ranching coalitions like the Western Range Association (WRA) and the Mountain Plains Agricultural Service (Verité 2010). According to the Migrant Farm Worker Division of Colorado Legal Services (CLS), most H-2A herders work on ranches in Colorado, Wyoming, Montana, Utah, Idaho, California, Arizona, Nevada, Oregon, and Washington. In the mountain states the majority of H-2A herders are from Peru, with others coming from Chile, Bolivia, Mexico, and Nepal (Lee 2012). While many H-2A herders are accustomed to hardship and poverty in their home countries (Bedoya 2009), they often find the rancher-herder "power imbalance" on U.S. ranches to be even more exploitative, abusive, and dehumanizing than anything experienced at home (Krögel 2010).

The H-2A program works as a “hospitality trap” (Krögel 2010) that facilitates the treatment of guestworkers not as ‘guests’ but rather as a cheap, importable, and expendable labor commodity. In a 2013 report, the Southern Poverty Law Center (SPLC) described the guestworker program as “a modern-day system of indentured servitude” in which “the worker has little or no recourse” if their situation is abusive or not what was originally promised (SPLC 2013). The fundamental problem with the guestworker program is the high degree of subordination it creates in the employer-worker relationship by attaching control of the guestworker permit to the employer. Put another way, “the employer—not the worker—decides whether a worker can come to the United States and whether he can stay” (SPLC 2013). The employer has the ability at any point to fire and report the worker to U.S. Citizenship and Immigration Services (USCIS) for deportation and, by extension, future visa blacklisting. As a result of this power imbalance, the H-2A program is “fundamentally flawed” (Bales and Soodalter 2009).

But the power imbalance and resulting exploitation in the guestworker program begins even before guestworkers reach the United States. Labor brokers hired by individual U.S. ranches, or ranching associations like the WRA, to recruit herders in their home countries are often manipulative and deceptive initiators of labor trafficking. By charging extortionate fees, putting workers into debt, and promising higher wages and better working and living conditions than they will actually receive, labor brokers often put guestworkers “in a precarious economic state” that makes them “extremely vulnerable to abuse by unscrupulous employers” (SPLC 2013).

Once in the United States, H-2A herders are often exploited by their rancher-employers by means of the H-2A ranching program’s legal exemptions from a variety of U.S. worker protection laws and minimal government oversight. These labor and rights exemptions in the guestworker program allow ranchers’ treatment of H-2A herders to proceed from financial exploitation to abuse, forced labor, and involuntary servitude. Ranchers maintain this abuse and exploitation by means of a monopsony over the tenuous employment of H-2A herders. Coupled with other restraints including geographic and social isolation, language barriers, ranchers’ restriction of herders’ free will and free movement, and herders’ lack of understanding of contracts and rights, ranchers’ actions breed deception, fear, compliance, and subservience in workers. Some ranchers restrict communication and withhold food, water, pay, contracts, paystubs, passports, and visa documents. Continued lobbying by powerful ranching associations like the WRA has maintained these power imbalances in the

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H-2A herder program.

As a result, the guestworker program exploits migrant herders. In some cases, this abuse amounts to human trafficking, debt bondage, forced labor, and involuntary servitude – iterations of modern slavery under the Trafficking Victims Protection Act (TVPA) and the United Nations Palermo Protocols. At the very least, if not an institutionalized form of human trafficking and involuntary servitude, the H-2A visa program is a conduit that allows unscrupulous ranchers to seduce herders into a “hospitality trap” that exploits their labor, abuses their humanity, takes advantage of their vulnerabilities, coerces their acquiescence, and then spits them out, only to repeat the process anew.

How did this state of affairs come to be? An examination of the legal exploitation of H-2A herders and its trajectory of forced labor and human trafficking must start with an exposition of the legislative history of guestworker programs. The paper next exposes the abuses made possible by exemptions to worker protection laws and by minimal government oversight of the regulations that do exist for the guestworker program. Third, the paper presents qualitative data culled from surveys of H-2A herders in Colorado, Wyoming, and California to give voice to herders’ accounts of the exploitations and abuses common to the guestworker program. The paper then examines these abuses with regard to national and international anti-trafficking laws. Finally, the paper concludes with a look at policy fixes for the H-2A herder program that would benefit herders while minimizing potential detriment to the ranching industry. Today, as comprehensive immigration reform comes to the forefront of the national agenda, such policy considerations are urgent and momentous.

## LEGISLATIVE BACKGROUND

Congress first enacted the H-2 guestworker visa program with the U.S. Immigration and Nationality Act (INA) of 1952. The INA emerged, in part, out of the *Bracero* guestworker program that brought up to 50,000 Mexican farm workers into the United States per year during the 1940s (Ashby 2008). Because employers overestimated labor needs to increase competition among workers, conspired to keep wages artificially low, and violated worker protection requirements, Congress abandoned the *Bracero* program during the 1960s (Jackson 2000). Just as a former DOL official once described the *Bracero* program as a “system of legalized slavery,” so too has current U.S. Congressional Representative Charles Rangel described the H-2 program as “the closest thing I’ve ever seen to slavery” (SPLC 2013).

Other characteristics of the H-2 program trace their origins to another



federal program created by three special “shepherd bills” that allowed ranchers to bring foreign herders to the United States on a more permanent basis (Verité 2010). In the 1950s, lobbying by the California Range Association, which later became the WRA (Verité 2010), allowed skilled immigrant herders to come to the United States by means of this special legislation that “permitted herders to gain lawful permanent residency, bring over family members, and ultimately become naturalized American citizens” (Lee 2012). These “shepherd bills” gave special privileges to ranchers to expedite the visa process (TEGL 2011) without requiring Department of Labor certification that foreign shepherders did not adversely affect U.S. workers (Verité 2010).

But in 1955 and 1956, at the behest of ranchers, the House Judiciary Committee investigated claims that herders “admitted under the special laws were leaving shepherding shortly after arriving in the U.S. and were instead employed in other industries and occupations” (TEGL 2011). The investigation and resulting 1957 congressional report substantiated the claims and stated that, “American employers and the sheep raising industry had not fully benefitted from the services of foreign shepherders” (TEGL 2011), as was the intent of the legislation and the lobby. As a consequence of the committee’s investigative report, Congress let the “shepherd bills” expire.

With two guestworker herding programs behind it, one abused by employers and the other by migrants, Congress passed the Immigration Reform and Control Act of 1986, which amended the INA and divided the H-2 visa into two parts: the H-2A program for temporary, unskilled agricultural workers (including farming and ranching), and the H-2B program for nonagricultural workers. Employers (not the DOL) are responsible for recruiting guestworkers, reimbursing their travel expenses to and from the United States (once workers complete 50 percent of their contracts), and providing housing and food (45 C.F.R. § 1626.11). As individual employers are the singular means by which unskilled foreign nationals gain lawful temporary employment in the United States, the H-2A program binds guestworkers to their employer. As a result, they cannot seek a different employer once in the country. While this employer control prevents employee desertion as seen in the “shepherd bills,” it also facilitates guestworker abuse, trafficking, and forced labor—a major structural defect of the guestworker program.

Employers must first seek approval from the DOL before bringing in foreign workers. The H-2A labor certification process requires employers to search for available U.S. workers and certify with the DOL that there is

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not sufficient domestic labor supply and that the employment of foreign guestworkers will not adversely affect the wages and conditions of domestic workers in that industry (8 U.S.C. § 1188 (a)(1)). Thus guestworkers often find employment in the so-called 3-D jobs that U.S. workers tend to avoid because they are dirty, dangerous, and difficult (Krögel 2010). The DOL indicates that “the unique occupational characteristics of sheepherding (spending extended periods of time with grazing herds of sheep in isolated mountainous terrain; being on call to protect flocks from predators 24 hours a day, seven days a week) have been recognized . . . as significant factors in limiting the number of U.S. workers who might be available for and capable of performing these jobs” (TEGL 2011). Even so, the H-2 program harms both domestic and foreign workers. Employers have little incentive to improve wages and working conditions or search in earnest for U.S. workers so long as cheap and expendable foreign workers without basic labor protections are available. A 1998 DOL audit concluded that the H-2A labor certification process is ineffective at protecting American jobs (Wasem 2001).

Despite the difficult nature of herding, H-2A herders are not afforded wage, labor, and housing standards commensurate with the hardships of the job nor equal to those afforded to U.S. citizens or non-herding H-2A guestworkers. Non-herding H-2A farmworkers enjoy a range of protections inherited from the *Bracero* program, including wage protections, transportation and housing requirements, access to legal services, and DOL-enforced safety standards (Verité 2010). By contrast, the H-2A program does not require the same protections for sheep, goat, and cattle herders, and actually exempts H-2A herders from federal wage, housing, and labor laws. This differential treatment finds its roots in ranchers’ successful lobbying for federal exemptions to protect the competitiveness of the U.S. ranching industry (Verité 2010). Thus, ranchers can pay H-2A employees much less than the federally mandated minimum wage because ranching is exempt from the Fair Labor Standards Act of 1938 (FLSA) (29 U.S.C. § 213(a)(6)(E)), which otherwise requires employers to pay the state or federal minimum hourly wage, or the prevailing wage in the sector if higher than the minimum wage. Although herders have been exempt from the FLSA minimum wage requirement since 1938, American Sheep Industry Association Executive Director Peter Orwick has suggested that H-2A ranchers pay very low wages because the rising price of fuel and feed has resulted in a 60 percent decrease in the number of sheep raised on U.S. ranches since 1993. According to Mr. Orwick, “Paying higher wages to the 1,500 sheepherders working in the United

States would force many ranches to close...” (Frosch 2009). However, this rationale does not justify exploitation—the FLSA exemption redoubles the detriment done to herders because their contracts, which the Labor Department approves, require them to be on call 24 hours per day, seven days per week (TEGL 2011).

## **THE REALITY OF THE RANGE: H-2A SPECIAL PROCEDURES, LEGAL EXEMPTIONS, AND SYSTEMATIC RIGHTS VIOLATIONS**

The H-2A ranching program explicitly exempts guestworkers from many of the basic labor, housing, and legal protections that are standard fare for U.S. workers. Some of these “special procedure” exemptions from federal law apply to all H-2A herders, while others are specific to ranching associations. The former includes exemptions from the 40-hour workweek, state and federal minimum wage, overtime pay, housing standards, and a private right of action to make legal claims against substandard working and living conditions. The latter provides member-ranchers with even greater control over guestworkers and less accountability to already negligible regulatory oversight.

According to a recent survey of 93 sheepherders conducted across Colorado by CLS, 92 percent of herders said they worked more than 60 hours per week; 81 percent said they worked more than 70 hours per week; 62 percent said they worked more than 80 hours per week; and 35 percent said that they worked more than 90 hours per week (Lee and Andres 2010). As of 2011, the typical monthly wage paid to H-2A sheepherders in Colorado was just \$750, regardless of hours worked or on call (Lee and Andres 2010). This translates into an hourly wage of \$2 to \$3 per hour for most H-2A herders, while virtually all earn under \$5 per hour (Lee 2012). This wage—far below the prevailing wage for domestic ranchers (Verité 2010)—is the minimum required by Colorado’s Labor Department for H-2A herders (Lee 2012). A general search on job board websites like Monster, Simply Hired, and Indeed.com confirmed that “ranch hand” jobs in Colorado for U.S. citizens usually pay at least \$10 per hour, or a full-time monthly wage of around \$1,600. According to Verité, an international fair labor advocacy NGO, the typical monthly wage paid to H-2A herders in Wyoming is even less—a meager \$650 (Verité 2010), or just under half the \$1,160 per month paid to full-time employees at the federal minimum wage of \$7.25 per hour. To put this in perspective, employers of non-herding H-2A farmworkers in Colorado were required to pay \$10.48 per hour in 2011 (Lee 2012), or three to five times H-2A

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herders' hourly pay. For a 40-hour week, non-herding H-2A workers in Colorado earned \$1,676.80 per month in 2011, or 2.24 times the amount that H-2A herders earned even with significantly longer workweeks and without the right to overtime pay or equal labor and housing protections.

In addition to low wages, H-2A herders are susceptible to other kinds of maltreatment to a greater extent than non-herders because the Labor Department's H-2A special procedures exempt herders from many H-2A protections (Lee 2012). H-2A ranchers are not required to comply with certain Occupational Safety and Health Administration (OSHA) housing standards, including running water, electricity, toilets, or a minimum amount of living space for each H-2A herder (29 C.F.R § 1910.142) because Occupational Safety and Health Administration (OSHA) standards do not cover mobile housing (TEGL 2011). Moreover, H-2A herders have little legal recourse for violations of their rights because they are excluded from the Migrant and Seasonal Agricultural Worker Protection Act (MSPA), which gives U.S. farmworkers a private right of action for claims relating to job recruitment, housing, wage, and working conditions (29 U.S.C. §§ 1801-1872).

Even considering the minimal H-2A program requirements, herders are often housed in substandard conditions. H-2A herders in Colorado and other western states are usually provided small mobile wagons called campitos built on two- or four-wheeled pull trailers slightly larger than a pickup truck bed and enclosed by corrugated sheet metal and canvas (Lee and Andres 2010). While H-2A standards require that housing be "structurally sound, in good repair, in sanitary condition, and ... provide protection to occupants against the elements" (TEGL 2011), campitos are often in a deplorable state of disrepair. Ranchers are allowed to self-certify that they comply with housing regulations, and government inspection is required only once every three years (TEGL 2011). This gives ranchers the opportunity to neglect already substandard housing. A 2000 Central California Legal Services (CCLS) survey found that H-2A sheepherders lived in isolation in "old, small, dilapidated trailers" without toilets, heating, showers, potable water, lights, refrigerators, or means of transportation or communication in case of emergency. A 2004 follow-up survey found that 91 percent had no access to a toilet, 70 percent had no bathing facility, 64 percent had no heat, and most had a container of potable water brought by their employers only once per week (Schneider et al. 2005).

Substandard housing and provisional neglect exacerbate herders' exposure to the elements. Inadequate water and food storage supplies are particularly hazardous to herders' health given the variable weather conditions on the

range. While the weather on the high pastures in the spring and summer can be searing during the day and below freezing at night, the winter months pose even greater hardship. Lambs are born from November to March, and sheepherders (who are contracted to work year round) are asked to assist in lambing as well as shearing and slaughter (Verité 2010). Frigid temperatures, high winds, and frequent snowstorms are the norm. Working outside, constantly exposed to the elements, herders are vulnerable to frostbite and hypothermia. Because ranchers cannot provide running water to the pastures, and sometimes bring potable water only at delayed and sporadic intervals (Verité 2010), herders without sufficient heating supplies can suffer from dehydration when cold temperatures prevent them from melting snow inside their campitos. Thirty-five percent of H-2A herders interviewed by CLS indicated that they had no form of heating, and 27 percent responded that they only had access to potable water “sometimes” (Lee and Andres 2010).

Herders are not only reliant on their employers for water but also for food. The H-2A special procedures mandate that ranchers provide herders three meals per day or the equivalent amount of food and cooking supplies (TEGL 2011). Herders’ diets consist mostly of canned food and rice and beans and often lack fresh fruit and vegetables (Lee and Endres 2010). Without proper storage facilities, fresh food is likely to freeze in the winter and spoil in the summer. Seventy-one percent of herders surveyed by CLS had no refrigeration and relied on boxes, drawers, coolers, and the outdoors to store food (Lee and Endres 2010). In extreme cases, herders have resorted “to stealing vegetables, eating their sheep, or eating dead animals that they find in order to obtain sufficient food” (Verité 2010), leading to foodborne illness or malnutrition (Lee 2012). In a particularly grotesque account from a 2008 complaint filed with the DOL that cited “abysmal working conditions” on H-2A ranches, a sheepherder “ate part of a rotting elk carcass” out of hunger, yet his employer accused him of poaching and “dropped him off at a local immigration office for deportation” (Frosch 2009).

While regulatory noncompliance and neglect are concerning, herders are most vulnerable to exploitation and abuse because the guestworker program binds them to a single employer. Guestworkers cannot change employers or leave their jobs without breaching their visa terms, and because workers have limited access to legal recourse for substandard working and living conditions and rights violations, H-2A employers use the threat of deportation and future visa blacklisting to coerce subservient behavior. Ranchers prevent herders from complaining about exploitation, leaving

the ranch, or trying to enforce their rights by evoking this threat, as well as through physical and verbal abuse, restrictions on food and water, and threats of reprisals against family members (Verité 2010). Ranchers also confiscate and withhold herders' passports, H-2A visas, USCIS I-94 arrival/departure forms, and other documents. Forty-two percent of the herders surveyed by CLS reported that their employers took these documents away, and 80 percent said that their employers did not allow them to leave the ranch (Lee and Andres 2010). Given their extreme social and geographic isolation, the withholding of herders' legal documents makes them especially susceptible to abusive exploitation. The H-2A program also allows employers to front the costs of transportation, food, and housing and then deduct those costs from workers' pay until 50 percent of the original 12-month employment contract has been completed (TEGL 2011). This provision exacerbates H-2A herders' vulnerability to employer control by coercing them to continue working even in highly abusive situations, particularly when herders are in debt from labor-brokerage fees during recruitment.

A number of H-2A special procedures that apply specifically to the WRA and other ranching associations increase employer control, enhance the power imbalance between ranchers and herders, and exacerbate herders' vulnerability to abuse. One association-specific provision permits "joint-employer" associations like the WRA to transfer sheepherders from one rancher-member to another without the worker's consent (8 U.S.C. § 1188(d)(2)). A sheepherder's refusal "may subject the worker to dismissal" (TEGL 2011). This provision creates the inherent possibility of deportation for sheepherders who refuse to be transferred, constricting workers' autonomy and freedom of choice. Because H-2A workers are tied to a single employer by their visa terms and work contracts, cannot "shop around" for better working conditions with other employers, and have almost no ability to enforce their rights or seek legal recourse, "they are routinely exploited" (SPLC 2013).

H-2A special procedures that favor associations also reduce ranchers' accountability to standard labor practices. One such procedure allows associations rather than individual rancher-members to be responsible for maintaining copies of work contracts and making them available to the DOL for inspection and enforcement of contractual obligations. In the CLS survey, 47 percent of herders were not allowed to read their contracts, and 33 percent of those who read their contracts did not understand their rights. While the H-2A program requires ranchers to pay herders at least once per month and provide monthly hours and earning statements, 35

percent of herders were not paid monthly and 46 percent received no record of their pay (Lee and Andres 2010). Finally, 51 percent of the herders in the CLS survey, and an even greater percentage in the CCLS survey (Verité 2010), did not believe that their employers complied with their contracts.

Though not all H-2A ranchers are responsible for violations, the evidence herders have provided to legal, labor, and immigrant rights advocacy groups demonstrates that pervasive exploitation and abuse exists within the H-2A ranching program. Due in part to the actions of individual ranchers and the influence of special interest groups like the WRA, the abuses documented in H-2A ranching are largely attributable to a structurally flawed and irresponsible guestworker program that facilitates, but does little to prevent or correct, exploitation.

## UNDER-REGULATION, ANTI-TRAFFICKING LAW, AND LITIGATION

When the structural flaws and statutory exemptions inherent in the guestworker program meet unscrupulous employers and under-regulation, mistreatment of H-2A herders can escalate to human trafficking, debt bondage, forced labor, and involuntary servitude, as defined in the U.S. Trafficking Victims Protection Act (TVPA) and the United Nations Palermo Protocols. This section demonstrates that such escalation has occurred by examining claims in recent litigation against H-2A ranchers in Colorado. It also argues that the Department of Labor does not do enough to prevent TVPA transgressions. And while better regulatory oversight is important for mitigating guestworker abuse, it will not be enough to rectify the systemic injustice in the H-2A program. As will be discussed in the final section, comprehensive reform of the guestworker program is necessary if the United States is to fix our broken immigration system.

While there has been an increase in the number of complaints, investigations, lawsuits, and advocacy campaigns related to guestworker abuse in recent years, as well as some increase in media attention, the Department of Labor's response to widespread allegations of abuse and exploitation has been ineffective. While the DOL is responsible for enforcing wage, housing, health, and other labor regulations, it has not often penalized employers for violations (Lee 2012). According to a 2009 article in the *New York Times*, the Department of Labor had at that time investigated around 100 complaints of shepherd mistreatment since 1999 (Frosch 2009). In 2011, the Labor Department certified a total of 7,000 ranching and non-ranching H-2A employer visa applications but conducted only

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157 investigations of those employers, resulting in deficient enforcement of regulations (SPLC 2013).

Such myopic government inspection and enforcement results from a variety of causes. Given the “itinerant nature” of H-2A herding, predicated on nonimmigrant foreign labor, temporary work contracts and the implicit prerogative of arbitrary deportation—and because herding is nomadic work that takes place transiently over vast tracks of land that are difficult to access—investigation and documentation are challenging and costly. Yet, the DOL’s limited regulatory oversight, as indicated in the CLS, CCLS, and Verité reports, is inexcusable considering the apparent abuses. Ineffective enforcement may also result from limited funding; uncooperative H-2A employers; a dearth of regulations to enforce; or, more cynically, personal relationships between ranchers and inspectors which disincentivize enforcement and penalties (Bales and Soodalter 2009). Malfeasance on the part of ranchers who, according to one attorney, “have a great deal of leverage over inspectors, as many are large landowners who are influential and have friends in Congress and in state and local offices” (Verité 2010) may also explain lax inspection of working and living conditions. Jennifer Lee, managing attorney of the Shepherd Project at the Migrant Farm Workers Division of Colorado Legal Services, noted that when the project began in 2000, “the Labor Department had not investigated many ranchers in Colorado primarily because the Labor Department did not appear to provide much affirmative oversight and the herders themselves were not coming forward to file complaints” due to fear caused by ranchers’ threats of deportation, blacklisting, and other reprisals; by their social, linguistic, and geographic isolation; and by a lack of procedures for dealing with abuse (Lee 2012). Since then, the number of complaints against H-2A ranchers has steadily increased.

But while the DOL has increased investigations, little progress has been made in enforcing regulations or preventing abuse. In 2000, the Department of Labor investigated John Peroulis & Sons Sheep ranch for guestworker claims of “rampant abuse” (Lee 2012). In April of that year the DOL filed suit, accusing the ranch of “beating, starving, and exploiting its shepherders for 10 years” (Frosch 2009). One of the H-2A herders represented in the suit claimed that his employer terrified him, verbally abused him, and summoned him by firing a shotgun. When he escaped, the employer tracked him down and threatened him in a town hours away from the ranch (Verité 2010). In spite of having been investigated by the Department of Labor six times between 1993 and 2000, and despite having DOL fines previously levied against it, the ranch settled out of court



without admitting misconduct (Cardona 2004) but was required to pay herders' back wages and a \$3,000 fine in addition to producing a manual on the proper treatment of workers (Frosch 2009). Twelve years later, in spite of several other (ongoing) guestworker lawsuits and similar claims of abuse—one involving a Peruvian herder named Remigio Damián who was beaten and wandered for days with head and neck injuries before reaching a hospital (Reding 2004)—the DOL continues to approve H-2A visas for foreign herders on the Peroulis ranch (Lee 2012). Considering the substantial time and money spent on litigation, penalties like the one described above are incommensurate with the abuses experienced by the claimants and ineffectual with regard to improving the treatment of H-2A herders in general.

Additionally, civil and criminal lawsuits are often hampered by insufficient documentation, quantifiable evidence, and/or plaintiff corroboration to ensure the sought-after outcome. Litigating H-2A rights violations is often inherently problematic because, as noted above, the Migrant and Seasonal Agricultural Worker Protection Act exempts H-2A workers from the legal recourse provided to U.S. farmworkers against recruitment, housing, wage and labor rights violations (Lee 2012). In effect, H-2A workers are excluded from the major federal statute protecting agricultural workers from exploitation and abuse at the hands of their employers (Verité 2010).

Though H-2A herders are not protected by the MSPA, the abuse they suffer may amount to human trafficking under current U.S. law. The Trafficking Victims Protection Act, passed by Congress in 2000 and reauthorized under the Obama administration in 2013, defines “severe forms of trafficking in persons” as:

“the recruitment, harboring, transportation, provision, or obtaining of a person for labor or services, through the use of force, fraud, or coercion for the purpose of subjection to involuntary servitude, peonage, debt bondage, or slavery” (22 U.S.C. § 7102).

As seen in the April 2000 suit and the other cases described below, employers' use of intimidation, as evidenced in verbal abuse, physical attacks, and threats of deportation to instill fear in employees, may well satisfy the coercion element of “severe forms of trafficking in persons.” Such coercion may also be an element of forced labor under 18 U.S.C. § 1589. With regard to the purposive element of “human trafficking,” debt bondage and involuntary servitude are the most relevant violations in the abuse of herders.<sup>1</sup> Individuals convicted for knowingly violating the TVPA provisions related to human trafficking face fines and/or a maximum 20-

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year prison sentence (18 U.S.C. § 1590). Finally, the TVPA provides a private right of action and civil remedy for human trafficking crimes (18 U.S.C. § 1595).

Because the H-2A system functions transnationally, it is also significant from a policy perspective that U.S. legislation is largely in line with international law in regard to human trafficking. Coercive practices in the employment of some H-2A herders covered by the TVPA fit equally well within the definition of “trafficking in persons” in the 2000 United Nations Palermo Protocols, which the United States ratified in 2005. It defines trafficking as:

“the recruitment, transportation, transfer, harboring, or receipt of persons, by means of the threat or use of force or other forms of coercion, of abduction, of fraud, of deception, of the abuse of power or of a position of vulnerability, or of the giving or receiving of payments or benefits to achieve the consent of a person having control over another person, for the purpose of exploitation” (UN 2000, Art.3(a)).

The term *transfer* deserves extra attention here in relation to the H-2A program’s special procedures that allow for the transfer of herders from one ranching association member to another without herder consent, and to H-2A workers’ inherent vulnerability to exploitation and abuse because of their subordinate position to employers with regard to recruitment, single-employer bondage, visa issuance, and deportation.

Thus, abuses in the recruitment and labor brokerage system used by most H-2A ranchers may fall within the definition of human trafficking when it leads to debt bondage, forced labor, and involuntary servitude (Lee 2012). Individuals employed by the WRA and the Mountain Plains Agricultural Service—the two major joint-employer associations of H-2A herders, each bringing in about a third of the H-2A herders employed in Colorado (Verité 2010)—have been accused of deceptive recruitment practices. Both groups reportedly employ the same individual recruiter-brokers in Chile and Peru (Verité 2010), who have been cited for exploitative and deceptive practices such as presenting prospective herders with false contracts, charging exorbitant recruitment and travel fees, loaning money at high interest for the payment of those fees, deceiving herders about the working conditions and wages they should expect, and retaliating against family members of sheepherders who file complaints (Verité 2012). These Chilean and Peruvian H-2A herders are particularly vulnerable to exploitation because member-employers have the legal authority to transfer

them to another member-ranch should they complain about fraudulent recruitment and can deport them if they refuse to be transferred.

These “deceitful and unlawful acts” are, in effect, mechanisms of human trafficking that force herders into a situation of debt bondage upon arrival at their employing ranch in the United States and greatly enhance their susceptibility to forced labor and involuntary servitude by further subordinating them to their employers (Verité 2010). The deceptive practices of labor brokers, and the threats of deportation, blacklisting from future visa issuance, physical violence, retaliation against families, and other repercussions used by some ranchers to maintain the quiet subservience of their H-2A herders, satisfy the TVPA definition of coercion, debt bondage, forced labor, and involuntary servitude, likely rendering these acts to be criminal violations of federal anti-trafficking law. Because the documented abuse, deception, intimidation, and coercion that ranchers and recruiters have imposed on H-2A herders may fit within the aforementioned legal definitions of human trafficking, debt bondage, forced labor, and involuntary servitude, CLS and other groups have filed suit against rancher misconduct “through novel litigation tools” including the TVPA (Lee 2012).

In 2010, after the Peruvian consulate in Denver notified CLS of a complaint, CLS filed a civil suit against the John Peroulis & Sons Sheep ranch, which had “a 20-year record of federal labor complaints” (Reding 2004). Peruvian H-2A herders Roel Camayo and Juvencio Damián accused the ranch owners of confiscating their passports and visas so that they could not leave for fear of arrest and deportation (Camayo 2010), verbal and physical abuse, and not providing enough food. Perhaps most significantly, the plaintiffs claimed that the local recruiter in Peru, employed by the Peroulis ranch, forced them to pay thousands of dollars in prohibited recruitment and travel fees to come to the United States (Cardona 2010).

CLS brought another lawsuit against John Peroulis & Sons Sheep ranch in 2011, on behalf of another Peruvian national, Jhosemar Fernandez. The following February, the presiding judge consolidated that case with the Camayo suit. The resulting case, ongoing at present, now represents Camayo and Damián, Fernandez, and a fourth plaintiff, Silvio Bruno, and alleges that the defendants violated the TVPA (Camayo 2012). A labor broker in Peru affiliated with the Peroulis ranch recruited Fernandez and Bruno in 2009. The men paid significant fees to obtain their visas, and an uncle of Fernandez, already employed on the Peroulis ranch, paid the owner \$2,000 to get Fernandez the job. Both men claim that Peroulis confiscated their passports, visas, and I-94 authorization forms upon ar-

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rival and that they did not receive copies of their contracts or employee handbooks. They worked “approximately 17 hours per day” in physically demanding conditions; their employers provided them “with the barest of provisions,” which they rationed in order to keep from going hungry; and the Peroulises verbally abused them. Additionally, the Peroulises, who were aware of Bruno’s financial difficulties after having to pay excessive fees to obtain the job, “threatened, implicitly and explicitly, to terminate his employment and send him back to Peru.” Both men “feared losing the ability to financially support their families in Peru, ‘being blacklisted,’ and suffering ‘the personal humiliation of being returned to Peru prematurely.’” Finally, the Peroulises never notified the men of their visa statuses, and they continued to work after their initial visas expired, effectively putting them in a situation of involuntary servitude. Although their employers withheld their immigration documents, both men eventually fled the ranch (Camayo 2012). In denying the defendants’ recent motion to dismiss, the judge found that “the defendants threatened to have [the plaintiffs] sent back to Peru, apparently simply to instill fear and promote compliance... this conduct could be found to constitute an abuse of the legal process, sufficient to support the TVPA claims” (Camayo 2012).

A positive result in this case would be but a small step along the path to guestworker program reform. Successful suits have not resulted in significant change in the H-2A ranching industry. For instance, in *Velasquez Catalan v. Vermillion Ranch Limited Partnership* (2006), six H-2A cattle herders sued their employer, a ranch with a history of exploitation and abuse (Bales and Soodalter 2009). The “illegal and inhumane conditions” alleged by the plaintiffs were substantive enough that the ranch agreed to pay monetary damages, stop withholding documents, provide access to telephones and bathrooms, and facilitate herders’ travel off the ranch. (Lee 2012). As attorney Jennifer Lee has noted, “this result is but a small victory” (Lee 2012). Reform through litigation is a slow, long-term strategy, and much more needs to be done.

In response to evidence of guestworker subjugation, the H-2A ranching industry has commonly asserted that a ‘few bad apples’ are responsible for the violations associated with human trafficking and forced labor.<sup>2</sup> Whether or not this is so—the Southern Poverty Law Center has asserted that the guestworker system is “rife with labor and human rights violations” that are “too common to blame on a few ‘bad apple’ employers” (SPLC 2013)—the more important consideration is that the structure of the H-2A ranching program and its exemptions from federal law facilitate exploitation and abuse. And considering the gravity and frequency

of abuse in H-2A ranching, incremental positive outcomes from civil lawsuits are not sufficient to rectify the systematic exploitation inherent to the guestworker program. For this, deep reform of the H-2A ranching program and amendments to federal and state legislation are necessary.

## **RECOMMENDATIONS: REFORMING THE GUESTWORKER PROGRAM, FEDERAL LEGISLATION, AND STATE LABOR CODES**

The exploitation and abuse documented in the guestworker program warrant legislative reforms, if not the full abolition of the H-2A visa as it currently exists. Such reforms should provide guestworkers with the same wage, housing, labor, and legal rights and protections—along with appropriate and sufficient regulatory oversight—afforded to U.S. citizens and should allow guestworkers the ability to change employers so that abusive situations do not escalate to human trafficking, debt bondage, forced labor, and involuntary servitude.

As the H-2A program itself facilitates exploitation, rectifying systemic injustices must occur at the federal level by extensively reforming the guestworker program. Reforms should unbind guestworkers from a single employer, provide stronger federal laws and regulations to protect guestworkers, increase funding, and enact more comprehensive procedures to aid federal agency enforcement of H-2A regulations, provide greater DOL transparency and accountability, increase oversight of state regulatory agencies, clear pathways by which guestworkers can deal with abusive employment without fear of losing their visa status, and ensure straightforward guestworker access to the U.S. justice system. In addition, the operational structure of the H-2A program must be changed so that employers do not have direct and uninhibited control over recruitment. In a reformed program, the DOL, which should be ultimately accountable for implementing, managing, regulating, and enforcing the guestworker program, could serve as a guestworker clearinghouse or intermediary between employers and guestworkers to eliminate the labor-broker-employer system, provide oversight of formally licensed recruiters, and allow guestworkers to change employers when appropriate.

In this improved system, employers could still petition the DOL for visa approval and specify individual guestworkers they wished to employ, but the DOL would directly hire guestworkers to come to the United States. To offset the costs of an expanded and rigorous guestworker program, fees paid to the DOL for recruiter training and monitoring could replace

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employers' labor-broker and logistics costs. Standardized recruitment could effectively undermine guestworker labor trafficking and debt bondage, not only by removing broker deceit and exploitation, but also by creating a firewall between recruitment and employment. Guestworkers would not be bound to a single employer, and DOL officials would inform guestworkers of their rights and provide a point of contact and procedures for support in cases of abuse.

With regard to the H-2A ranching program specifically, reforms should eliminate the special procedures exemptions, including those specific to ranching associations, in order to provide all H-2A herders with labor, housing, and legal protections equivalent to those of U.S. workers. Wherever possible, ranchers should be required to comply with OSHA standards for temporary agricultural labor camps, including the provision of 100 square feet of living space per worker, 35 gallons of water per worker per day, hot and cold running water, electric lights and outlets, heating and cooking equipment, bathing and washing facilities, and toilets (29 C.F.R. § 1910.142). Water and propane tanks, diesel generators, and other portable facilities may be necessary to fulfill such requirements. Additionally, H-2A herders should have access to legal recourse against rights violations as provided to U.S. workers by the MSPA. Finally, H-2A herders should receive fair pay. Ensuring this will require that the minimum wage exemption in the Fair Labor Standards Act be amended, or H-2A ranching program special procedures be changed, so that H-2A herders receive a monthly wage at least equal to that which full-time minimum wage earners receive, instead of the meager \$650 to \$750 per month (\$2 to \$3 per hour) herders currently receive.

The ranching industry contention that increased wages would threaten their financial solvency cannot legitimize the continued exploitation of guestworkers. But to offset the financial burden that such reforms might have on the ranching industry, the cost of room and board could be negotiated by the DOL and deducted from guestworker paychecks. Congress could also provide tax breaks to H-2A ranchers who comply with federal laws and regulations including better wages or provide monetary subsidies redirected from other agricultural programs. H-2A reforms could also be implemented in a piecemeal fashion. For example, housing standards and wages could be increased incrementally over several years to mitigate shock to the ranching industry. Incremental reforms would also allow for better feedback from ranchers, workers, and state and federal regulators with regard to what is and is not working. Finally, other incentives could be offered, such as streamlining and simplifying the application and labor

certification process for employing H-2A herders.<sup>3</sup> Such compromises could generate mutual understanding and cooperation among the DOL, policymakers, ranchers, associations, labor organizations, and immigration advocates to help achieve a palatable outcome to all concerned parties.

But with comprehensive immigration reform at the forefront of the American political agenda,<sup>4</sup> it is not unlikely that Congress will remain deadlocked on the contentious issue of agricultural guestworkers<sup>5</sup> in spite of such compromise and cooperation. Therefore, reform at the state level is another viable option for rectifying guestworker program abuses. Advocates in H-2A ranching states should introduce legislation similar to California's Assembly Bill No.1675 (Koretz 2001), which passed in 2001. Political leaders should follow California's example and codify similar legal protections that provide state level requirements for wages, hours, and housing and working conditions to be overseen and enforced by state labor regulators like the State Workforce Agency, which could also penalize employers for violations.

Reforming the H-2A program will require the advocacy and activism of concerned citizens, legal and fair labor advocacy organizations such as CLS and Verité, and workers themselves. Advocacy will occur not only in the courtroom, but also in the media, the classroom, and the streets. It will require public outreach and community organizing campaigns in towns and rural residential areas adjacent to the ranchlands where abuse has been documented. Social networking should be used to increase awareness and support local social justice. Immigrant rights and fair labor advocacy groups should ramp up public activity with social media and grassroots initiatives that target the agriculture industry. In addition to creating strategic alliances with agricultural organizations and ranching associations such as the Colorado Wool Growers Association, advocacy groups should increase their presence at county fairs, stock shows, and other events to increase relevant public exposure and awareness. These strategies should aim to influence electoral constituencies so that legislators take notice and become proactive champions of meaningful reform. To this end, advocacy groups should identify leaders of state legislatures in H-2A ranching states to sponsor labor code amendments and advocate for guestworker reforms at the federal level. Policymakers should meet special interest groups' resistance to reforms with the decisive view that the H-2A program was created to help fill jobs, not to allow employers to improve profit margins by exploiting and abusing an endless stream of cheap and expendable laborers at the expense of human dignity, U.S. jobs, and wages.

There is little doubt that reforming the H-2A guestworker program will be an uphill battle fraught with controversy. But given the incidence of human trafficking, forced labor, debt bondage, and indentured servitude associated with the H-2A program, the United States should view reform as imperative for our continued commitment to justice and equal rights. This fight will be met with the hostility of those with a vested interest in maintaining the cheap, expendable, and vulnerable labor that the H-2A program creates, but the hostility it confronts will be no more bitter than the bone-numbing winter winds, searing summer heat, and fearful silent solitude faced by guestworkers on the desolate ranges of the United States.

## NOTES

- <sup>1</sup> These elements are further defined in the statute at 22 U.S.C. § 7102.
- <sup>2</sup> For an example of the ‘few bad apples’ perspective, refer to the film *Shepherds of the Western Range*, available on the Colorado Sheep Industry website at [http://www.coloradosheep.org/H-2A\\_Sheep\\_Herders.html](http://www.coloradosheep.org/H-2A_Sheep_Herders.html) (accessed March 10, 2013).
- <sup>3</sup> For an example of prospective streamlining, or ‘labor attestation,’ refer to the 2009 federal AgJOBS bill available at <http://www.govtrack.us/congress/bills/111/hr2414#summary/libraryofcongress>. A 2011 White House immigration reform blueprint contends that “making changes to the H-2A temporary agriculture worker program that carefully balances the needs of businesses and worker rights, which are encompassed in the AgJOBS bill” is an important part of immigration reform: [http://www.whitehouse.gov/sites/default/files/rss\\_viewer/immigration\\_blueprint.pdf](http://www.whitehouse.gov/sites/default/files/rss_viewer/immigration_blueprint.pdf) (accessed April 8, 2013).
- <sup>4</sup> A bipartisan “gang of eight” senators, agribusiness lobbyists, and labor unions are presently negotiating guestworker reforms of this kind, including a new “W” visa; see Lauren Hogges, “Immigration Change is One Step Closer to a Bill,” NPR, March 31, 2013, <http://www.npr.org/blogs/thetwo-way/2013/03/31/175845588/immigration-reform-gets-one-step-closer-to-a-bill>; and Jackie Tortora, “Five Things You Need to Know About the Immigration Agreement,” AFL-CIO Now, March 01, 2013, <http://www.aflcio.org/Blog/Political-Action-Legislation/5-Things-You-Need-to-Know-About-the-Immigration-Agreement> (accessed April 8, 2013).
- <sup>5</sup> Such impasse can be seen at Ashley Parker, “Immigration Talks Hit Snag Over Business and Labor Concerns,” *New York Times*, March 22, 2013, <http://thecaucus.blogs.nytimes.com/2013/03/22/immigration-talks-hit-snag-over-business-and-labor-concerns/?emc=eta1>; and Lauren Fox, “Immigration Bill May Blow Up Over Ag Workers,” *US News and World Report*, April 05, 2013, <http://www.usnews.com/news/articles/2013/04/05/immigration-bill-may-blow-up-over-ag-workers> (accessed April 8, 2013).



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## IRAN: RESOLVING THE NUCLEAR CRISIS

*Farzan Sabet*

American President Barack Obama currently has an unprecedented opportunity to resolve the Iranian nuclear crisis. In the first year of his second term, he has substantial political capital at home and a strong coalition of countries supporting his sanctions strategy and nuclear negotiations abroad. Just as importantly, devastating economic sanctions since 2012 may have increased the willingness of the Islamic Republic of Iran to compromise on its nuclear program. This policy paper argues that President Obama should capitalize on this historic window of opportunity by acknowledging Iran's right to a peaceful nuclear program and offering a roadmap for lifting sanctions in exchange for deep concessions by Iran on its nuclear program. The United States has not yet placed substantive sanctions relief on the table, and this may be the key to breaking the deadlock in P5+1-Iran nuclear negotiations. However, the current strong U.S. negotiating position will erode over time and thus President Obama must take decisive action to resolve the Iranian nuclear crisis.

### INTRODUCTION

As President Barack Obama resettles into the White House and as pres-

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*Farzan Sabet is a first year doctoral student in International History at the Graduate Institute, Geneva. He holds a Master of Arts in International History & Politics from the Graduate Institute (2012), where he focused on international relations, international trade law, and Iranian domestic politics and foreign policy. He is co-founder and editing manager of IranPolitik.com and can be reached at farzan.sabet@graduateinstitute.ch.*

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ident-elect Hassan Rouhani prepares to take on his new office, a historic window of opportunity may exist for the United States of America and the Islamic Republic of Iran to not only resolve the crisis over the controversial Iranian nuclear program but to also seek broader rapprochement. There are, however, many obstacles in the path of successful negotiations. Both sides will be under pressure from hardline domestic actors seeking a continuation of the status quo. The United States will also be under strong pressure from important allies abroad, including Israel and the Gulf Cooperation Council (GCC), to extract maximum concessions from Iran. The Islamic Republic, for its part, wants to project an image of strength to foreign audiences and can only accept a deal which, at the very least, allows it to save face (Mousavian 2013). This creates constraints on the both sides, limiting the range of possible agreements.

Failure to reach a negotiated settlement, however, could have potentially catastrophic consequences for American interests. At one extreme, this failure may allow Iran to develop a nuclear weapons capability, shifting the balance of power in the Middle East and beginning a nuclear proliferation cascade. The Obama administration, however, has ruled out a situation in which the United States is forced to contain a nuclear weapon-latent Iran. At the other extreme, the United States may have to carry out military operations on Iranian nuclear facilities, an option which could temporarily set back the Iranian nuclear program but would likely have disastrous humanitarian consequences and lead to a regional conflagration. An attack could also give Iran a justification to withdraw from the Non-Proliferation Treaty (NPT) and make a dash for nuclear weapons, undermining the cause of nuclear non-proliferation. The Iranian nuclear crisis is thus one of the most important international security issues today.

Since the failure of the first round of negotiations between the Obama administration and the Islamic Republic in October 2009, the United States has pursued a “comprehensivizing” and “multilateralizing” economic sanctions strategy. This means that the United States has expanded the scope of sanctions to broader swaths of the Iranian economy, particularly its financial and petroleum sector, and multiplied the number of actors complying with sanctions. Since the five permanent members of the United Nations Security Council plus Germany (P5+1) and the Islamic Republic resumed high level political negotiations in February 2013, a question has hung in the air: Has the Obama administration’s sanctions strategy sufficiently changed Iran’s cost-benefit analysis to make a nuclear deal more likely?

This policy paper argues that this is the case. More specifically, it argues

that by applying sanctions to Iran the United States has increased the costs of failing to reach an agreement for Tehran. Sanctions appear to have strongly contributed to the rapid deterioration of the Iranian economy since at least 2012. What this means for Iran is that the price of continuing its nuclear program on the current trajectory is no longer diplomatic condemnation or vague threats of military action but deteriorating social conditions and severe economic pain that it can measure in the billions of dollars. While sanctions have largely succeeded as a mechanism of economic pain, this paper argues that expectations of what sanctions can achieve should be tempered and that pain must be applied in a broader framework that also includes incentives. As such, while sanctions have made a negotiated settlement of the nuclear crisis more likely, they cannot be relied upon to achieve a breakthrough by themselves. Negotiations must ultimately offer acknowledgement of Iran's right to a peaceful nuclear program under the NPT and a viable road map for lifting sanctions if they are to succeed.

While President Obama's re-election, Rouhani's election, and the relative success of sanctions thus far provide a window of opportunity for a mutually beneficial negotiated settlement of the nuclear crisis, several factors may erode the current strong U.S. position over time. First, as time passes, other policy priorities will divide the Obama administration's attention and political capital, weakening its ability to sell a negotiated settlement at home. Second, the Islamic Republic is already mitigating some of the effects of sanctions through a variety of methods, decreasing sanctions' value as a bargaining chip for the United States. Finally, the P5+1 and sanctions coalitions may begin to unravel over a wide range of issues, such as the attractiveness of Iranian petroleum resources at steep discounts or the humanitarian impact of sanctions, reducing the impact of sanctions and the international momentum for a negotiated settlement. Time is thus of the essence.

Based on these observations this paper proposes four specific policy recommendations for the U.S. strategy toward P5+1-Iran nuclear negotiations, taking into account both domestic, foreign, and temporal factors. First, President Obama should end the dual-track strategy as it is currently conceived. This means halting the expansion of the Iran sanctions regime by the U.S. Congress while negotiations are ongoing, as this may encourage Iran to escalate its nuclear program to maintain the balance of power in negotiations. Second, President Obama can offer to help suspend E.U. and some U.S. sanctions in exchange for suspensions of elements of the Iranian nuclear program. This suspension-for-suspension proposal creates further trust and builds momentum. Third, President Obama should use

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this momentum to reach a final agreement. A final resolution of the nuclear crisis will require the Obama administration to offer both acknowledgment of Iran's right to a peaceful nuclear program and a viable road map for sanctions relief. Fourth, the Obama administration must put in place guarantees that make any final agreement lasting. This paper makes its case in three parts. Part one briefly reviews the historical background of the Iranian nuclear crisis. Part two argues that current conditions could allow for a mutually acceptable deal, but that this window of opportunity will not last forever. Part three lays out the four policy proposals in detail.

## HISTORICAL BACKGROUND

### *Overview of the Iranian nuclear program*

The history of the Iranian nuclear program and the nuclear crisis of the last decade is long and complex. The origins of the Iranian nuclear program can be traced to 1959, when the United States built the Tehran Research Reactor (TRR) as part of the Dwight Eisenhower administration's (1953-1961) "Atoms for Peace Program" (Milani 2010). Before the Islamic Revolution of 1979, Iran under Shah Mohammad-Reza Pahlavi (1941-1979) planned to create a "full-fledged nuclear industry" with a 23,000 megawatts electricity production capacity (Milani 2010). Iran joined the International Atomic Energy Agency on 16 September 1959 (IAEA). While the Shah's nuclear program was, in theory, aimed at generating nuclear energy, there were already nuclear proliferation concerns at this time. Although the Islamists who emerged victorious in 1979 had criticized the Pahlavi dynasty's nuclear ambitions and initially rolled back the Iranian nuclear program, in the midst of the Iran-Iraq War (1980-1988) the regime decided to reconstitute its nuclear program, potentially to create a nuclear deterrent against Iraq (Milani 2010; Chubin 2006). Despite concerns about the Iranian nuclear program since 1979, the precise origins of the current nuclear crisis can be traced to August 2002 when the Iranian opposition group the Mujahideen-e Khalgh Organization (MKO) revealed the existence of the Natanz uranium enrichment facility near Esfahan, which Iran had failed to declare to the IAEA as it was bound to do under its safeguards agreement.

At this time, the Iranian government under the reformist President Mohammad Khatami (1997-2005) did make some efforts to cooperate with the IAEA, the United States, and the European Union. One of Khatami's main foreign policy platforms was the "Dialogue of Civilizations" (Halliday 2001), which included attempts by his administration to improve

relations with the West. These efforts to engage the IAEA, United States, and European Union are viewed by some as a classic example of a missed opportunity in U.S.-Iran relations. The George W. Bush administration in its first term (2001-2005) pursued what many perceived as an implicit policy of regime change toward the Islamic Republic (Sebenius and Singh 2012), and thus did not take Khatami's diplomatic initiatives seriously. Between 2003 and 2004, the Khatami administration took a number of steps that in light of subsequent events appear to have been aimed toward reconciliation with the United States. For example, under the Iran-E.U. Agreement on Nuclear Programme in November 2004, Iran volunteered to suspend uranium enrichment and enrichment-related reprocessing for three months. Iran had finally implemented the full suspension that the West had been asking for, albeit temporarily, overseen by IAEA inspectors and cameras (Reardon 2012). However, the mood in Washington was not conciliatory. The Bush administration's unwillingness to offer Iran even limited sanctions relief despite Khatami's confidence-building measures effectively discredited the latter's foreign policy in Iran. This put another nail in the coffin of the Khatami administration and empowered hardliners to take power in the 2004 parliamentary and 2005 presidential elections. These hardliners, led by President Mahmoud Ahmadinejad, rejected talks and expanded the nuclear program.

It would not be until President Barack Obama took power in 2009 that negotiations would get back on track. Early into his first term, President Obama sent a number of conciliatory signals to the Islamic Republic and its leaders, including a special Nowruz message in March 2009 (The Economist 2009). In October 2009, Iran was offered a draft agreement whereby it would ship 1,200 kg of low enriched uranium (LEU) (75 percent of its stockpile) to Russia for further enrichment, on to France for fabrication into fuel and back to Iran for use in the TRR (Borger 2009). While Iran's signing of the draft agreement would certainly not resolve the nuclear crisis, it was viewed by the parties involved as a test of Iran's seriousness toward negotiations and as a confidence-building measure. Though there was initial optimism about Obama's outreach and the October 2009 draft agreement, Iran sidestepped the deadline for signing it by making a counterproposal that was viewed as unacceptable by the other parties involved. In addition, the events of the previous summer hung heavily on all sides. The breakout of mass demonstrations in Iran between June 2009 and February 2011 over the allegedly fraudulent 2009 Iranian presidential elections further strained the Islamic Republic's relations with the United States and the European Union, effectively ending negotia-

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tions. While the May 2010 Brazil-Turkey nuclear initiative, backed by Iran, attempted to put a similar offer back on the table, it was viewed by the United States and the European Union as too little too late (Kaplan 2010). Furthermore, the timing of Iran's offer was viewed with suspicion. In the intervening months the Obama administration had shifted its strategy toward Iran, focusing on economic sanctions to pressure the Islamic Republic into negotiation and making concessions on its nuclear program. With a U.N. Security Council resolution on the Iranian nuclear program set to come up for a vote in summer 2010, Iran's acquiescence to the Brazil-Turkey initiative was viewed as potentially a ploy to derail the U.S. sanctions strategy.

By 2012, the signs of the negative impact of sanctions on the Iranian economy were apparent. This, alongside the end of the Green Movement demonstrations, appears to have created the political space necessary for nuclear negotiations to restart. The next round of high-level negotiations between the P5+1, consisting of the United States, Great Britain, France, China, Russia, and Germany on one hand and the Islamic Republic on the other, took place in three successive stages, with the first round in Istanbul (April 2012), then Baghdad (May), and finally Moscow (June). Before these negotiations, Iranian Supreme Leader Ayatollah Ali Khamenei publicly restated his "nuclear fatwa" which declared that nuclear weapons are prohibited in Islam (Eisenstadt and Khalaji 2011). While Iranian negotiators presented this as a concession and sign of good faith, P5+1 negotiators were skeptical of its value given Khamenei's power to revoke the fatwa. These negotiations were not considered a failure as both sides were able to establish long-absent dialogue and agree to further low-level technical talks, but major obstacles to a final resolution clearly existed. President Obama's re-election in November 2012 gave renewed impetus for negotiations in February 2013.

### *Current positions and latest negotiations*

In recent negotiations, both sides have highlighted a number of items they want, with varying degrees of flexibility in terms of the extent to which they are willing to compromise on each item. The Islamic Republic has at least two major demands: recognition of its right to enrich uranium for peaceful purposes, including the production of energy and medical applications, and the lifting of sanctions (Rozen 2013). The P5+1 have at least three major demands. The first is Iran's acceptance of the Additional Protocols and other measures that would allow invasive inspections to monitor Iranian compliance with its international obligations. The second is that



Iran ceases uranium enrichment around 20 percent, the level believed to be a technical step short of the ability to produce weapons-grade uranium (Heinoneh 2012). Finally, the P5+1 has in the past demanded dismantling or suspension of the underground Fordow enrichment facility.

The February 2013 Almaty talks included elements of all five of these demands (Erlanger 2013). The P5+1 continued asking for suspension of enrichment around 20 percent, although it agreed that Iran could retain a small percentage of its existing stockpile of this material for use in the TRR for medical purposes. While it only asked for suspension of enrichment at Fordow and not its dismantling, it did demand monitoring measures to prevent an unexpected Iranian nuclear break out. The P5+1 offered a limited suspension of sanctions, although the most stringent financial and petroleum sanctions would remain in place. The 05-06 April Almaty II and 15 May talks did not progress beyond this, demonstrating the gap that still exists between both sides. This leaves much of the heavy lifting for when the two sides meet again in September 2013.

## STATE OF PLAY

With this historical background in mind, the current section looks at a number of key factors that are important for formulating a policy proposal. These factors include the structure of the Iran sanctions regime, the visible economic impact of sanctions, and questions surrounding the timing of any deal.

### *The Iran sanctions regime*

As a recent report has pointed out, “in 2012, Western sanctions on the Islamic Republic of Iran’s oil and gas industry, aimed at putting economic pressure on it to change its nuclear policy, have reached an unprecedented level” (Economist Intelligence Unit 2012). While the United States has imposed sanctions on the Islamic Republic in one form or another since 1979, today’s sanctions are unprecedented due the combination of at least three characteristics. First, sanctions are multilateral, being applied by more actors than ever before. The Obama administration’s multilateral diplomacy has gained the support of major importers of Iranian oil, including the European Union, China, India, Japan, and South Korea. Second, these sanctions are increasingly broad, attacking Iran’s financial and petroleum sectors and thereby undermining its entire economy. Finally, they are better enforced than past sanctions, with U.S. secondary sanctions convincing state and non-state actors to reduce or cut economic ties with Iran.

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Arguably, the biggest change to the Iran sanctions regime has been the European Union's support for the U.S. sanction strategy. The July 2012 E.U. oil embargo and financial sanctions have been particularly devastating. These sanctions require E.U. member states to end Iranian crude oil imports, accounting for 25 percent of Iran's oil exports, and prevent E.U.-based maritime insurers, who provide insurance for nearly 90 percent of the global oil tanker trade, from selling insurance to vessels carrying Iranian oil (Economist Intelligence Unit 2012). Section 1245 of the U.S. National Defense Authorization Act (NDAA) has targeted the Iranian financial system's transactions with third parties (United States Government Printing Office 2012). Section 1245 is a secondary sanction which forces state and non-state actors to choose between the American and Iranian financial systems. It specifically targets third-party oil transactions with Iran. The sanction does provide waivers for those who decrease their imports of Iranian crude oil. By isolating the Iranian Central Bank and financial system, this sanction has made it increasingly difficult for Iran to receive payments for oil exports. The Iran Threat Reduction and Syria Human Rights Act of 2012 (ITRSHRA) and Iran Freedom and Counter-Proliferation Act of 2012 (IFCPA) began coming into effect starting February 6, 2013 (Bureau of Economic and Business Affairs 2012). These sanctions build on NDAA 2012 Section 1245 to cut off non-oil sectors of the Iranian economy from the international financial system.

The American component of the Iran sanctions regime is complex. As a recent report has pointed out, U.S. sanctions on Iran seek multiple policy objectives, including non-proliferation, anti-terrorism, and human rights (International Crisis Group 2013). Although President Obama has some flexibility in giving reprieve from some sanctions, he requires congressional cooperation to lift many (The White House 2011). This gives him limited flexibility when negotiating with Iran. Given the bipartisan congressional hostility toward Iran, this means that short of full capitulation to all U.S. demands by Iran, many of the most severe sanctions cannot be lifted. Rather than a foreign policy scalpel for encouraging behavior change, sanctions have come to resemble a blunt hammer aimed at regime change. The difficulty of unmaking U.S. sanctions on Iran is one factor we have to consider when formulating our proposals.

### *Impact of sanctions on the Iranian economy*

Sanctions have been devastating to the Iranian economy. According to Iranian Oil Minister Rostam Ghassemi, Iranian petroleum exports between 2011 and 2012 fell by forty percent. The Organization of Petroleum

Exporting Countries (OPEC) reported that Iranian oil exports fell from nearly 2.4 million to 1.0 million barrels/day during the same period, a decline of nearly 60 percent (Gladstone 2013). Even when Iran has been able to export oil, it has had trouble receiving payment in dollars or euros and has been forced to accept payment in bartered goods, local currencies, and gold (Faucon 2012). Given that Iran has historically been reliant on oil exports for up to 80 percent of its foreign exchange earnings and up to 60 percent of state revenues, the precipitous decline in oil exports and difficulties repatriating oil revenue may create an Iranian fiscal crisis in 2013 (Farhi 2013). As a result, Iran will have one of the fastest shrinking economies in 2013 (The Economist 2013). Even before 2012, the Iranian rial, which had been pegged to the dollar at a rate of 10,500 rial per dollar, had begun a downward spiral. Since then the rial's black market price has decreased by at least 40 percent, making imports more expensive (Gladstone 2012).

Iran's economy, which before these sanctions suffered from high unemployment and inflation due to long-term mismanagement by the regime, has begun descending to new lows. As a result, the majority of Iranians who still have jobs have found their purchasing power decreasing rapidly. Shortages of essential medicine and medical equipment in Iran as a result of sanctions have been documented (Namazi 2013). Sending students to study abroad, one of the safety valves the regime has used for years to deal with disgruntled youth at home, has now become much more difficult because of the decline of the rial and difficulty sending money abroad. The inability of many domestic Iranian airlines to pay their fuel bills, in large part because of sanctions, may soon force these airlines to be grounded, even as many foreign airlines stop flights to Iran (Sheahan and Webb 2013). The economic picture in Iran has not been rosy for years, but since at least 2012 ordinary Iranians have been confronted with a significant decrease in their standard of living. Jobs, healthcare, food, education, and travel, among other things, have suddenly been made more inaccessible for the majority of Iranians. This downward trend is sure to continue as the government is forced to make difficult budget cuts in 2013. It is unclear how Iranian society and the regime will react to the deteriorating situation in the short term. The IRGC has recently shown signs that it expects unrest because of the state of the economy (IranPolitik 2013). For the time being, the regime is placing much of the blame for the hard economic times on the Ahmadinejad administration (Larijani 2013). Ahmadinejad has in turn blamed sanctions (IRNA 2013). Iranians are fully aware of the role of the regime's mismanagement and corruption in creating the current

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economic situation. However, it is not unlikely that as time passes and the humanitarian impact of sanctions becomes more pronounced, blame will begin to shift to sanctions and the West.

### *Timing*

Time may be of the essence in the sense that the Obama administration's negotiating position and ability to conclude a final settlement of the nuclear crisis are likely to be at their strongest earlier in his term rather than later. Here is why. First, fresh from his victory in November 2012, the president has a renewed mandate from the American people. As time passes, however, domestic and other foreign priorities are likely to divide the Obama administration's attention, reduce its political capital for the nuclear issue, and enable the Republican opposition to regroup. Second, Iran continues to find ways to evade sanctions and minimize their impact, meaning that sanctions cannot be relied upon to impose their current level of economic pain in the future. Iranian oil, especially if it comes at a steep discount, is likely to find other markets. Furthermore, as with other sanctioned states in the past, Iran can use front companies and smuggling to import illicit goods and export oil. It is also restructuring parts of its economy to adjust to sanctions. Already the Central Bank is instituting a system of currency controls that allocates foreign exchange on the basis of priorities, such as food and medicine. More expensive imports and Iranians' willingness to accept lower wages in the current economic climate could be an impetus for domestic industry, undermined by cheap imports before 2012, to increase production and create jobs. (Sam 2012). Past studies have shown that semi-authoritarian regimes like Iran, which are less accountable to their people, are better equipped to manage sanctions (Brooks 2002). The experience of Iraq certainly bears this out. In the long term, the regime could very well survive by reallocating Iran's remaining wealth to existing constituencies like the IRGC or new ones like domestic manufacturers while forcing the rest of the population to accept a lower standard of living.

Third, it is unclear how long the United States will be able to keep its P5+1 and sanctions coalitions together. These partners may break with the United States for several reasons. For example, a sudden spike in global energy prices may make cheap Iranian oil attractive for some. What appears to be China's first oil purchase from Iran since the E.U. oil embargo and insurance ban may be a sign of this (Arnsdorf & Wang 2013). These sanctions' interference with the economic sovereignty of states is also creating incentives for non-Western states to develop alternatives that undermine

the West's economic clout in the long term. For example, following the E.U. maritime insurance ban, which made it more difficult for Iran to ship its oil, the Japanese government approved sovereign guarantees to allow it to continue importing Iranian oil (Maeda 2012). In other scenarios, for example, if the West intervenes militarily in Syria, P5+1 partners such as China and Russia may be less cooperative with the U.S. sanction strategy and provide greater support for Iran. Given the United States and European Union's global clout and emphasis on the nuclear crisis, key states with strong ties to Iran such as China, Russia, India, Japan, and South Korea have been accommodating to the West on this issue. Changing economic and political winds can weaken the P5+1 and sanctions coalitions.

The election of Hassan Rouhani as the next president of Iran on 14 July 2013 also presents an important window of opportunity for President Obama. Rouhani is a former nuclear negotiator who is intimately familiar with Iran's nuclear program and P5+1 nuclear negotiations. More importantly, Rouhani is considered a moderate in the context of Iranian politics and has expressed willingness to take a much more conciliatory approach toward nuclear negotiations. While we should temper our expectations of what Rouhani can do, the Iranian president-elect will have greater flexibility at the beginning of his term (which begins in August 2013) versus later on when Iranian hardliners have had the opportunity to regroup and limit Rouhani's room for maneuver. This small but crucial window must not be missed and should be factored into the U.S. negotiation strategy.

## RECOMMENDATIONS

### *Abandon the dual-track strategy*

If there is one thing Congress has a wide bipartisan consensus on, it is the need to sanction Iran over its nuclear program. After the failure of the October 2009 talks, the Obama administration used this dynamic to extend the Iran sanctions regime and to buttress its multilateral diplomacy as part of the dual-track strategy, but escalating congressional sanction making may now be actually hurting diplomacy. The implementation of these sanctions even as P5+1 and Iran negotiate not only creates the impression on the Iranian side that the United States may not be negotiating in good faith, but also limit President Obama's ability to offer to lift sanctions without explicit congressional approval, thereby hamstringing his foreign policy-making ability. Beyond creating mistrust, escalating congressional sanctions may actually encourage the Islamic Republic to escalate its own nuclear program, as it has recently done by installing a second generation

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of more efficient centrifuges, in order to maintain the balance of power in negotiations. President Obama should prevent Congress from hijacking his foreign policy. Ideally, he should work with Democrats in Congress to defeat new sanctions legislation. Where this is not possible, he should use his veto. Either way, the dual-track strategy has not borne fruit and should be abandoned in its current form.

### *Suspend sanctions for suspension of Iranian nuclear activities*

It is unlikely that a final agreement can be reached without signs of good faith from Iran and American willingness to ultimately lift sanctions. Given that many of the most potent financial and petroleum sanctions require congressional action to lift, the Obama administration is likely unable to promise an end of these nuclear-related sanctions until there is considerably more momentum in nuclear negotiations. As such, the United States should seek to create further momentum for resolving the crisis by proposing a temporary suspension of some sanctions for suspension of some Iranian nuclear activities. This suspension for suspension could be done in one or several stages and would be temporary to help maintain pressure for a more permanent agreement.

Given that President Obama and federal agencies under his control are ultimately tasked with implementing sanctions, the president should use his power to issue waivers on sanctions like ITRSHRA and IFCPA to temporarily exempt third parties from secondary sanctions. The European Union, which has fewer restraints in terms of suspending and lifting sanctions, could do likewise with some financial and petroleum sanctions. The scope of the suspension of sanctions by the P5+1 would help determine the scope of suspension of nuclear activities demanded and provisional IAEA monitoring obtained from Iran. The specific configuration, scope, and timing of suspension for suspension depends on the priorities of the actors themselves. However, the broader the scope of suspension for suspension and the more limited the period for which it lasts, the more pressure can be generated for further talks and a final settlement.

As an intermediate step to a final agreement, suspension for suspension serves three crucial functions. First, it tests both the calculation-changing impact of sanctions and Iran's willingness to negotiate in good faith, laying the groundwork for determining further course of action should Iran fail to cooperate. Second, it acknowledges the marathon-like nature of these nuclear negotiations, balancing the need to create momentum with the possible constraints faced by both parties. Finally, suspension for suspension creates the momentum for selling a final nuclear deal within the United States.

### *Establish key conditions for final agreement*

There are two key concessions the P5+1 must make for a final agreement that substantially curtails the Iranian nuclear program to be politically and materially palatable to the Islamic Republic. The first is recognizing Iran's right to enrich uranium for peaceful purposes under the Non-Proliferation Treaty (NPT). This is well within the realm of possibility, as noted by former Secretary of State Hillary Clinton: "It has been our position that under very strict conditions Iran would, sometime in the future, having responded to the international community's concerns and irreversibly shut down its nuclear weapons program, have such a right [to enrich] under IAEA inspections" (United States Government Printing Office 2011). The second concession is at the very least a clear road map for permanently lifting nuclear sanctions, particularly E.U. financial and petroleum sanctions and U.S. secondary sanctions. In the case of the United States, this may be easier said than done, given the bipartisan congressional consensus against any Iranian nuclear activities. While most of the harshest sanctions are ostensibly aimed at curtailing the Iranian nuclear program, the parochial interests of congressmen and a desire for regime change among some of them means that even if Iran makes major concessions on its nuclear program, sanctions may remain in place. This can be addressed through a two-pronged strategy.

The low-hanging fruit of E.U. sanctions would already provide substantial sanctions relief by restarting E.U.-Iran petroleum trade, lifting the maritime insurance ban, and easing financial restrictions on Iran. The lifting of the harshest U.S. secondary financial and petroleum sanctions needing congressional action, however, will require President Obama to stand up to Congress. Three tools aid him in this mission. First, using the momentum created by suspension for suspension, the president can present a final draft agreement with Iran for resolving the nuclear crisis to Congress as a genuine solution and those failing to support it as obstructing global peace. Second, in the scenario where a final agreement is within sight, the Obama administration can reduce its multilateral diplomacy that has been central to enforcing congressional sanctions. This slackening of diplomacy and the momentum toward a final agreement would enable mass noncompliance by key international partners such as the European Union, China, India, Japan, and South Korea, who until now complied with sanctions by substantially curtailing their import of Iranian crude. Congress will be faced with the unenviable choice of enforcing punitive, sovereignty-violating secondary sanctions against important international

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partners or lifting sanctions, *de facto* and *de jure*. Finally, President Obama can use a system of guarantees to reassure Congress that a final agreement for ending the nuclear crisis will be enduring. These guarantees are addressed in proposal four.

Acknowledging Iran's right to a peaceful nuclear program alongside a clear and viable roadmap for lifting sanctions will likely enable the United States to exact major concessions from Iran. These include a system of long-term and invasive IAEA inspections, end of enrichment at 20 percent or above 5 percent, and closure of the Fordow facility. The specific configuration, scope, and timing of P5+1 concessions in a final agreement depend on its priorities. The more Iran concedes, the more the P5+1 can offer and the more palatable a final agreement for U.S. domestic audiences.

### *Create a system of guarantees*

The fourth and final proposal would create a system of guarantees that creates mechanisms to keep all parties involved, especially the United States and Iran, from renegeing on their international obligations. In particular, once negotiations are concluded, Iran's nuclear rights are acknowledged, and sanctions are lifted, Iran's immediate motivation for continued compliance with the final agreement may decrease. As such, any final agreement should require the P5+1, and thus the U.N. Security Council, to reimpose broad and multilateral sanctions if Iran decides to unilaterally renege on its pledges. Given that reimposing international sanctions can be difficult once they are lifted, the United States requires guarantees against such Iranian action. This system would help make any final agreement convincing and assure both domestic constituencies in the United States and key allies such as Israel and the GCC that the Obama administration has been able to put the Iranian nuclear genie back into the bottle.

Guarantees, however, must work both ways. This means that the United States must reassure Iran that sanctions will not simply be reimposed on other grounds such as counterterrorism or human rights, as the regime in Tehran fears. The United States can do this while maintaining its commitment to fight terrorism and promote human rights by bifurcating sanctions. Barring unforeseeable *force majeure* circumstances, secondary financial and petroleum sanctions should be tied to Iran's continuing compliance with a final nuclear agreement. However, the United States, and Congress in particular, could remain free to use targeted sanctions aimed at specific individuals and entities whom support militant groups or violate human rights. This would have the crucial benefit of easing the potentially calamitous humanitarian impact of sanctions on the Iranian people as a whole while holding Iranian leaders to account for their decisions.



## CONCLUSION

There are no easy solutions to the Iranian nuclear crisis. Past negotiations have revealed difficulties in dispelling mutual distrust and making the necessary concessions on both sides. However, a negotiated agreement appears to be better than the alternatives, which could involve containing a nuclear-armed Iran or a war with Iran. Early in his second term, President Obama is flush with political capital after his electoral victory, potentially giving him the power to achieve his foreign policy priorities. His national security cabinet, including Secretary of State John Kerry and Secretary of Defense Charles Hagel, are viewed as being seriously committed to resolving the nuclear crisis and thus give the United States more credibility in negotiations. Most importantly, sanctions have imposed a high price on Iran for continuing its nuclear program that was largely absent in the past.

The major shortcoming in previous negotiations addressed in this paper has been the lack of a credible strategy for resolving the crisis and, specifically, a viable road map toward lifting sanctions on Iran. While the United States has grounds to suspect Iran's intentions and goals, this is a two-way street. At several critical junctures since 1989, Iran has made strong conciliatory gestures toward the United States that have gone unrequited (Ramsey 2013). Furthermore, there is a real sense of disproportionality on the Iranian side when it is asked to end its nuclear program, a strategic asset for which it has spent considerable blood and treasure, in exchange for civilian aircraft spare parts and vague promises of lifting sanctions in the future. The time is now ripe for the United States to put its cards on the table and offer Iran substantive sanctions relief in exchange for nuclear concessions. Sanctions relief comes at a minimal cost to the United States as sanctions have cost it relatively little to impose. Moreover, under the fourth proposal presented in this paper, the P5+1 would be able to quickly reimpose sanctions if Iran unilaterally reneges on the final agreement.

A viable roadmap for lifting sanctions and actual sanctions relief will likely help move the negotiations forward to a successful conclusion. In the worst-case scenario that they do not, this move will allow the United States to do two other important things. First, it allows it to see if its current strategy toward Iran is working and to what extent sanctions have been able to change Iran's calculations. Second, if negotiations are clearly failing and Iran is rapidly moving ahead toward a nuclear-weapons capability, the proposals outlined in this paper will help the Obama administration prepare the ground for the use of military force. As long as the United States has not made a credible effort in negotiations, military action will

be perceived as illegitimate by much of the international community, particularly China and Russia. The United States' current strong negotiating position, mainly due to President Obama's second-term mandate and especially the impact of sanctions, will not last forever. President Obama will likely never be in as strong a foreign policy-making position as he is in 2013. He should use this historic opportunity to resolve one of the most pressing international security issues of our time. In so doing, he could be taking an important step toward resolving the over thirty-year U.S.-Iran conflict and larger problems in the Middle East.

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## THE BRIEF, WONDROUS LIFE OF WOKAI: WHAT A FLEDGLING NON-PROFIT CAN TEACH US ABOUT THE CHALLENGE OF MICROFINANCE IN CHINA

*Daniel Tam-Claiborne*

The opportunity for microfinance in China has never been more acute. At present, China boasts the world's second-largest number of poor, and nearly 75 percent of China's rural population lacks access to credit. However, despite its long history on the mainland, microfinance continues to face myriad challenges infiltrating the Chinese market. Using the case study of Wokai, this paper seeks to address how restrictions on financial institutions, difficult registration requirements for international NGOs, and a large market for informal credit hamper the spread of microfinance institutions in China. It concludes by offering policy recommendations that suggest a revamped domestic market for microfinance NGOs built around access and trust may hold the key to microfinance's future Chinese success.

### INTRODUCTION

In late 2009, Casey Wilson, the co-founder and CEO of Wokai ("I

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*Daniel Tam-Claiborne is a MA candidate at Yale University's Jackson Institute for Global Affairs, where he focuses on international development and sustainable agriculture. He can be reached at dtamclaiborne@gmail.com.*

Open”) was interviewed on Bloomberg News to discuss how her startup planned to transform the microfinance landscape in China. Wokai, the then two-year-old U.S. nonprofit with operations based in Beijing, was a platform that allowed individual contributors from around the world to connect with entrepreneurs in rural China. It was molded after the model pioneered by Kiva Microfunds, a U.S. nonprofit that funds microfinance institutions (MFIs) in over 60 countries around the world. Through its online platform, Wokai employed a person-to-person lending structure, where donors could choose to fund individual borrowers through a variety of microfinance projects. After a loan was paid back, donors were able to reinvest their initial capital to fund another project. During the Bloomberg interview, Wilson noted that Wokai had already linked over 700 donors with 220 borrowers in the provinces of Inner Mongolia and Sichuan for a total investment of over \$100,000 (Wilson 2009). One way in which Kiva’s model strays from that of Wokai, however, is that in spite of its large and rapidly expanding base of MFIs in Asia, Kiva does not have a single client in China.

In spite of its successes, in May of 2012—just five years after the organization’s founding—Wokai announced that it was in the process of concluding operations. Its exit from the market came after raising over half a million dollars in loan capital to support over 4,000 people in starting new businesses and moving out of poverty (Wokai 2012). Industry experts cited Wokai’s exit as a “setback for microfinance in China,” especially as the organization seemed “poised for growth” (Yuen 2012). In a country where millions of people still idle in poverty and the income gap between rural and urban areas is growing wider, the prospect for microfinance in China is becoming increasingly more relevant. Microfinance as a lending tool has been time-tested in markets as varied and diverse as Bangladesh, Kenya, and Guatemala and is a movement that since its beginnings in 1976 has challenged the conventional wisdom of the financial services sector. However, it still has a notably minimal footprint in China. What can account for this disparity? Will the story of Wokai be the fate of all microfinance organizations to reach the mainland?

On Wokai’s website, Casey Wilson cited only “unexpected road blocks” as the rationale behind its shutdown, but many of the challenges she faced were not unique to her organization (Ardaiolo 2012). In fact, microfinance as an industry has experienced enormous challenges in the face of technical and structural barriers that can be attributed to China’s bureaucratic system and societal makeup. This paper explains how restrictions on financial institutions, difficult registration requirements for international

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NGOs, and a large market for informal credit hamper the spread of MFIs in China. It concludes by offering policy recommendations that suggest a revamped domestic market for microfinance NGOs built around access and trust may hold the key to microfinance's future Chinese success. This paper will not assess the criticisms of the microfinance model as a whole, which have been argued and addressed to some extent in other scholarly research. Instead, it will operate under the prevailing assumption that microfinance is by and large a beneficial social tool to improve the lives of impoverished people in developing countries and assess the consequences of its integration into the Chinese system.

## MICROFINANCE IN CHINA

In 2008, Fu Yajun and her husband worked 16-hour days as day laborers in rural Sichuan just to provide a living income for themselves and their two sons (Wilson 2010). They were fortunate to start working on a mushroom farm three years prior and learn the trade and eventually were able to save enough money to start their own business. Their business was quite successful, and their mushrooms consistently sold out every time they went to market. But they had a problem. They were not able to scale up their business to the point where they were making enough income to send their children to school. On a neighbor's recommendation, Fu Yajun partnered with one of Wokai's field partners on the ground. She took out a \$600 loan to buy some raw materials, and, in the next two years, her business's profits increased to the point that she had enough money to afford healthcare and schooling for her family (Rosenberg 2012).

The story of Fu Yajun is a textbook example of Wokai's approach to microfinance. In Yilong County, Sichuan, where Fu Yajun lives, Wokai worked with the Association for Rural Development of Yilong County (ARDY), one of its two field partners that had been established in collaboration with the United Nations Development Program (UNDP) in the 1990s (Wokai 2012). Of its nearly 2,500 clients, about one third were female, with loans ranging from several hundred to a few thousand Chinese renminbi (RMB). Wokai was by no means the only international NGO to work in the field of microfinance in China. Organizations as wide ranging as The Nature Conservancy, Habitat for Humanity, and the Concordia Welfare & Education Foundation have all actively incorporated microfinance and microcredit as part of their guiding policy for poverty alleviation in China (Nature Conservancy 2013). However, instead of directly funding microfinance projects the way that most other international NGOs did, Wokai was unique in that it acted as an intermediary that



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fundraised on the behalf of MFIs. Casey Wilson's guiding vision behind Wokai was that of a "China helps China" model. In other words, Chinese MFIs were already doing good work on the ground and understood the domestic needs of their clients better than a foreign interloper. The problem was that these MFIs had trouble raising enough capital to sustain their operating costs. Wokai's niche, then, was to raise money for MFIs so that they could continue lending to Chinese borrowers, according to an interview Wilson gave to this author in 2013.

One reason to explain the surge in microfinance-related organizations is that China today faces a great need for microcredit to serve the population left most vulnerable by its 30-year journey of industrialization: its rural poor. In spite of being the world's fastest growing economy and the second-largest economy in the world behind the United States, China ranked a dismal ninety-one in terms of per capita GDP growth in 2011 (OECD 2009). This is due primarily to its large and disproportionately poor rural population, which constitutes 650 million people—49 percent of its total population—second only to India as highest in the world (OECD 2009). This demographic stands as antithetical to China's otherwise spectacular growth because, according to the World Bank, poverty in China is an almost exclusively rural phenomenon with 90 percent of the poor population residing in rural areas (Yuen 2012). China has the second-largest number of poor people after India. About 254 million in China live on less than \$1.25 a day, compared with an average annual household income in the country of \$5,500 (Akula 2009). In addition, the ratio between urban and rural incomes has climbed to record levels, reaching a peak of 3.3 in 2007, meaning that the average income in the cities is over three times higher than that in the countryside (OECD 2009).

A leading cause for this disparity in wealth is that 75 percent of the rural population lacks access to credit and financial services (Barnes 2009). Focusing on high-margin, low-risk markets, China's four largest banks—all state owned—have closed a combined 30,000 branches in poor and rural regions over the last few years, further eroding the already weak financial foundation forged from the increasing numbers of migrant workers fleeing to the cities in search of economic opportunities (Reboot 2013). Because banks have slowly moved their resources from small, agricultural loans to more profitable, industrial loans found in China's metropolises, rural communities have not shared the same economic growth that the rest of China has recently achieved (Kendall 2008). This is especially true of the millions of Chinese citizens living in remote regions with weak infrastructure and challenging natural conditions. This increasing divide between rich

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and poor across geographic and regional lines has the potential to create tremendous instability and uncertainty in China.

For this reason, the rural-urban income gap has received significant attention from China's top leadership. One of the major targets of the 12<sup>th</sup> Five-Year Plan is the "stable development of the rural economy" (PlaNNet Finance China 2012). The plan goes on to suggest that new and more innovative initiatives may be required if the goal to "eradicate poverty in ten years" is to be accomplished, specifically by "improving public services and infrastructure construction in rural areas, and seeking new ways to increase farmers' incomes" (PlaNNet Finance China 2012). Rural areas dependent on agriculture are likely to show the highest poverty rates. This suggests that income diversification is now a key factor in eradicating the remaining niches of absolute poverty in China (OECD 2009).

For income diversification in the rural sector to succeed, individuals must have access to basic financial services. As the density of poverty declines nationwide, there is a need to target the 480 million people—representing 66 percent of China's rural villagers—who do not have access to credit at the household level in order to invigorate the rural economy (Chinoy 2009). That is why creating a diversified financial system of microfinance providers that can meet the needs of different types of borrowers in rural areas should be one goal of China's future financial reforms (Yusuf 2008). Given its large population of rural poor, China has the second-biggest potential for microcredit in the world after India. But, unlike India, China has yet to fully capitalize on the market. The microfinance industry is extremely small in China, estimated at \$200 million, compared to India's nearly \$3 billion industry. Furthermore, there are approximately 100 MFIs in all of China, a stark contrast to the greater than 1,000 MFIs in India (Yuen 2012).

The consequences of full implementation of microfinance programs in China's rural sector could be enormous. Loan sizes would be larger than in India because GDP at purchasing power parity (PPP) per capita in China is higher, but loans would still be useful for income-generating activities such as raising livestock, buying materials for micro-businesses and farming, and setting up small trades and services (Akula 2009). In addition to providing capital to help micro-entrepreneurs start new businesses, Wokai and other international NGOs have offered loans to clients to fund the purchase of household alternative energy units, invest in livestock, and transport equipment to get goods to market (Concordia Welfare and Education Foundation 2013).

A World Bank report in 2006 argued that there was a strong link between

weak access to credit and low incomes. It states that a small loan of \$100 to buy animals or seeds for planting can “make a major difference for a poor family, and a series of loans within a community can transform it” (Knowledge @ Wharton 2012). Furthermore, according to the UNDP, “using microfinance to improve the economic status of the poor is an important way of rebalancing and consolidating China’s development achievements” (United Nations Development Program 2012). The Chinese government has experimented with a variety of poverty-alleviating policy measures over the last several decades. Microfinance, in making up the newest of such schemes, has faced considerable obstacles and backlash as a result.

## CHALLENGES AND LIMITATIONS

Microfinance, from its first foray into the Chinese landscape in 1994, has occupied a unique position. It began as a response to a series of largely unsuccessful subsidized loan programs in the 1970s and 1980s called the Policy on Poverty Alleviation (Akula 2009). At the same time, microfinance models were being introduced to China as part of a worldwide proliferation of NGO-led microfinance programs (Park et al. 2003). Thus, the main objective for the Chinese government in switching to microfinance methods was two fold: one, to try and raise repayment levels from those achieved by the failed subsidized loan programs, and two, to reflect the exuberant optimism of the international development community (Pan et al. 2012).

Over the next decade, microfinance evolved to further incorporate the international community—notably the UNDP—and in light of successful loan repayment rates, the People’s Bank of China formally recognized the legitimacy of MFIs in 1999, a decision that scholars called a “milestone in the development of microfinance in China” (Knowledge @ Wharton 2012). Since then, other formal financial institutions became involved in expanding microcredit services, including rural credit cooperatives (RCCs), microcredit companies (MCCs), and village and township banks (VTBs) (Du 2004). Broadly speaking, microfinance in China began as foreign donor funded pilot projects and grew to include dedicated government initiatives. MFIs in China now include a diverse set of bank branches, government-sponsored credit cooperatives, local NGOs, and international NGOs. Though I will focus predominantly on challenges to international microfinance NGOs, these limitations are endemic to the entire microfinance field as a whole.

Wokai entered the Chinese market in 2007, riding the wave of compara-

tively open attitudes of government policy toward the influx of microfinance programs. In fact, by 2008, microfinance had gained enough traction and recognition as an important tool for poverty alleviation that the central government and bank “showed even more interest in microfinance than ever before” (Du 2004). But despite being able to infiltrate the market, Wokai, like all foreign-based microfinance NGOs, encountered a number of difficulties. Casey Wilson cited three major hurdles that inhibited her NGO’s growth: tight regulation of MFIs by the Chinese government; the non-legal status of NGOs; and the large market for informal credit.

### *Regulation*

After the failure of the Policy on Poverty Alleviation in the late 1970s and 1980s, Beijing has been understandably wary of allowing for a more laissez-faire approach to the financial sector. Specifically, Chinese leaders worry that if financial regulations were too liberalized, they may be quickly overwhelmed by corruption and co-opted by poor management (Chinoy 2009). To that end, the government is very explicit about what is and is not allowed within the realm of microfinance. First of all, MFIs on the ground are prohibited from accessing debt or equity investment, which means that investors have trouble investing in the market. This is a problem for domestic investors, but it is especially problematic for foreign individuals and firms. The market demand for microloans in China is estimated at 5 trillion RMB, and while the supply is estimated at only 1 trillion, the market cannot be fully tapped because of regulatory restrictions (Chinoy 2009).

Secondly, regulations prevent microfinance programs from registering as financial institutions, and interest rates have been tightly controlled at below market-clearing levels (Park and Ren 2001). These artificially low interest rates are a problem for lending to the poor because the cost of lending is much higher and generally requires higher returns for banks to be willing to lend (Park et al. 2003). This, in turn, has contributed to an increase in non-performing loans and mounting losses for RCCs in China (Cheng and Xu 2004). Limited interest rates also played a significant role in the mediocre outcome of UNDP’s more recent microfinance projects in the 1990s and into the 2000s. Ironically, low lending rates are also not beneficial to borrowers because interest expense constitutes only a small part of overall borrowing costs, and much of it gets absorbed through gifts and bribes to loan officials (Cheng and Xu 2004).

Strict monetary policy regulations also prohibit Chinese currency from being converted into other currencies. This made it impossible for Wokai

to launch a lending-based model similar to the one Kiva employs in other countries, whereby lenders can take their money out of the system after their loan is repaid (Rosenberg 2012). Wokai, instead, had to rely on *donations*, which could be recycled through different individual projects, but could never be returned as cash to the lender. This severely limited the potential market for foreign lenders and also stifled Wokai's impact on the mainland.

### *Barriers to entry for NGOs*

Activities for NGOs in China are extremely limited. This is true for NGOs that span the social and ideological spectrum, but it is especially true for those in microfinance. In fact, NGO microfinance programs are technically illegal, though they have been able to compromise informally with local governments on their activities (Lau 2008). One facet of China's central government is that its power penetrates from the core administration down to the grassroots level in rural areas through the administrative network, such that the few NGOs that do operate in rural areas are very weak, while many exhibit no activity at all. In contrast to the relative ease with which NGOs may register themselves and act as MFIs in India, China's policy environment is much more restrictive, requiring all NGOs to have an official government unit sponsor their application to register as "social organizations." Therefore, even the limited numbers of NGOs devoted to microfinance that exist in China are not purely nongovernmental (Tsai 2004). The ambiguity and lack of a clear and legal financial role for NGO microfinance programs can undermine the sustainability of the microfinance movement in China.

One other issue that all microfinance NGOs face is trust—without official recognition from the government, local people are unlikely to accept outsiders with new projects and will rely instead on well-entrenched informal credit systems (Ling et al. 2002). Lack of large-scale NGO microfinance schemes in China has made it difficult to convince the government that microfinance can be successful, despite the fact that its own regulations are a major reason the sector has not developed quickly (Chinoy 2009). Ever since they came online through the pilot UNDP programs of the mid-1990s, the aggregate scale of NGOs has contracted rather than expanded (Park et al. 2003). NGOs involved in microfinance have the additional problem of not being recognized as financial institutions, which prevents them from mobilizing deposits, which is critical for expansion and for developing a commercial banking culture (Park et al. 2003). Consequently, none have access to capital and few have adequate

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cash flow to cover financing and operating expenses (Yuen 2012).

A third issue is that it is extremely difficult to register as an NGO in China, and it is impossible for all but the largest international NGOs. More specifically, publicly fundraising and accepting local donations is illegal for both domestic and international NGOs. As a result, for its first three years, all of Wokai's monetary support had to come from overseas. This was made even more difficult against the backdrop of China's spectacular economic growth, a further disincentive for foreign individuals to want to donate money to the country. In an interview with the author, Wilson said it took three years before Wokai was able to launch a partnership with a government-owned NGO (GONGO) called the China Population Welfare Foundation. By joining forces with a government foundation, Wokai was able to skirt the normal NGO restrictions and publicly fundraise on the mainland. However, even domestic fundraising was a challenge. Wokai spent nine months in active negotiations looking for a partner who could be both transparent and effective, which proved to be difficult search criteria in a GONGO. Moreover, though Wokai succeeded in receiving small donations from a number of individuals, the organization found it much harder to identify any single major donor, making funds scarce and unreliable, according to Wilson. Financial solvency is a critical issue for the sustainability of microfinance NGOs in China. As of 2009, there were only 10 such NGOs (10 percent of the total) that could independently cover the cost of their loans (Chinoy 2009).

### *Informal credit*

The third challenge for Wokai had less to do explicitly with inadequacies or constraints in the government, but rather with the complex and unique realities of Chinese society. The informal credit market in China has been around far longer than the established formal market for credit and is one of the biggest of its kind in the world. Over the course of that history, the formal financial system has prioritized state agencies and government-supported state-owned enterprises (SOEs) and has not been able to meet farmers' demands for credit. As a result, various informal credit organizations have emerged (Ling et al. 2002). In much of rural China, any form of formal credit was virtually nonexistent and the market for money lending was vast and profitable. In modern China, there is not the same economic fortitude for more usurious forms of informal lending, but the market for lending amongst friends and relatives is still very strong. They share many of the same characteristics with the formal financial sector, including limited collateral and flexible terms, a low

interest rate, and an incentive to pay back the loan forged through social pressure (Turvey and Kong 2008).

Current findings suggest that approximately two-thirds of farm households with debt had borrowed from friends or relatives with the remainder coming from RCCs. Informal borrowing is preferred to formal borrowing, largely because it is inextricably tied to a strong sense of community trust, whereas NGOs and even RCCs have yet to evince the same level of confidence (Turvey and Kong 2010). In the absence of trust, the flow of funds within a community are restricted such that there are not economic efficiencies and poverty persists. This can be alleviated only by tapping into the indigenous trust of communities through the formation of member-based institutions (Turvey and Kong 2010). Informal credit is so prevalent, in fact, that some experts have called for its legitimization and recommend that formal credit to rural areas recognize the realities of agriculture (Turvey and Kong 2008).

A final point to make is that the poorest of the poor may be missed by microfinance for many of the same reasons that the poor as a whole are excluded from the formal financial sector: higher transaction costs and default rates usually result in higher interest rates, and the absence of collateral can drive the interest even higher (Montgomery and Weiss 2006). China's poor are increasingly concentrated in remote, mountainous regions where income-generating activities are more agricultural and less diversified than in more densely populated areas. Given their location, rural villagers lack sizable urban demand centers to support extensive self-employment activity, thus relegating loans to cropping or livestock, which puts less of a demand on the increasingly large entrepreneurial function of microcredit (Park et al. 2003). As a consequence, those who benefit most from microcredit are not the most poor but those who have comparatively higher levels of income, a higher proportion of off-farm income, higher levels of education and better access to the limited but existing microfinance market (Pan et al. 2012). In that way, MFIs have automatically targeted the "better off" within the poor areas of China (Cheng 2007).

## BRIGHT SPOTS

In spite of all of its challenges and limitations, there are many reasons to be optimistic about the future of microfinance in China (Park and Ren 2001). After initial skepticism toward microfinance models, the Chinese government has become an active proponent. In fact, it is the only government in the world that actively sponsors its own microfinance programs in the way of RCCs, MCCs, and VTBs (Park and Ren 2001). While government

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programs still only reach a small share of China's rural population, they are relatively large in absolute terms in comparison to those of other countries. Furthermore, this kind of rapid expansion has no international precedent and, in the words of one scholar, "should be cause for as much concern as excitement" (Park and Ren 2001). The Chinese government has, in recent years, expressed a renewed interest in adopting new microfinance initiatives, beginning with former President Hu Jintao claiming that in order for China's economy to continue to grow, it must first "repay its debt to the countryside" (Kendall 2008). In prioritizing the development of the rural countryside, the Chinese government began investigating ways to integrate the microfinance system into the overall financial system in order to build a truly inclusive financial sector (UNDP 2012). This gives credence to claims that it is not simply the conflicted financial and struggling NGO sectors that see the potential in microfinance, the government also has a stake in its success.

Like in 1994 at the dawn of microfinance in China, the government has once again been willing to experiment with different microfinance policies. One such program permits foreign banks to fully serve rural communities, with the goal of making rural provinces more accessible for the commercial banking industry. This was made possible in 2006, when China, as part of the stipulation for its ascension to the World Trade Organization (WTO), had to allow foreign banks unrestricted access to its banking industry (Kendall 2008). HSBS was the first foreign bank to launch microfinance services in rural China, and other major banks are following suit. More recently, Citibank, in a partnership with the Grameen Bank, agreed to launch a rural branch in China (Kendall 2008). Furthermore, Accion International was established in 2009 as the first fully foreign-funded microfinance bank in Inner Mongolia, and only the second in all of China—a very positive step for foreign investment opportunities with the potential for higher industry growth (Yuen 2012).

Training courses for MFIs are also being expanded, with the Citibank-backed China Microfinance Training Center giving a \$1.5 million grant to the Chinese Academy of Social Sciences to provide better services to improve the efficiency of microcredit (Knowledge @ Wharton 2012). In 2004, the China Banking Regulatory Commission (CBRC) liberalized the lending interest rate limit, which was a giant stride for the industry because microfinance requires significantly higher interest rates than regular banks to sustain operations (Yuen 2012). As a result, compared with local RCCs, the newly established township and village banks (TVBs) have an advantage thanks to flexible interest rates and loan terms and a



streamlined approval process (Jia and Guo 2007). There is also hope for the NGO sector. Because “doing good” is inherently a nonpolitical space, there is less of the threat of censorship and more potential for progress in the quest for political legitimacy. Furthermore, the high household savings rate in China is generally believed to be an important key to financial self-sustaining operations and insulation against economic shock (Dickie 2004).

In addition, an increasing number of domestic commercial banks are diversifying into microfinance, either directly or through partnerships with financial NGOs. This is a significant trend, indicative of the fact that private sector profits can be compatible with poverty reduction. Though the influx and infusion of commercial banks may sound antithetical to the stated goal of helping the most impoverished in China, studies suggest that it may actually work. Commercial banks possess distinct advantages in their ability to “reach down” to low-income communities and help the Chinese economy. They have established and streamlined management systems and, unlike the Chinese government, have a history of expertise in market-driven economies. Commercial banks also possess significant capital that may be utilized without regard to overarching governmental policies (Kendall 2008).

## RECOMMENDATIONS

In conjunction with recent trends and developments outlined in the preceding section, I offer four policy recommendations to strengthen and advance the cause of microfinance in China. These include liberalization of financial markets, overhaul of the NGO sector, integration of MFIs into the formal banking system, and building on existing informal services.

### *Liberalize financial markets*

The need to liberalize markets for products and services is an essential element of China’s economic reforms as a means to end financial repression and boost personal incomes. But it is one that has not yet trickled down to the markets for credit, especially in the rural, underdeveloped sector. This need is particularly relevant and important since flexible, open credit markets for the poor will facilitate economic growth and development in rural areas and allow these regions to catch up with the rest of the economy (Ling et al. 2002). At the heart of liberalization lies the need for the state to authorize banks and RCCs to lend at market interest rates to informal organizations, thus allowing them to make their own decisions regarding

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interest rates (Ling et al. 2002). Chinese banks must find the equilibrium between cost-efficient interest rates and those rates that will not scare away potential low-income borrowers. Not only have interest rate caps stifled profitability and led to millions of nonperforming loans, but also their implementation has resulted in large losses in profits in other countries (Kendall 2008). Establishing a comprehensive credit system would reduce the risk of lending to low-income borrowers without commercial banks having to expend any capital.

### *Overhaul of the NGO sector*

It is of the utmost importance for China to establish a legal framework where international NGOs and collective organizations can operate legally through a revamped registration process (Dickie 2004). Without such a framework, NGOs will lack credibility and will not be optimally effective in reaching low-income groups. It is especially important for such a framework to enable NGOs to operate independently of the governmental structure, in order to provide autonomy from government restrictions (Sun 2003). However, because the registration process for international NGOs is so flawed, foreign-owned organizations like Wokai looking to penetrate the Chinese market for microfinance may find more success by registering as for-profit consulting companies.

The reason for this is that NGOs can operate as consulting companies provided that they define their objectives broadly (Pearson 2013). In return for quasi-legal status afforded by the government, foreign-owned consulting companies would still have to comply with the law and pay taxes in return. They must also find a way to explain the circumstances to their constituents in their home country. However, this is a small price to pay for a legal vehicle that would allow an NGO to carry out its activities in China, hire local and expatriate staff, and receive funds from abroad (Pearson 2013). Though this may succeed in solving the critical problems of legality, trust, and registration, it still would not allow an NGO in this capacity to publicly fundraise on the mainland. Wilson recommended to this author that NGOs be allowed access to debt investment and make it possible for them to receive debt capital and equity investments as opposed only to grants. Overall, better guidelines based on international standards should be adopted to encourage NGO microfinance type programs to continue their work. NGOs should also find ways to cooperate with RCCs in order to divvy up responsibility in attracting rural clientele.

### *Integrate MFIs into the formal banking sector*

Most scholars agree that integration of MFIs into the formal banking sector would be beneficial to the industry as a way to encourage existing financial institutions to profitably target previously excluded savers and borrowers. As most NGOs feel they have to evolve into banks to get adequate funding, the central banks appear to be the top candidates for an effective regulatory body (Dickie 2004). MFIs need to evolve into banks so that they are empowered to take deposits and borrow from other banks, with the goal of moving towards sustainable operations (Dickie 2004). Experts agree that the future of microcredit and microfinance requires strong cooperation between banks that can provide capital and grassroots organizations that can reach down to the village level. If the government banks, MFIs, and NGOs can begin to work together, microcredit could have a major impact on poverty in China's rural areas (Knowledge @ Wharton 2012).

### *Build on existing informal services*

For inclusive financial services to be successful, they must take into account current practices and the motivations behind them. As it is now, marginalized populations meet their financial needs through networks of informal services forged by social connections. Informal buyer-lender relationships are rooted in trust, born of mutual reliance, and built on powerful and long-standing social connections (Wilkes 2013). Without a strong underlying social network of trust, individuals are unwilling to risk their financial solvency on the adoption of new, untested financial services, especially from an unknown institution or organization. Therefore, MFIs may do well to complement, as opposed to compete with, existing informal services because people often prefer them due to convenience, access, ease of use, and trust (Reboot 2013).

To accomplish this task, NGO service providers could build new services into existing networks of relationships, such as by hiring informal lenders as delivery agents. In addition, traditional structures of geography-based markets have been severely strained in light of increasing waves of rural-urban migration that have upended the family structure. Rather than continue to utilize these means of social networks, it is important for NGOs to focus on the human networks that connect them. In particular, the relationship between managers and employees is a critical connection. Managers, like informal lenders, can be recruited to increase market awareness and trust among target populations and to serve as delivery agents to accelerate user adoption rates (Reboot 2013).

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## CONCLUSION

Massive structural inequalities between the urban and rural sectors have led to an increasingly wide gap between the very rich and the very poor in China. Most recent efforts aimed at boosting rural incomes and reducing the rural-urban income gap, including tax rebates to rural families, rural land ownership reforms, and IT-enabled productivity enhancement, have had mixed rates of success. One way that other developing countries have dealt with this problem is through microfinance. Microfinance, as exemplified by international NGOs, has succeeded in doing what, until recently, large banks have been unwilling to do—take a chance on the millions in the rural sector who have no access to credit and are unlikely to get loans. China is the second-largest untapped market for these types of structural reforms, but the NGO sector still suffers from strict financial regulation, difficult registration requirements, and a large market for informal credit.

Any suggested path for development of the microfinance industry in China must be tempered with the foreknowledge that China is a highly regulated, state-dominated environment and that any microfinance initiatives will likely be subject to heavy government intervention (Montgomery and Weiss 2006). However, though China's financial and legal reforms have yet to create an institutional space in which microfinance can thrive and expand, instead of idly waiting for the key system reforms to be put in place, microfinance NGOs can help push the boundaries of existing practice and accelerate meaningful reform by actively engaging China's formal financial institutions, creating new avenues for overcoming registration hurdles, and complementing rather than competing with the existing informal sharing network (Park et al. 2003). Microfinance practice in China thus far has demonstrated enormous viability while facing up to these challenges.

If nothing else, Wokai has proven that microfinance programs in China can improve lives and play a part in reducing the rural-urban income gap. NGOs are uniquely qualified to provide services and financial products to the rural poor as a conduit to help them to graduate and access mainstream financial services (Lau 2008). Especially in light of the 2008 Sichuan earthquake, the Chinese government has begun to adopt a more positive perspective on the role that NGOs can play in shaping civil society in China as a result of their active part in the rebuilding of Sichuan (Pearson 2013). With regard to microfinance, NGOs are approaching financial sustainability thanks to unusually low operating costs and high rates of repayment, and they have historically performed better in these

two categories than government-run microfinance programs (Park and Ren 2001). Finally, NGOs possess many unique characteristics, such as grassroots relationships with their clients, community building, and the ultimate goal of poverty alleviation (Lau 2008).

China today is in a prime position to spearhead a domestic market for microfinance NGOs. More Chinese than ever are working in the non-profit space, and there is no shortage of young leaders in China looking to advance the cause of microfinance in their country, according to Wilson. The problem comes with a lack of morale due to the unfavorable domestic regulatory conditions that define the current microfinance landscape. The capricious and mercurial environment in China requires that, in some instances, organizations working in microfinance make big compromises with the Chinese government in order to conduct their work. However, with formal financial institutions now actively involved, scholars posit that microfinance programs look to become even more diverse in the future. This has borne true thus far with the increasing number of commercial banks diversifying into microfinance, either directly or through partnerships with financial NGOs (Montgomery and Weiss 2006). In addition, domestic NGOs like the China Foundation for Poverty Alleviation have provided a good model on which microfinance projects can be based locally.

The proliferation of NGOs that harness the registration loopholes afforded by consulting companies and leverage the access and trust of local informal lenders will ultimately be the best indicator and offer the greatest hope for sustaining microfinance in China. Since the lack of adequate capital is the primary bottleneck for MFIs, the creation of a funding platform similar to Wokai could help spur the development of microfinance in China and incur the support of the large network of China supporters both in and outside of the country. Even though Wokai itself was ultimately unable to sustain itself as an organization, its impact is still felt. Its initial 1,500 microloans continue to be self-sustained and perpetuated by its two field partners in Sichuan and Inner Mongolia and are expected to continue to contribute to positive social change in China's rural sector by empowering an estimated 9,000 entrepreneurs over the next ten years (Wokai 2012). As the options for those at the very bottom, like Fu Yajun, narrows, the opportunity and the need for more NGOs like Wokai to enter the microfinance field in China becomes ever more pronounced.

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## DEMOCRATIC COUPS? REGIONAL RESPONSES TO THE CONSTITUTIONAL CRISES IN HONDURAS AND NIGER

*Albert Trithart*

Regional organizations—especially the Organization of American States (OAS) and African Union (AU)—have begun playing an increasingly prominent role in responding to unconstitutional changes of government in member states. Most notably, both the OAS and AU have developed regional democratic charters with anti-coup mechanisms. These two organizations, however, have pursued markedly different approaches in responding to coups d'état. Their divergent responses to the 2009 coup in Honduras and the 2010 coup in Niger, which share many similarities, highlight these differences. Comparison of these cases indicates that the AU's legal mechanism for responding to unconstitutional changes of government provides a basis for more effective responses than the OAS's more consultative mechanism. Moreover, both organizations should increase attention to preventing the democratic erosion that often precipitates coups in the first place.

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*Albert Trithart is a 2013 graduate of the Master of Arts in Law and Diplomacy program at the Fletcher School at Tufts University, where he focused on conflict resolution and democracy and governance. He can be reached at [albertbrithart@gmail.com](mailto:albertbrithart@gmail.com).*

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## INTRODUCTION

In 2009, Latin America witnessed its first successful coup d'état since the end of the Cold War with the military's ouster of President Manuel Zelaya in Honduras. One year later, Africa experienced its fifth coup d'état in as many years when the military overthrew President Mamadou Tandja in Niger—the fourth coup in that country's history. Despite occurring in vastly different regions of the world, these coups were remarkably similar—they both ostensibly sought to restore democratic rule in the face of increasing presidential authoritarianism. Their effects, however, were quite different. Condemnation of the coup in Honduras was far stronger and more genuine than that of the coup in Niger. Moreover, while Niger quickly underwent a broadly recognized democratic transition, the new government in Honduras struggled to gain international legitimacy.

Given the similarities between the two cases, what can we learn from these divergent outcomes? This paper addresses this question within the broader context of unconstitutional regime change in Latin America and Africa. Both of the two most serious threats to democracy today—illegal extension of presidential term limits and coups d'état—were at play in each crisis. Comparative study of the cases indicates that regional governance had a substantial impact on their outcome. The Organization of American States (OAS) and African Union (AU) have developed stronger anti-coup mechanisms since the end of the Cold War, contributing to an increase in the proportion of coups leading to elections. This paper, therefore, analyzes the influence regional organizations can have on the outcomes of constitutional crises. Through consideration of OAS and AU provisions and mechanisms for addressing unconstitutional regime change and these organizations' responses to the crises in Honduras and Niger, the paper assesses the effectiveness of regional responses. This assessment is broadly relevant to Latin America and Africa considering the increasing activism of the OAS and AU in response to unconstitutional changes of government, as witnessed in the subsequent crises in Mali, Guinea-Bissau, Paraguay, the Central African Republic (CAR), and Egypt.<sup>1</sup>

This paper has four main sections. First, it provides a background and comparison of the constitutional crises in Honduras and Niger. Second, it analyzes the outcomes of unconstitutional changes of government more broadly. Third, it compares the OAS and AU mechanisms for responding to unconstitutional changes of government. Finally, it compares the OAS and AU responses in Honduras and Niger and offers three main conclusions.

First, the OAS and AU both play an active and commendable role in responding to coups but should increase attention to preventing the democratic

erosion that often precipitates these coups. Second, the AU's legal mechanism for responding to unconstitutional changes of government provides a basis for more rapid, unified, and effective responses than the OAS's more consultative mechanism that often becomes entangled in regional politics. Finally, although not all coups are morally indefensible, the AU and OAS should not risk undermining their anti-coup mechanisms by recognizing the possibility of a "good" coup; they should respond consistently and strictly to all coups.

## BACKGROUND

### *Constitutional crisis in Honduras*

Honduras's 2009 coup interrupted a relatively long period of democratic continuity; Honduras had held seven consecutive democratic elections, and its military had been subordinate to civilian control since the late 1990s (Ruhl 2010). The constitutional crisis began in November 2008 when leftist President Zelaya announced a non-binding opinion poll assessing support for a referendum on rewriting the Constitution. In March 2009, Zelaya issued a decree that the poll would take place in conjunction with national elections the following November. As Zelaya moved forward with his plan, opposition from the military, judiciary (the Supreme Court declared the referendum unconstitutional), and legislature mounted. When Zelaya fired the head of the armed forces, the Supreme Court declared this action illegal and unanimously ordered the military to arrest him. In response, the OAS passed a resolution on June 26 calling for all actors to avoid a disruption of the constitutional order and to form a special commission to visit Honduras, but the resolution was too late. Soldiers arrested Zelaya during the night on June 28, 2009, and flew him to Costa Rica. Congress immediately convened, produced a "letter of resignation" ostensibly signed by Zelaya, and voted 122–6 to remove Zelaya from office.

Domestically, the political elite demonstrated clear support for the coup, while the public had mixed reactions. Civil authorities, including all 15 members of the Supreme Court, the Attorney General, and an overwhelming majority of Congress were supportive, issuing communiqués insisting Zelaya's ouster was constitutional (Cassel 2009). Interim President Roberto Micheletti "seemed to plead with the world" that the arrest was based on an official warrant and pledged to hold elections in November as originally scheduled (Cooper and Lacey 2009). However, pro-Zelaya protests erupted in Tegucigalpa, and polls conducted by three agencies between June and October 2009 revealed complex opinions among the Honduran public: 41 percent believed Zelaya's actions justi-

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fied his removal from office, while 28 percent believed they did not; a clear plurality opposed Zelaya's expatriation; a plurality held a favorable opinion of Zelaya (an increase from before the coup); and different polls showed majorities both favoring and opposing restoring Zelaya to power (CID-Gallup 2009; COIMER & OP 2009; Greenberg Quinlan Rosner Research 2009).

The international community, including the United States, European Union, and UN General Assembly, immediately and vociferously condemned the military ouster, and the United States eventually suspended assistance to Honduras (Main and Johnston 2009). The OAS labeled the event an "unconstitutional alteration of the democratic order" under the Inter-American Democratic Charter and unanimously voted to suspend Honduras. Members of the Bolivarian Alliance for the Americas (ALBA), which Honduras had joined in 2008, were particularly condemnatory, and President Chávez went so far as to put the Venezuelan military on alert.

In the face of international demands for Zelaya's reinstatement, Honduras found itself in a political stalemate. Negotiations on the return of Zelaya stalled, and his attempts to reenter the country failed. The coup government used the army and police to arrest and beat pro-Zelaya protesters, resulting in 20 official deaths (Murphy 2012), and a mission of international observers documented systematic human rights violations (Misión Internacional de Observación 2009). The government shut down or took over opposition media, and "billboards with smiling faces of well-fed peasants... thanking Micheletti for defending democracy adorn[ed] major thoroughfares" (Grandin 2009).

Nonetheless, elections took place as scheduled in November 2009. These elections attracted decent turnout, witnessed little violence, conformed to international standards, and brought Porfirio Lobo to power in a landslide (Casas Zamora 2009). They did not, however, solve Honduras's problems. Besides the United States, the only OAS member states to recognize the result were Colombia, Costa Rica, Panama, and Peru—all of which had center-right governments at the time (Ruhl 2010). The OAS only readmitted Honduras—over the lingering opposition of Ecuador—in June 2011, more than one and a half years after the election. As Honduras's government hung in international limbo, its domestic situation worsened. Government intimidation of journalists and activists continued with impunity (Taraciuk 2010), corruption levels remained among the highest in the region (Transparency International 2011), and murder rates rose to the highest in the world (The Economist 2012; Bosworth 2010).

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*Constitutional crisis in Niger*

Unlike Honduras, Niger had a long history of coups before 2010, most recently in 1999. Constitutional democracy began eroding in May 2009 when President Tandja proposed a constitutional referendum to extend presidential term limits. As Tandja moved forward with his plan, opposition from the military, judiciary (the Constitutional Court twice declared the referendum illegal), legislature, public, and regional organizations mounted. In response, Tandja dissolved parliament and the Constitutional Court and appointed new pro-referendum ministers. The referendum took place in August and passed with 92.5 percent of the vote amid widespread accusations of fraud.

In October, Tandja moved forward with parliamentary elections boycotted by the opposition. The Economic Community of West African States (ECOWAS), whose Protocol on Good Governance and Democracy prohibits altering election law within six months of an election, promptly suspended Niger, citing “violation of the 1999 constitution by the authorities in Niger, the intolerance of divergent opinions, and the muzzling of the opposition political parties” (Cowell 2011). Opposition mounted further following the scheduled end of Tandja’s term on December 22, as the United States suspended aid and massive demonstrations erupted in Niamey, Niger’s capital. On February 18, a junta calling itself the Supreme Council for the Restoration of Democracy captured Tandja, suspended the Constitution, and dissolved the government.

This coup had broad support within the Nigerien elite and public. All three main opposition parties, most of civil society, and the largest union supported the junta and called for elections. As the head of one civil society organization admitted, “Deep down, we are cheering for it. For us, it’s a good coup d’état” (Armstrong 2010). Two days after the coup, large pro-coup demonstrations erupted in Niamey. The international community, including the UN and France, condemned the coup, while the AU automatically suspended Niger through its anti-coup mechanism. Overall, however, condemnation was relatively mild, and no one called for the reinstatement of Tandja, instead calling for a swift return to democracy. This tepid reaction reflected the international community’s tacit support for the junta (Miller 2011). Many African countries welcomed the coup as a sign of political moderation in Niger (Baudais and Chauzal 2011).

With implicit international support, the junta quickly prepared for Niger’s return to democracy. It broadcast its intention to “make Niger an example of democracy and good governance” and “save [the country] and its population from poverty, deception, and corruption” (Miller 2011).

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Within days, coup leaders promised free and fair elections and a swift return to civilian rule. The junta staffed many agencies with civilians and initiated a consultative constitution-drafting process. The constitution that emerged sought to address many of the problems that led to the coup, clarifying the role of the Constitutional Court and guaranteeing its independence, reintroducing presidential term limits, and regulating the use of referenda (Baudais and Chauzal 2011). ECOWAS readmitted Niger in June 2010, even before elections.

The presidential election, which observers declared free and fair, took place in two rounds in January and February 2011, resulting in the election of Mahamadou Issoufou. The AU subsequently readmitted Niger in March. The new government has taken steps to combat corruption and has restored freedoms of speech and the press. While instability persisted, particularly in the north, this instability was largely endemic and did not stem from the coup (Freedom House 2012).

### *Comparing the crises*

Despite some important differences, the constitutional crises in Honduras and Niger followed similar paths, offering a useful basis for comparison. Both presidents sought to extend term limits through constitutional referenda. The national legislatures were both heavily opposed to the extension of presidential power, and the national judiciaries declared the referenda illegal, only to be ignored by their respective executives. Following this failure of institutional checks on presidential power, the military removed both executives. The international community, including relevant regional organizations, condemned both coups. Each junta promised a swift return to democracy and organized elections widely regarded as free and fair, leading to the inauguration of new, civilian-led governments.

However, key differences emerged in the coups' outcomes. Public opinion and civil society were far more united behind Niger's coup than they were in Honduras, leading to predominantly anti-coup demonstrations in Tegucigalpa and pro-coup demonstrations in Niamey. While the international community condemned both coups, condemnation of the coup in Honduras was more strident and called for the reinstatement of Zelaya, while condemnation of the coup in Niger seemed token and did not include calls for Tandja's return. Following the post-coup elections, many OAS member states refused to recognize the results, and the OAS did not agree to readmit Honduras until more than a year later; the AU immediately recognized the results of Niger's post-coup elections and soon after readmitted it to the organization. Finally, the elections in Honduras

failed to resolve the country's domestic political crisis, while the elections in Niger bolstered government legitimacy. These differences reveal vastly divergent internal and regional dynamics.

These two cases offer a compelling comparison despite one other notable difference: Honduras's coup took place before a constitutional referendum was held and Niger's several months after. As a result, the countries were at different stages in the process of democratic erosion, and it is impossible to know what would have happened had Honduras's coup been delayed until after a constitutional referendum extending term limits. Indeed, President Zelaya even denied that he intended to extend term limits, although few found this claim credible. Despite this notable difference, underlying regional dynamics—and the OAS response that reflected these dynamics—explain much of the coups' divergent outcomes. Regardless of when the coup in Honduras took place, leftist governments would likely have been strongly opposed and center-right governments less so, and this divide would have inhibited an effective OAS response. The fundamental similarity—a military coup in response to increasing presidential authoritarianism—remains and provides a sound basis for comparison.

## ANALYZING OUTCOMES OF UNCONSTITUTIONAL CHANGES OF GOVERNMENT

The coups in Honduras and Niger present a particularly useful comparison because both involved moral and legal ambiguities—both could be seen as “good” coups—and these ambiguities increased the prospects for divided regional responses. The argument for the “good” coup rests upon the notion that such coups are actually “counter-coups” intended to restore democracy in response to presidential attacks on the constitution. However, controversy over whether or not the coup in question was “good” contributed to a divided OAS response, while the AU response remained coherent. Examining illegal constitutional amendments to term limits and coups d'état in their regional contexts helps explain these divergent responses. Unlike in Africa, extension of term limits in Latin America is associated with a particular political ideology. As a result, counter-coups in Latin America are more likely to create a political backlash.

### *Constitutional amendments to term limits*

The constitutional amendment efforts of Presidents Zelaya and Tandja have many recent precedents in Latin America and Africa and are gener-

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ally associated with an executive power grab vis-à-vis the other branches of government. In Latin America, *continuismo*, as the trend has come to be called, has followed a familiar path: the president calls a constitutional convention, amends the constitution to remove term limits, undermines the other branches of government when they try to stop him, and represses any remaining dissent (Walsh 2010). This path to *continuismo* has become primarily associated with the member states of ALBA. Venezuelan President Chávez convened a referendum removing presidential term limits in 2009, Bolivian President Morales followed suit later the same year, and Ecuador's President Correa held a referendum extending term limits and expanding presidential powers in 2011 (Walsh 2010). It is thus unsurprising that these three presidents voiced the fiercest opposition to the coup in Honduras and that opposition fell along ideological lines.<sup>2</sup>

Africa has an even longer history of presidential efforts to extend term limits. Recent successful examples include Tunisia, Burkina Faso, Chad, Uganda, Cameroon, Algeria, and Djibouti (Reuters 2012). In country after country, political institutions proved too weak to check executive overreach, and President Tandja continued this trend. Unlike in Latin America, however, this executive overreach was not associated with a particular political ideology.

### *Coups d'état*

The coups in Honduras and Niger that ostensibly aimed to halt this authoritarian trend demonstrate an evolution in the nature of coups in both Latin America and Africa. Coups have historically plagued Latin America but largely ceased after the Cold War, and Honduras's coup was the first successful one since then.<sup>3</sup> The coup in Honduras, however, represented a new variety rather than a reemergence of military challenges to civilian control. In fact, the military in Honduras acted at the behest of civilian authorities, incorporated these authorities into its temporary junta, and quickly returned power to civilian control (di Iorio 2010).

Unlike Latin America, Africa has retained a consistently strong tradition of military coups. In addition to Niger, coups have led to the overthrow of civilian governments in Guinea-Bissau and São Tomé and Príncipe in 2003, Togo in 2005, Mauritania in 2005 and 2007, Guinea in 2008, Madagascar in 2009, Mali and Guinea-Bissau (again) in 2012, and the CAR and Egypt in 2013. The progression of coups in Africa, however, demonstrates evolution over time. Instead of entrenching themselves in power, coup leaders increasingly have justified their actions by referencing democratic principles and promised elections to restore civilian rule.



Niger was an early representative of this trend when a 1999 coup ostensibly aimed to “rectify the democratic trajectory by overthrowing an illegitimate government;” whereas previous juntas in Niger had entrenched themselves after overthrowing civilian governments (1974–1991 and 1996–1999), the 1999 junta swiftly returned power to civilian authorities, in many ways paralleling the 2010 coup (Baudais and Chauzal 2011). More recently, the leaders of the coups in Mali and Egypt swiftly handed power to transitional governments and promised elections, as elections have occurred in Mali.

Does this trend paradoxically represent an increased commitment to democracy among coup leaders, and does it mean that a coup can be “good” if it aims to counter presidential authoritarianism? Many reject the notion of a “good” coup. Andrew Miller of the Council on Foreign Relations argues that most coups have not resulted in transitions to democracy, and democratic governments that have emerged from coups have lacked the will or capacity to address key problems, have not established durable political systems, and have not achieved long-term stability. According to Miller’s analysis of coups from 1940–2008, 16 percent in Africa and 26 percent outside of Africa caused adverse change, while only 5 percent in Africa and 9 percent outside of Africa led to democratic transitions. Moreover, where coups led to a democratic transition, the resultant democracies lasted an average of only 4.5 years (Miller 2011). Demonstratively, Niger’s 1999 coup led to the election of Tandja later that year, but the fledgling democracy’s inability to ensure a peaceful transfer of power led to the 2009 coup just ten years later. Similarly, elections in Honduras have not brought that country stability.

Miller does not, however, analyze differences in the data before and after the Cold War, belying the demonstrable evolution of coups. From 1960–1990, only 25 percent of coups led to elections within five years, but from 1991–2004, this proportion markedly increased to 74 percent. Based on these results, the political scientists Hein Goemans and Nikolay Marinov argue that, “Depending on the specific circumstances, a coup can sometimes provide few reasons for condemnation” (Goemans and Marinov 2011). Noted academic Paul Collier offers another tentative defense: “I find it a little awkward to be writing in praise, however faint, of coups. They are unguided missiles, as likely to topple a democracy as a dictatorship. But there is still something to be said for them” (Collier 2008). While stopping short of endorsing coups, some now recognize their occasional utility.

As the coups in Honduras and Niger demonstrate, distinguishing good coups from bad is a subjective and controversial task. It does not, however,

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spark equal levels of controversy in all contexts. The coup in Honduras sparked a more virulent, politicized debate than in Niger. To understand why, we turn to both regions' responses to unconstitutional changes of government.

## REGIONAL RESPONSES TO UNCONSTITUTIONAL CHANGES OF GOVERNMENT

Increased international attention to democratic principles has been an important factor in the post–Cold War trend for coups to lead to democratic transitions rather than entrenched military juntas. Some of this pressure has come from the West. For example, the United States links aid channeled through the Millennium Challenge Corporation to certain governance indicators and suspended this aid to Honduras and Niger following the coups (Millennium Challenge Corporation 2009a, 2009b). Regional organizations, however, have begun to lead the international response to unconstitutional changes of government in their respective regions. Latin America and Africa have led the way by developing regional democratic charters (Legler and Tieku 2010). Both regional charters contain provisions for addressing unconstitutional changes of government, but OAS and AU actions, particularly in Honduras and Niger, reveal divergent approaches.

### *Organization of American States*

Although the OAS's 1948 Charter required representative democracy among member states, strong norms of sovereignty and nonintervention overshadowed this requirement at least until the late 1980s (Martin 2009). Since the end of the Cold War, however, the OAS has adopted a number of key instruments aimed at promoting democracy,<sup>4</sup> culminating in the 2001 Inter-American Democratic Charter. The Democratic Charter's conception emerged from the absence of OAS mechanisms to counter democratic backsliding, particularly under President Fujimori in Peru (Legler and Tieku 2010). The Charter thus establishes a mechanism for responding to "an unconstitutional alteration of the constitutional regime that seriously impairs the democratic order in a member state" (Article 20). It establishes different mechanisms, however, for responding to illegal constitutional interruptions and illegal constitutional alterations: in the case of the former, a special session of the General Assembly can suspend the member state (Article 21), while in the case of the latter, a member state or the Secretary General can request that the Permanent Council undertake diplomatic initiatives "to foster the restoration of democracy"

(Article 20). The Charter thus has stronger provisions against coups than against unconstitutional *continuismo*. Moreover, both provisions depend on the political will of member states (Rudy 2005).

As a result of the different mechanisms and dependence on political will, the OAS has not responded consistently to threats to democracy in the region. It has been more effective in responding to—rather than preventing—crises, forcefully responding to coups but largely ignoring *continuismo* (Legler and Tiekü 2010). The only two times the OAS has invoked the Democratic Charter demonstrate this discrepancy. In 2002 and 2009 it reacted forcefully to the coups in Venezuela and Honduras, but it failed to respond to the increasing authoritarianism of Chávez and Zelaya that preceded these coups (U.S. Senate Committee on Foreign Relations 2010). This failure reflects the OAS's strong norms of territorial sovereignty and nonintervention, as well as Latin America's sharper ideological cleavages (Legler and Tiekü 2010).

### *African Union*

The AU—and its predecessor, the Organisation of African Unity (OAU)—witnessed a similar proliferation of democracy promotion mechanisms after the Cold War. In 1990, the OAU issued the Addis Ababa Declaration, in which member states committed themselves “to the further democratization of [their] societies and to the consolidation of democratic institutions” (Cilliers and Sturman 2002). The 2000 Lomé Declaration on the Framework for an OAU Response to Unconstitutional Changes of Government greatly strengthened this commitment. This Declaration defined what constitutes an unconstitutional change of government and clearly established the progressive steps the OAU would take when such a change of government occurred. As part of this progression, the OAU would automatically suspend any state subject to military takeover.

As with the Democratic Charter in Latin America, the 2007 African Charter on Democracy, Elections and Governance demonstrated recognition that existing mechanisms did not address the gradual erosion of democracy. The Charter therefore broadened the Lomé Declaration's definition of unconstitutional changes of government to include “any amendment or revision of the constitution or legal instruments, which is an infringement on the principles of democratic change of government” (Article 23). It also elaborated more precise rules governing the return to democratic rule: it banned coup perpetrators from running in elections or holding government office; authorized trying these perpetrators before the regional court; banned member states from harboring coup perpetrators;

required member states to extradite coup perpetrators; and authorized sanctions (Article 25). The AU Democratic Charter thus developed a single mechanism for addressing all unconstitutional changes of government, laying the basis for a strong and clear response. The Charter only entered into effect in February 2012, so its effects cannot yet be assessed (Electoral Institute for Sustainable Democracy in Africa 2012).

The AU, like the OAS, has responded more successfully to coups than to constitutional manipulation. Since adopting its anti-coup measures, the AU has quickly suspended every state where coups have occurred and generally succeeded in restoring civilian rule.<sup>5</sup> According to political scientists Thomas Legler and Thomas Kwasi Tiekou, the AU's approach to coups has been effective because of "the mechanical and legalistic manner in which the anti-coup sanctions have been applied." Coups automatically trigger suspension, but the state in which the coup occurred can rejoin the AU after it holds elections and restores constitutional order, leaving little room for political manipulation. This response mechanism, however, has been vulnerable to political manipulation in the case of illegal constitutional alteration, and authoritarian governments have largely blocked action in this area (Legler and Tiekou 2010).

### *Comparing the mechanisms*

Legler and Tiekou outline four main similarities between the OAS and AU mechanisms for responding to unconstitutional changes of government: both include promoting and defending democracy as explicit organizational purposes; are grounded in a "strong anti-coup norm;" incorporate strong sanctions against coup perpetrators; and have democratic charters. Moreover, both organizations have proved more effective in responding to constitutional interruptions than constitutional alterations.

According to Legler and Tiekou, however, the OAS reflects Latin America's more "state-driven regime evolution," while the AU reflects Africa's "expert-driven process of regime construction." Whereas states—particularly those recently emerged from authoritarianism—drove the development of a regime for the collective defense of democracy in the OAS, OAU bureaucrats with technical support from regional think-tanks developed this regime in Africa. Consequently, the OAS represents a system of "narrower interstate multilateralism" that prioritizes state sovereignty, and its responses often expose regional divisions. By contrast, African instruments "bind member governments of the AU, including the illiberal ones, to a common set of liberal democratic and good-governance principles, thereby compelling them to defend and promote democracy in every African state"

(Legler and Tiekou 2010). As a result of this distinction, Latin America has a “by-invitation” norm that does not exist in Africa. This norm causes complex diplomatic maneuvering that slows responses in contrast to the AU’s ability to intervene without the consent of the country concerned.

## CONCLUSIONS

### *Honduras: A deepening political crisis*

In Honduras, even the use of the term “coup” to describe the military ouster of Zelaya generates controversy. Much of the debate centers on the coup’s constitutionality. Defenders of the coup argue that the military action was justified because Zelaya had already violated the Constitution in a number of ways: he ignored the requirement that a two-thirds congressional majority approve all referenda; he abused his authority in ignoring the Supreme Court’s rulings against the referendum; he usurped the duties of the Supreme Election Tribunal; and he violated the constitutional prohibition against amending the presidential term limit (Walsh 2010). Moreover, the Honduran Constitution states that those who break the provision on presidential term limits, propose changing this provision, or indirectly or directly support someone who proposes doing so “cease immediately in the exercise of their respective positions” and cannot hold public office for ten years (Article 239). Although Zelaya was arguing for a constitutional convention and never officially proposed amending presidential term limits, his actions mirrored the progression toward *continuismo* of his Bolivarian allies. As the conservative attorney Miguel Estrada argues, “the only conceivable motive for such a convention would be to amend the un-amendable parts of the existing constitution”—notably, the presidential term limit (Estrada 2009). Coup supporters thus argue that Zelaya’s violation of this article immediately terminated his presidency, “no trial required... no impeachment needed,” and that the military acted legally based on an arrest warrant issued by civilian authorities (Sánchez 2009).

Constitutional arguments also predominate among those who opposed the coup. Nearly everyone acknowledges that the military’s decision to fly Zelaya to Costa Rica after arresting him was illegal—the Constitution bans expatriation of Hondurans (Article 102)—and most also agree it was irresponsible (e.g., O’Grady 2009). Accusations of illegality do not stop there, however. International legal scholar Doug Cassel argues that Congress had no constitutional authority to impeach Zelaya (Cassel 2009). Historian Greg Grandin also argues that the proposed constituent assembly, misrepresented as a power grab, was actually “broadly supported

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by social movements as an effort to democratize Honduras's notoriously exclusive political system" (Grandin 2009).

Legal arguments over the crisis in Honduras mask an essentially partisan debate. Those supportive of the coup come predominantly from the right side of the political spectrum, while those opposed come from the left. This political divide is unfortunate because the issues at stake—illegal constitutional interruptions and alterations—threaten broad democratic principles and should thus transcend narrow political interests. From a legal perspective—and the law should be the basis for initial assessment—Zelaya clearly violated the Constitution on numerous counts, regardless of his intentions for the constituent assembly. The main problem thus lay in the lack of a constitutional provision for impeachment, leaving other branches of government few legitimate institutional mechanisms through which to remove Zelaya. As such, they found themselves in a dilemma: they could either take decisive yet dubious action or let the president violate the Constitution. Without knowing what would have happened if the National Assembly, Supreme Court, and military had acted differently, it is difficult to evaluate alternative responses to Zelaya's actions. It is clear, however, that they handled the arrest of Zelaya poorly, particularly by expatriating him, which heightened perceptions that his removal constituted a coup.

Regardless of these domestic, legal, and political complications, an effective OAS response could have helped prevent or resolve the crisis. Instead, the OAS mirrored the domestic political divide on the regional level. The Democratic Charter's mechanism for preventing democratic erosion proved weak. On June 2, just weeks before the coup, an OAS conference in Honduras offered regional leaders the opportunity to respond to the political crisis (Cooper and Lacey 2009). Yet the Secretary General waited until June 17 to send a special envoy to Honduras, and the Permanent Council did not take action until June 26, after the Supreme Court had issued its arrest warrant. Moreover, the OAS's envoy actually exacerbated the situation through public statements seemingly endorsing Zelaya's proposed poll, exposing the lack of regional consensus (U.S. Senate Committee on Foreign Relations 2010).

The OAS response following the coup further exposed deep regional political divides. The OAS swiftly and unilaterally condemned the coup, but its threat to suspend Honduras unless Zelaya returned to power in three days was unrealistic and served only to heighten tension. Moreover, subsequent positions shifted, with leftist governments—particularly the members of ALBA—demanding Zelaya's reinstatement, and the United States and right-leaning governments favoring a return to democratic rule through

elections. This lack of regional consensus exacerbated the domestic stalemate and politicized negotiations. Moreover, the refusal of many OAS member states to recognize the election results unnecessarily prolonged the crisis, as did the long delay before readmitting Honduras to the OAS. As former vice president of Costa Rica Kevin Casas Zamora lamented, the OAS proved “incapable of protecting the lofty goals of the Inter-American Democratic Charter and equally unable to bridge not just the traditional divide between the hemisphere’s North and South but also the ideological rift that is threatening to split Latin America between left and right” (Casas Zamora 2009). These divides have contributed to the OAS’s more state-driven regime development and created structural obstacles to reforming the Democratic Charter.

Partly as a result of the bungled OAS response, the Honduran government has struggled to gain broad international acceptance, and Hondurans are the most dissatisfied with democracy in the region (Hinton et al. 2013). The 2012 political crisis in Paraguay highlighted the persistence of these regional divisions. Left-leaning presidents from neighboring countries and left-leaning media vociferously condemned the Paraguayan Congress’s extraordinarily rapid impeachment of left-leaning President Fernando Lugo as a “civilian coup” (e.g., Weisbrot 2012). The United States did not condemn the action, and right-leaning media dismissed critics as interfering in a legitimate constitutional process (e.g., O’Grady 2012). Again, politics took precedence over democracy, and the OAS, caught between the two camps, took only weak action.

### *Niger: A welcome coup*

The debate over the coup in Niger has followed an entirely different course, lacking either clear political divisions or appeals to uphold national law. Legal arguments were not employed partly because the crisis involved far fewer legal ambiguities. As Tandja was farther advanced in the constitutional amendment process than Zelaya—in fact, he saw it through to the end—the illegality of his actions was indisputable. Niger’s 1999 Constitution banned altering the clause that limited presidents to two terms (Article 36), and Tandja’s drive to bypass this ban involved flagrant executive overreach. Moreover, the coup did not occur until after Tandja completed his second term and began illegally serving his third. The coup itself also involved less legal ambiguity as it occurred on the initiative of the military—partly because Tandja had already dissolved all relevant government institutions—and thus could not be justified as a civilian-ordered arrest.

The debate, moreover, did not reflect a deep ideological divide because

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no such divide existed either in Niger or regionally in Africa. All sides acknowledged that Tandja was antidemocratic and should not have remained in power, so opponents and proponents instead based their arguments on the coup's implications for democracy. Coup supporters insisted it was not a coup, but a "counter-coup," the first coup having occurred when Tandja illegally extended his term (Armstrong 2010). Tandja's power grab thus left political actors no alternative course of action, as the broad executive powers granted him in the new constitution would have rendered his removal impossible through institutional mechanisms (Pham 2010). Moreover, the composition of the coup coalition indicated it was not a traditional military power grab but a genuine attempt to restore democracy and reflected a broad political and societal consensus (Baudais and Chauzal 2011).

Opponents of the coup in Niger universally subscribed to the notion that coups are always reprehensible, even in response to an equally reprehensible authoritarian regime. Regardless of its moral justifiability, the coup violated AU provisions and may have undermined legal solutions to the crisis (Cowell 2011). Efforts to isolate Tandja were underway, as ECOWAS had suspended Niger, and the European Union and the United States had frozen aid payments (McLure 2010). Critics also noted that supporting a "good" coup in Niger is a slippery slope (Armstrong 2010); Niger has experienced four coups and chronic instability since independence, and initial post-coup stability does not guarantee long-term stability, as proven by the country's "good" coup in 1999.

Ultimately, however, it is difficult to see how else Niger could have saved itself from interminable authoritarianism. If there is such thing as a good coup, this was it. Moreover, the AU response played a productive role in resolving the conflict. The automatic suspension of Niger following the coup prevented the intrusion of political considerations and obviated high-level public debate about whether the coup was good or bad. The AU's anti-coup mechanism then laid out a clear path, providing a strict timeline for return to democratic rule and Niger's readmission to the organization. With the response tracked through legal channels, political divisions did not emerge, and Niger quickly regained acceptance in the international community.

Where the AU faltered, however, was in not taking stronger measures to halt Tandja's constitutional manipulation, and here a political divide was apparent—a divide between democratic and authoritarian governments. While even authoritarian leaders can support anti-coup mechanisms that could protect them from military ouster, mechanisms against constitutional



manipulation challenge authoritarian power.

Nonetheless, the sub-regional organization ECOWAS demonstrates that such mechanisms can work in Africa. Unlike the AU, ECOWAS suspended Niger well before the coup by triggering its ban on changing election law within six months of an election. ECOWAS's more robust and comprehensive mechanism for countering democratic erosion could serve as a model for the AU as a whole. Indicatively, ECOWAS took the lead in responding to the 2012 coup in Mali, although the subsequent loss of more than half the country to separatist rebels stalled the return to democracy.

## RECOMMENDATIONS

The lessons from Honduras and Niger inform three policy recommendations for the OAS and AU. First, both organizations should devote greater attention to the threat of democratic backsliding. The inauguration of democratic charters intended to address this problem is promising, but they are not enough. Under the Inter-American Democratic Charter, the OAS response to constitutional alterations is weak and does not include suspension. The OAS Democratic Charter should address constitutional interruption and alteration through a single mechanism, with suspension an option in both cases. Political divisions in the OAS, however, make a renegotiation of the Charter unlikely. Alternatively, the OAS could take a series of more politically feasible actions within the framework of the Charter. For example, the U.S. Committee on Foreign Relations has proposed encouraging the OAS secretary general to use his or her full powers under the Charter to help resolve crises, empowering the Inter-American Commission on Human Rights, strengthening the capacity of the OAS to address crises proactively, encouraging other branches of government besides the executive to request action by the Permanent Council, and increasing engagement with civil society (U.S. Senate Committee on Foreign Relations 2010). These steps could help the OAS develop a more preventive approach to democratic backsliding.

The AU Charter on Democracy, Elections and Governance already addresses constitutional interruption and alteration through a single mechanism and thus provides a stronger basis for preventing democratic backsliding. The Charter should also, however, include sanctions against incipient signs of democratic backsliding, such as modification of the election law within six months of an election (similar to ECOWAS). Considering that the Charter just entered into force, however, it is too soon to amend it. The AU could instead take smaller actions similar to

some of those recommended for the OAS, including strengthening its capacity to address crises proactively and increasing engagement with civil society. In addition, the AU Commission could work more closely with the African Peer Review Mechanism, which tracks political indicators in many AU member states and could help foresee impending crises.

Second, the OAS should adopt a set of legal procedures for automatically suspending and readmitting member states that undergo coups, in line with the AU. The strong legal foundation for the AU's mechanisms against unconstitutional changes of government provides for a more coherent and effective response than the OAS's politically dependent approach. If the OAS had automatically suspended Honduras after the coup and automatically readmitted it following elections, it could have resolved the political crisis much more quickly. This change, which would require amending the Democratic Charter, would be politically difficult, running against regional norms of sovereignty and nonintervention. In lieu of amending the Charter, the member states of the OAS should at the very least endeavor to coordinate a more coherent response to coups.

Finally, the OAS and AU should respond consistently and strictly to all coups, regardless of their perceived justifiability. Nuanced responses to "good" coups could undermine anti-coup norms in both regions. Instead, the OAS and AU should employ mechanisms that expedite resolution of coups through a rapid democratic transition. The AU is farther along on this than the OAS. It was right to suspend Niger after the coup, even if many leaders were glad to see Tandja go; the AU's clear process for readmission ensured this suspension was not an indefinite punishment but a step on the path toward restoring democracy.

## NOTES

<sup>1</sup> Africa has experienced four military coups since the coup in Niger. In 2012, military coups toppled the governments in both Mali and Guinea-Bissau, and, in 2013, coups ousted the leaders of the CAR and Egypt. While Latin America has not experienced another bona fide coup, Congress's rapid impeachment of the president in Paraguay in 2012 was widely condemned as an unconstitutional change of government.

<sup>2</sup> It should be noted that presidential-term extensions are not inherently problematic, particularly in countries like Honduras where the executive is limited to one term. The problem with *continuismo* in Latin America, however, is that it has consistently involved executive overreach and marginalized the opposition and other branches of government (although Colombian President

Uribe bucked this trend in accepting the Constitutional Court's ruling that his proposed referendum was unconstitutional).

<sup>3</sup> Other post–Cold War coup attempts, such as that against Chávez in 2002, were not successful.

<sup>4</sup> These include the 1985 Protocol of Cartagena de Indias, which added to the OAS's express purposes "to promote and consolidate representative democracy, with due respect for the principle of nonintervention;" OAS General Assembly Resolution 1080 in 1991, which instructed the Secretary General immediately to convene the Permanent Council in the event of the "sudden or irregular interruption of the democratic political institutional process" in a member state; and the 1992 Protocol of Washington, which authorized the OAS to suspend any member "whose democratically constituted government has been overthrown by force."

<sup>5</sup> This does not, however, include the recent coups in Guinea-Bissau, the CAR, or Egypt, which have not yet led to democratic transitions.

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## THE BASEL III ACCORD AND THE EUROPEAN SYSTEM OF FINANCIAL SUPERVISION: POLICY PRESCRIPTIONS FOR AN INADEQUATELY REGULATED COMMON MARKET

*Mark Walker*

In the wake of the 2007-2009 European bank crisis the European Union created the European System of Financial Supervision (ESFS) to monitor European banking and financial institutions and agreed to the Basel III Accord to ensure a more resilient financial system. This paper presents an examination of the 2007-2009 EU bank crisis and the policy prescriptions that have followed. First, the paper will study the ESFS and the Basel III Accord, both designed to mitigate future bank crises. Second, the paper will show, through examination of the cases of Hungary and Poland, that the European Union is no better prepared to avoid or mitigate issues arising from within its financial economy than it was during the crisis. Finally, the paper will conclude with a discussion on comprehensive solutions to the EU's inadequately regulated financial economy.

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*Mark Walker is a 2013 graduate of the Master of Arts program at Carleton University's Norman Paterson School of International Affairs, where he focused on international banking and financial regulation. He would like to thank Professor Crina Viju at Carleton University for her help and support. He can be reached at [marktwalker@gmail.com](mailto:marktwalker@gmail.com).*

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## INTRODUCTION

The 2007-2009 European bank crisis (“The EU crisis”), which was a part of the larger global financial crisis, occurred largely due to imprudent international and domestic regulation of European banks and financial institutions. When American subprime mortgages held by European institutions defaulted, contagion spread across Europe from institution to institution and from country to country. Default, bailout, and merger—words previously confined to the financial sector—entered the vocabulary of average households. Whilst European banks’ exposure to American subprime mortgages was not due to poor regulation in the European Union, the lack of international regulation and enforcement, oversight, and effective coordination arguably led to the spread of the financial crisis within the European market. This is especially troubling when one considers that the rate of internationalization of banking and financial service providers in the European Union is higher than anywhere in the world (de Nicolo et al. 2004; Naaborg 2007).

The regulatory outcomes of the EU crisis at the European level include the European System of Financial Supervision (ESFS), and, at the international level, the Basel III Accord. It is possible that even with these new regulations in place, the EU crisis could happen again in exactly the same way. This paper therefore examines the Basel III Accord and the ESFS, using Hungary and Poland as case studies. These countries are suitable as case studies due to their trajectories as new member states with similar economic histories and macroeconomic data, and their different experiences during the crisis. I argue that Hungary’s regulations within the European Union are inadequate to prevent a similar bank crisis, and that Poland, with its more robust regulations, will fare comparably well in the face of a similar crisis. Finally, I provide policy prescriptions based on these two case studies. These will focus on EU-wide implementation of the Basel III Accord and minimum harmonization of regulatory and supervisory standards.

## REGULATORY BACKGROUND

### *Basel III*

The Basel III Accord came into being in late 2010 in response to the 2007-2009 global financial crisis as the successor agreement to the Basel II Accord. As the EU crisis of 2007-2009 has shown, Basel II did not go very far in preventing failures such as large risk spreading through institutions like Northern Rock and Fortis-Dexia bank. Like its predecessor, Basel III



is not an international treaty and is non-binding. Member countries may modify and change the agreement in order to better suit their financial regulatory standards (Eubanks 2011). It is also important to note that the OECD has reported that its implementation could result in a reduction of GDP growth of between 0.05 and 0.15 percentage points in the economies in which the Basel III recommendations are implemented (Slovik and Cournède 2011).

In contrast to Basel II's three-pillared approach, the Basel III Accord introduces four key focus areas, designed to help contain systemic risks arising from procyclicality and from the interconnectedness of financial institutions. These are: first, raising the quality, consistency, and transparency of the capital base of banks and financial institutions; second, enhancing risk coverage; third, supplementing the risk-based capital requirement found in Basel II with a leverage ratio; and fourth, reducing procyclicality and promoting countercyclical buffers (Basel Committee on Banking Supervision 2010). All of these four focus areas are important. However, focus areas three and four are of particular importance in Basel III, as they exist to address key deficiencies in Basel II.

The third focus area, the supplementation of the risk-based capital requirement focusing on exogenous risk with a leverage ratio, is designed to provide incentives for banks to use stable sources to fund their operations (Eubanks 2011). Furthermore, the addition of the leverage ratio addresses endogenous risk and the overall health of a banking system, as opposed to exogenous risk, which only affects the health of an individual institution. Under Basel II, the amount of liquidity a bank or financial institution was required to have on hand was directly related to the amount of debt it had on its balance sheets. However, in the wake of the EU crisis, it became apparent that on-balance-sheet debt was not an adequate indicator of the risk that those debts could pose. A truer indicator of risk lay in the bank's debt leverage ratio (Basel Committee on Banking Supervision 2010). This is an indicator of interconnectedness and exposure throughout the financial system to the transmission and receipt of financial shocks. The leverage ratio requires banks and financial institutions to have more capital on hand, depending on the extent to which the debt on their balance sheets is leveraged and, therefore, risky.

The fourth focus area, the reduction of procyclicality and the promotion of countercyclical buffers, is an important part of Basel III because it seeks to address the lack of attention paid to the potential spread of systemic shocks throughout the banking and financial sector in Basel II. Procyclicality is the tendency of banks to disproportionately expand

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lending when economic activity is expanding and to disproportionately contract lending when economic activity is contracting (Eubanks 2011). As such, during economic expansions, when lending is less risky, Basel III recommends greater on-balance-sheet capital requirements, the theory being that profitability, restraint, and careful policy can all co-exist even if faced with higher capital requirements. During economic contractions, when lending and liquidity tend to dry up, Basel III recommends the relaxing of on-balance-sheet capital requirements, thus permitting the continued supply of liquidity and lending (Eubanks 2011). The tightening and relaxing of capital requirements will follow business and national economic cycles, ideally responding at required times.

### *ESFS*

From 2010 to 2011, the European Commission and Parliament set out and implemented the ESFS as a new structure of monitoring and coordination for the EU's banking and financial industry as a response to the EU crisis. The ESFS replaces the previous EU-level system of four supervisory authorities that arose from the Lamfalussy process (Lamfalussy 2001). During the EU crisis, these four entities performed largely ceremonial roles, as forums in which officials could hold meetings and discussions related to the respective committees. Based on the findings and suggestions of the 2009 de Larosière report, the European Commission replaced these entities with the ESFS. The ESFS includes three European Supervisory Authorities (ESA): the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). A separate entity, the European Systemic Risk Board (ESRB), operates in a complementary manner to the three ESAs, monitoring risks across the union. While all three ESAs are equally important, the EBA and ESMA are the focus of this paper because insurance and occupational pensions were not a large factor in the EU crisis. Therefore, this paper does not consider the EIOPA further.

The European Commission has charged the EBA with protecting the stability of the financial system, promoting the transparency of markets and financial products, and ensuring the protection of depositors and investors. This mandate shall promote supervisory convergence and provide advice to the union institutions in the areas relating to its mandate (European Parliament 2010b). The same document later states that:

The legislature may deem it necessary to provide for the establishment of a Community body responsible for contributing to the implementation of a process of harmonization in situations

where, in order to facilitate the uniform implementation and application of acts based on that provision, the adoption of non-binding supporting and framework measures seems appropriate.

Each member state monitors credit institutions as their own regulations apply. Currently within the European Union, neither the ESFS, nor any EU-level authority, can monitor the international actions of an institution because of this national-level focus. A non-binding agreement would appear contradictory to a mandate charged with protecting the stability, transparency, deposits, and investors of the entire European Union. A binding agreement would certainly be more in line with a compelling directive seeking effective, supra-national regulation of the EU banking sector. However, as will later be discussed, for the time being, there does not appear to be much interest in such policies.

The European Commission has charged the ESMA with preventing regulatory arbitrage, guaranteeing a level playing field, and strengthening international coordination for the benefit of the economy at large, including financial institutions, other stakeholders, consumers, and employees. The regulation continues by noting that the ESMA should also include promoting supervisory convergence and providing advice to the union institutions in the areas of responsibility. Its scope is concerned with the adoption of a non-binding, supporting framework for national regulators (European Parliament 2010c). Again, in this regulation, much stronger terms than “non-binding” would ensure a broader functioning and more effective ESMA.

In addition, the ESRB monitors the EU financial system to identify and manage systemic risk. Its voting board consists of the heads of the national Central Banks of EU states, European bureaucrats from the European Commission, the Chairperson of the ESRB’s Advisory Technical Committee, the Chairs of the ESAs, and the President and Vice-President of the European Central Bank. Its founding document states that:

The ESRB’s task should be to monitor and assess systemic risk in normal times for the purpose of mitigating the exposure of the system to the risk of failure of systemic components and enhancing the financial system’s resilience to shocks... The ESRB should contribute to ensuring financial stability and mitigating the negative impacts on the internal market and the real economy (European Parliament 2010a).

The ESRB will assess systemic importance and potential risk of markets and institutions through three criteria. These are the volume of financial

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services provided or present, the extent to which other components of the system can provide the same services in the event of a failure, and the number of linkages between the institution or market in question and the rest of the system.

## LITERATURE REVIEW

The ESAs and the ESRB that make up the ESFS and the Basel III Accord were regulatory responses to the EU crisis. It is clear that the ESFS only has the power to monitor, notify, seek convergence, and coordinate. It has not been tested by a systemic bank crisis as grave as the one between 2007-2009. Extensive literature exists on the ESFS and Basel III and the state of regulatory affairs in Europe more generally. Overall, the regulatory arrangement in Europe appears weak, fragmented, and contradictory.

Costantino (2012) and Dabrowski (2010) both take issue with the ESFS' weak oversight system, pointing out that this leads to fragmented financial supervision. The supra-national nature of the problem exacerbates the situation. Masciandaro et al. (2011) note that, given the predominantly decentralized model of financial regulation and supervision, national structures and government practices can stand in the way of more effective cross-border supervision. These practices have led Issing (2011) to conclude that the institutional framework must be cast more broadly: without state competency at the European level, responsibility must be transferred to a European surveillance system.

Even with the scheduled implementation of Basel III, EU regulators are playing catch-up to instruments and products that are developing faster than legislation can regulate them. For some scholars, Basel III does not mandate enough restraint, leaving the possibility of further bank failures and contagion. For example, Kudrna (2012) notes that while Basel III may reduce the overall likelihood that fiscal financing for banks and financial institutions may be necessary, it cannot exclude it completely. Quaglia (2012) writes that the policy responses to the EU crisis have failed to address key regulatory issues concerning banking, focusing instead on the regulation of financial activities mainly in the securities markets that were not at the center of the crisis. In short, the literature seems to suggest that the ESFS and Basel III will not be enough to protect against a future crisis.

## CASE STUDIES

To evaluate whether the ESFS and Basel III will be enough to protect against a future crisis, I examine the different experiences of Hungary and Poland

during the EU crisis. The similarities of Hungary and Poland, which are both new member states, are both former centrally planned economies, and have similar macroeconomic profiles, make them suitable cases for comparison. These similarities are evident from the countries' GDP and claims on the private and public sector (World Bank Online Database, 2013). At the outset of the EU crisis in 2006, Hungary and Poland's GDP per capita were \$5,868.00 and \$5,553.00, respectively. Claims on the governments of Hungary and Poland as a percentage of GDP in 2006 were 13 percent and 9 percent, respectively. Claims on the private sector as a percentage of broad money in the economy in 2006 in both countries was 16 percent. These indicators show striking similarities between the two economies as relatively prosperous new member states with stable national finances and modest debt claims on their private sector prior to the crisis. Their divergent economic trajectories following the crisis provide empirical evidence for how domestic and international regulatory policies can affect countries' experiences in the face of a financial crisis.

### *Hungary*

The case of Hungary bears mention due to its rapid evolution from economic expansion to contraction. In the lead up to the EU crisis, Hungary was in the midst of undertaking the Euro convergence criteria. Ideally, once a country has met the convergence criteria, its economy is sound enough to weather, and not exacerbate or transfer, endogenous or exogenous shocks within the European Union. While endeavoring to meet these criteria, Hungary was seen as a model emerging economy. The returns appeared to be catch free. The economy appeared to be sound.

Still, some Eastern European countries like Hungary became victims of their own success following enlargement. The euphoria of private investors, researchers and analysts, national authorities, and EU governing bodies, who all had greatly underestimated the magnitude of the potential risks, quickly ended (Dabrowski 2010). In 2007 and 2008, foreign institutions owned approximately 70 percent of Hungarian banks (Banai et al. 2010), of which 55 percent were German, Austrian, Italian, or Belgian. When foreign banks entered into Hungary's host market from Western European home countries under the then-current regulatory rules, they began offering services that were completely new to the Hungarian market and generally risky. Household indebtedness in Hungary rose by over 50 percent in the four years leading up to the crisis (Bod 2009). International banks, unable to finance lending to Hungarians with Hungarian capital, borrowed from abroad to lend to Hungarians in foreign currency (Bod

2009). This action in and of itself shows serious problems. Ideally, a national economy should not accumulate large claims on its private sector denominated in foreign currencies. Cases like Russia and Argentina have shown how quickly a currency crisis can develop when foreign capital that is financing domestic lending suddenly leaves an economy and the domestic currency quickly depreciates (International Monetary Fund 2002). Local debts can suddenly be worth many times more than their original book value, potentially sending the domestic economy into a deep recession.

However, in this particular situation, the host Hungarian national regulatory authorities had no incentive to stop the lending. This would have slowed their economic growth. Even if they had wanted to, the foreign home country regulatory authorities supervising these international banks had no prerogative to do so. This was due to the supervisory system then in place wherein a national authority could not, and still cannot, exercise authority over a foreign bank's operations outside of its borders. Because of the questionable private lending that took place, facilitated by poorly regulated banks, Hungarian Treasury bill yields escalated, and then stopped selling for a few weeks. In 2008 and 2009, liquidity in Western Europe dried up and many international banks operating in host markets like Hungary stopped borrowing from abroad to finance domestic consumption; credit in Hungary dried up; and the Hungarian currency, the forint, depreciated rapidly against the euro (Bod 2009). From 2008 to 2009, private debt as a percentage of GDP went from 155.7 percent to 170.6 percent (European Commission 2013).

### *Poland*

The case of Poland bears mention due to its aforementioned economic similarities with Hungary in the lead up to the crisis on the one hand, and the different regulatory structure it possessed on the other, which enabled it to weather the EU banking crisis better than Hungary.

In 2007, Poland was also a new member state. Its finances and regulation were perceived to be fairly robust, and, like Hungary, its banking sector was not immune to systemic shocks during the EU crisis. For example, in 2009, 72 percent of the assets of Polish banks were foreign owned (Strojwas 2010) and therefore exposed to the financial problems of countries across the union during the crisis. While they had numerous economic similarities prior to the crisis, Hungary and Poland's different regulatory structures resulted in much different economic experiences during and after the crisis.

Moving out of the crisis in 2009, 1.3 million bank accounts were

opened, and as many as 44 percent of Poles still did not own a bank account (Strojwas 2010). From 2008 to 2009, private debt as a percentage of GDP increased from 72 percent to 72.4 percent (European Commission 2013). In 2008 and 2009, respectively, Poland had the second lowest and then the lowest private debt as a percentage of GDP in the EU (European Commission 2013). These statistics show that not as much borrowing took place in Poland during the crisis when compared to Hungary. Growth potential and actual growth were present and encouraging, regardless of endured losses.

## DISCUSSION

### *Hungary*

The main problems in Hungary's bank crisis were created and perpetuated by: two-way contagion channels between foreign parent banks and Hungarian subsidiaries; substantial credit expansion; disproportionately high leverage; asset price bubbles; and banking systems financed and supported only by external financing, operating with excessively high loan-to-deposit ratios (Banai et al 2010). When these problems came to a head, the foreign credit dried up, the forint depreciated, and domestic consumption slowed. This in turn led to decreased private and public-sector revenues and debt payments. These problems became unmanageable in the lead up to and during the crisis, ultimately resulting in the current recession in the Hungarian economy. Given today's policies, created in response to the EU crisis, it is important to assess what outcomes their existence would realize.

Given that the Basel III Accord calls for countercyclical credit expansion, increased capital-to-leverage ratios, and lower debt requirements than previous agreements, it would go a long way in reducing the problems of contagion channels, substantial credit expansion, high leverage, and high loan-to-deposit ratios. Basel III would not entirely address the issues of asset price bubbles or systems financed and supported only by external financing. Unfortunately, Hungary has not committed to adopting Basel III. The European Commission has committed to it, and while many Western European nations have pledged to adopt it, Basel III is still making its way through analysis and implementation in the new member states (Lehmann et al. 2011). The European Union has yet to issue union-wide regulations and the international deadline for total implementation has been set for 2019 (Bank of International Settlements 2012).

The ESFS' response to the Hungarian problems noted above is wanting.

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It has no mandate to monitor the financial activities (contagion channels) taking place between host and home member states. It has no mandate to monitor substantial credit expansion (procyclical activities), save perhaps the ESRB, which can only compel action with a majority board vote and even then only in extreme cases. It has no mandate to consider, or monitor, what may be disproportionately high leverage on balance sheets. The ESRB, as part of the ESFS, can monitor asset bubbles but, again, has few means by which to require action. Lastly, the ESFS cannot address banking systems financed and supported only by external credit, operating with excessively high loan-to-deposit ratios, because under its auspices this problem is the prerogative of the national regulatory sphere. The EBA and ESRB would be compelled to monitor such a situation but have no means by which to address it.

In Hungary, the existence of the regulations recommended by the Basel III Accord would have greatly helped the banking and financial industry. Such regulations would have required at least a minimum level of restraint in the banking and financial industry. While the ESFS is not strong enough to compel Hungary to make any regulatory changes, had its harmonization of best practices been actionable leading up to the crisis, it is likely that the crisis in Hungary would not have been as severe.

### *Poland*

Kozinski (2010) identifies the problem present in Poland as the turbulent EU crisis, which saw mutual drops in confidence across regional banking groups. Thus, even in the absence of risky domestic debt leveraging in the lead up to the crisis, the Polish banks (some of which are members of these regional groups) faced a crisis of confidence. Because of this, liquidity in the local money and foreign exchange markets decreased. Moreover, increased risk aversion of global investors resulted in a “flight to quality” and the withdrawal of capital from emerging markets.

The Basel III Accord’s call for increased countercyclical buffers would have marginally helped the Polish position during the EU crisis. However, given that most of the problems Poland experienced concerned liquidity resulting from international investor confidence and not necessarily domestic confidence, the Basel III Accord would not have made much of a difference in the Polish case. This is because Poland already embodies most of Basel III’s principles in the regulation of its domestic bank market and financial institutions. Had the ESFS been in place at the time of the EU crisis, it would only have been able to monitor the developing liquidity issues in the country. Poland’s response to the issues it experienced was



in line with the advocated convergence criteria and best practices of the ESFS. Even if the ESFS did have enforcement mechanisms to compel national regulators to act, Poland's responses would have likely mirrored any ESFS intervention.

While Poland has not yet implemented the Basel III Accord, some structures of the accord are mirrored in the regulation of its financial economy, as discussed above. In addition, the regulatory procedures and competencies of Polish national regulators are mostly in line with those advocated, but not enforced, by the ESFS. The Polish experience, which can easily be termed one of the better ones in the European Union during the crisis, shows a country and regulatory framework that weathered the storm well—thanks to prudent policy.

There are immediate differences between Poland and Hungary in this instance. The liquidity crunch that Poland experienced was not as severe as the liquidity crisis that Hungary experienced. This is because, even when international credit providers left Poland in their “flight to quality,” domestic credit lending was robust enough and debt not so leveraged that consumption halted. Borrowers and lenders continued their transactions, albeit at a reduced rate. Additionally, Polish regulations during the EU crisis were, and still are, sound. The nature of the domestic banking industry maintains countercyclical buffers, is risk averse, and does not lend itself to extremely high debt ratios or excessive leverage (Strojwas 2010). The Bank of Poland and Polish regulatory authorities by most accounts responded well to the crisis and its aftermath (Kozinski 2010; Lehmann et al. 2011; Strojwas 2010). It is important to note that, because Polish national regulations were sufficient, the crisis did not affect Poland as adversely as it did Hungary.

## RECOMMENDATIONS

The experiences of Hungary and Poland were similar in the lead up to the crisis yet dissimilar during and after it due to their different approaches to financial regulation. These two case studies provide strong support for the implementation of Basel III and a mandate for the ESFS to compel harmonization of best practices across the union's national regulators. Ideally, a regulatory structure whereby Basel III is implemented across the European Union, along with a minimum harmonization of standards from the ESFS, would go a long way in helping to stave off a future EU bank crisis (Masciandaro et al. 2011). Presently, the Basel III Accord and the ESFS are complementary initiatives. Eventually, the ESFS should adopt and enforce the Basel III Accord.

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Whatever iteration further policy developments take, their implementation will be protracted and likely difficult. While the politics surrounding the implementation of the Basel III Accord are clear – the EU is committed to its implementation, albeit on a slower schedule than the United States (Bank of International Settlements 2012) – the politics surrounding an advanced mandate for the ESFS are not. The European Union does not uniformly favor a supra-national regulatory structure. The topic of further integration of regulation of banking and financial institutions divides the EU. In the East, new member states are hesitant to give more regulatory prerogative to Brussels, especially if their experiences in the EU bank crisis were associated with high levels of foreign bank ownership (Spendzharova 2012). In comparison, national regulatory authorities in countries like France and Germany have been pointing to the need to pursue reforms at the EU level, rather than nationally (Quaglia 2012). A combination of Western EU nations pushing for such a reform would likely lead to a binding regulatory implementation process, given the weighted decision-making system that exists in the European Council and Parliament. While the topic divides the union and the founding documents of the ESFS and Basel III are not legally binding, the current European regulatory framework's inadequacies need correcting.

In this case, the EU's open method of coordination is the best framework under which to move forward. The open method of coordination, which is a form of EU soft law, sets out various stages of implementation for EU policy. Implementation of various social, industrial, and economic policies has taken place over the years using the open method of coordination, without the necessity of treaty negotiations that other initiatives sometimes require (Eurofound 2013a). While soft law may seem to be counterintuitive in light of the ESFS' non-binding language and Basel III's extended time frame, the open method of coordination will allow for eventual implementation of a robust regulatory regime in the European Union.

Currently, EU regulations are the basis for the non-binding regulatory framework. However, it does not make sense to legislate a non-binding regulation. A binding regulatory framework implemented through the open method of coordination's soft law would allow for a more gradual, benchmark "regulatory creep," the theory being that "member states may undertake voluntarily to do what they are less willing to do if legally obligated" (Eurofound 2013b). The binding regulatory framework would come into force as follows: the council of ministers would need to agree upon the principle of a binding regulatory framework; member states

would then translate the guidelines into national and regional policies; benchmarks and indicators of best practice would be agreed upon; and, finally, monitoring and evaluation of results would take place (Eurofound 2013a). Monitoring and evaluation would be the prerogative of the European Commission. While the open method of coordination has been associated with the EU policy of “naming and shaming,” the voluntary commitment to shared objectives that it requires for effective implementation would eliminate negative externalities and create welfare gains with this sort of policy coordination (Collignon 2003).

Given the lack of desire to move towards a European-wide regulatory body, perhaps this intra-European harmonization towards best practices of accountability based on the current Basel III Accord and the standards of the ESFS would be most actionable. This seems like the best path forward, given the European Commission’s emphasis on the supremacy of national regulators when it comes to the financial economy. The ESFS principally embodies this compunction; all it needs is a commitment to harmonize minimum standards and a concrete timeline.

## CONCLUSION

European officials, the private sector, and citizens understand the issues associated with their financial services industry. The 2007-2009 EU crisis highlighted the industry’s capability for destruction. Moving forward with further regulation is not an initiative to be undertaken lightly. At this moment, negotiations towards a European Banking Union are ongoing. However, there are many different hurdles to overcome; the single supervisory mechanism, deposit insurance, and a common bailout fund among them. The policies discussed in this paper would be complementary yet very separate from such initiatives given that these would not necessarily ameliorate existing national regulatory frameworks that may require improvement. It may be more advantageous to initiate the policy recommendations on the ESFS and Basel III sooner and allow what certainly will be protracted negotiations on the details of a Banking Union to proceed.

The experiences of Hungary and Poland during the EU bank crisis are, at the two extremes, illustrative of many European countries. In the aftermath of the crisis, Poland has some of the lowest private debt-to-GDP percentages in the entire EU. Hungary has some of the highest. Many indicators leading up to 2007 showed these two countries to be relatively comparable. However, their different experiences during and after the crisis show how much effective regulation matters. In this way, Poland is as comparable to Slovakia and Lithuania as Hungary is to Spain and Estonia.

The recommendations of this study would help the entire European Union. When wholesale market failure in an industry takes place, as it did most recently in the 2007-2009 EU bank crisis, regulation is required. For the sake of members' economies, banks, and banking customers, the EU must institute minimum binding standards from the ESFS and implement the Basel III Accord.

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## AGAINST MILITARY MERCANTILISM: THE ECONOMICS OF ARMS TRADE SUBSIDIES

*Ben Grubb*

The British Government heavily subsidizes its domestic arms industry to promote exports—a policy approach known as "commercial pragmatism." This paper explores whether support of this industry promotes Britain's national interest through critical analysis of the policy's impact on employment, balance of payments, technological progress, and equipment costs. The findings suggest that the case for commercial pragmatism is tenuous, being neither commercial nor pragmatic. The article advocates shifting government investment from the defense sector to the wider civil economy—a policy recommendation relevant to other governments with similar arms industry policies such as the United States, Russia, Germany, France, and China.

### INTRODUCTION

For the past thirty years, Britain has aggressively promoted defense exports, spending billions subsidising its domestic arms industry in an approach known as "commercial pragmatism" (Freedman 1978; Sampson 1977).

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*Ben Grubb is currently pursuing a Master of Science in Social Policy at the London School of Economics and working as a parliamentary assistant for the British Labor Party's chief policy coordinator. Grubb developed a particular interest in Britain's role in the arms industry after reading Anthony Sampson's The Arms Bazaar. He can be reached at [bengrubb10@gmail.com](mailto:bengrubb10@gmail.com).*

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Politicians, journalists, and the British public assume that this approach handsomely contributes to Britain's economy. While a few commentators have questioned the morality of commercial pragmatism, none have analyzed how effectively this approach promotes the British national interest. This essay takes aim at commercial pragmatism on economic grounds. While this study focuses on the economic impact of commercial pragmatism in Britain, the arguments and conclusions also apply to other arms exporting countries including the United States, Russia, Germany, France and China.

What is commercial pragmatism? It is the provision of heavy state support to UK defense export companies (Freedman 1978). This support rests on four key pillars: investment, consumption, promotion, and regulation. First, the British government heavily subsidises defense exports by directly investing in military research and development to the tune of approximately £841,300,000 annually.<sup>1</sup> Second, the Ministry of Defense (MoD) regularly manipulates its equipment procurement process in favor of British companies, incurring approximately £150 million a year (Campaign Against Arms Trade, 2004). Third, the British government helps market the nation's defense products abroad, with annual costs estimated at approximately £300 million.<sup>2</sup> Finally, the government offers implicit support for defense export companies in the form of weak regulation (Campaign Against Arms Trade, 2004). While the government, in principle, reserves the power to regulate and prohibit arms sales that violate Britain's wider foreign policy goals, this power is rarely exercised— only 3 percent of all defense export licence requests are rejected (Phythian 2000).

Advocates of commercial pragmatism invariably invoke one of these four economic arguments: commercial pragmatism boosts employment, improves the balance of trade, quickens technological innovation, and reduces defense equipment costs. These will now be critically assessed in turn.

### *Employment*

In 2003, then UK Prime Minister Tony Blair stated in a speech, "There are roughly 100,000 jobs in this country that depend on defense or associated industries" (The National Archives 2003). These alleged employment benefits constitute the most commonly cited justification for commercial pragmatism.

A sizeable number of people do indeed rely on defense exports for their livelihoods; 2002 estimates suggest as many as 105,000 jobs depend directly on Britain's involvement in the arms trade and another 115,000 indirectly depend on it (Stockholm International Peace Research Institute 2012).



However, defense exports contribute relatively little to total UK employment, representing only 0.25 percent of the national labor force (Ingram and Isbister 2013). Furthermore, there has been a steady downward trend in the contribution arms sales make in this regard, with employment in the industry having consistently fallen since the 1980s (Ingram and Isbister 2013).

Despite the aggregate benefits to employment, current subsidies beg a fundamental question: Is commercial pragmatism an effective way to promote employment? On average, each job supported by arms exports costs the UK government between £3000 and £18,000 (Phythian 2000; Ingram and Isbister 2013). Though such figures do not account for the fact that such subsidies exist for a variety of reasons, of which employment is just one, a figure half as large would still demand close examination. Several studies detail just how inefficiently the military export sector promotes employment, since civilian industrial production far surpasses the military export sector in labor intensity (Smith, Humm and Fontanel, 1985; Dunne and Smith 1984; De Grasse 1983). The labor intensity of civilian industry means that funds currently used for defense subsidies could potentially create between 50 percent and 140 percent more jobs if reallocated to the areas of clean energy, health care, and education (Pollin et al 2009; 2011). Redirecting investment from the defense sector to these areas of civilian industry would be a far more cost-effective method of promoting employment—costing as much as £11,500 less subsidy per job created.<sup>3</sup> Commercial pragmatism, given its inefficient creation of jobs, is neither commercial nor pragmatic.

### *Balance of payments*

Commercial pragmatists often cite the allegedly beneficial effect of arms sales on the balance of payments. Graham Chisnall, the Deputy Chief Executive of ADS, the premier UK trade organization that advances defense sales, describes the industry as “a major economic force, contributing over £22 billion of annual revenues to the UK, of which £5.4 billion are from exports” (Gov.uk 2013). At first glance, the balance of payments advantages that Britain enjoys from commercial pragmatism are significant. Arms sales generate a net revenue of approximately £9 billion annually (Levine, Smith, Reichlin, and Rey 1997). However, the aggregate effect on the balance of trade is more ambiguous. Indeed, strong evidence suggests that Britain potentially suffers a balance of trade loss from selling arms as a direct result of government subsidies (Smith 1985; Chalmers et al 2002).

Because heavy global competition continually forces down the price of defense equipment, countries increasingly sell weapons at a loss; this is

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despite the fact that companies themselves still earn a profit, a gain only made possible by government subsidies. This global competition and consequently low profit margins offers a possible explanation of why the defense industry is one of the few areas of manufacturing characterised by a relative absence of private enterprise companies operating independently of the state (Smith 1985; Martin et al. 1997).

One researcher, Levine, offers evidence of this pressure on weapons sales. Noting a “significant downward trend in the real price of arms,” he finds that the implied price index for defense products fell from 1.8 in 1982 to 1.0 in 1994 (Levine et al. 1997). This decrease in the price index likely counteracted the balance of trade surpluses gained from the arms trade, increasing the likelihood that military exports lead to a trade deficit. Recent trends suggest that Britain’s ability to command high prices for arms have degraded beyond Levine’s estimates, with greater competition from countries such as Israel, South Korea, and India further eroding the balance of payments benefits (Bishop 1995; Freedman 1978). While the complex nature of transactions and the lack of transparency within the industry make any firm conclusions difficult, one estimate puts the balance of trade loss at £359 million annually (Martin 1999).

The competitive nature of the global defense market also generates further costs. Arms suppliers often need to incorporate “supply extras” (separate from the equipment itself) into defense export deals in order to gain a competitive edge. These often include items such as spares, training, access to technology, export credits, insurance for payment, and offset agreements (Smith et al. 1985). Supply extras, while harmful to the import-export balance, are, however, minor when compared with “counter-trade arrangements,” which involve the buying nation, in return for its promise to purchase military equipment from the supplier, securing a counter-agreement that the supplier will similarly import civilian products from its own economy (Smith et al. 1985). Extra costs incurred via such export deals not only eat into any balance of payments surpluses gained from exporting arms but also are often covered by the government. This greatly obscures the true effect of commercial pragmatism on the UK’s balance of trade.

Evidence suggests that defense exports bring uncertain balance of trade benefits to the UK and could even be contribute to a net *loss* in the balance of payments. The UK could more effectively promote positive balance of trade surpluses by redirecting current investment in the defense export sector to more profitable areas of the civilian manufacturing economy.

### *Technological progress*

The MoD claims a domestic defense industry supported by exports will benefit civilian industry through the transfer of military technologies, a process known as the “technological spin-off” effect (Ministry of Defense 2005). Defenders of the status quo regularly invoke the rationale of technological spin off to justify heavy government investment in defense research and development that in 2009 totalled more than £300 million (Office of National Statistics 2013). In relation to their respective shares of total UK exports, the defense industry receives nearly 20 times more investment than civilian industry (Office of National Statistics 2013; Campaign Against Arms Trade 2012).

Most estimates of the effects of defense development on civilian technology suggest that any benefits are limited (Levine et al. 1997). The special demands of military equipment generally restrict interconnection with the wider economy and thus “militate against technological transfer” (Dunne and Smith 1984; Smith et al. 1985; Maddock 1983; De Grasse 1983). The technological spin-off effect is stifled by certain aspects of the UK defense industry such as the elaborate and expensive nature of the UK weapons systems, the small batch production methods that dominate the industry, and the uncompetitiveness of defense firms (Dunne and Smith 1984). Indeed, the MoD themselves admit that in relation to the actual benefits accrued, “overall the picture is not clear” (Ministry of Defense 2005).

Evidence for a “technological spin-in” effect reveals the inefficiency of promoting technological progress primarily through military research investment. Civil products can be shown to provide more cross-industry technological applications than their military equivalents (Buck, Hartley, and Hooper 1998). Even though technology historically flowed from the military outwards, the MoD themselves admit, “in recent years, this trend has reversed” (Ministry of Defense 2005).

Government investment in military development not only inefficiently promotes Britain’s technological progress but also may actually inhibit innovation. Subsidizing defense development may hamper technological progress in the UK’s civil sector by depriving it of scarce scientific and technical resources. Heavy investment in the military industry exacerbates the pre-existing scarcity of scientific and technological skills in the British economy, distorting the distribution of engineering talent (Dunne and Smith, 1984; Smith et al. 1985; Ingram and Isbister 2013). Government investment means that some 40,000 scientists and technologists now work in the British defense industry, “thereby exacerbating a shortage in the

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non-military economy and harming prospects for long-term economic growth” (Morales-Ramos 2002).

In summary, evidence suggests that the technological benefits of subsidizing defense exports are questionable. Investment in military technology appears to make minor contributions to the wider UK civilian economy, but it may have adverse effects if we consider the opportunity cost of this investment. Direct government investment in civilian development could generate greater economic benefits (Dunne and Smith 1984).

### *Equipment costs*

The final alleged economic benefit of subsidizing defense exports is the cost savings associated with procuring military equipment. According to this rationale, British defense companies, by securing defense export deals, are able to increase their output and thus benefit from resulting economies of scale (Krause 1995). These reduced costs then translate into lower equipment prices for the government, estimated at around £150-200 million annually (Campaign Against Arms Trade 2004; Krause 1995).

These cost savings, however, all rely on the assumption that the MoD should automatically purchase the vast majority (around 95 percent) of its equipment from British firms (Hartley and Hooper 1987; Martin 1999). This position rests on the belief that Britain’s interests are intrinsically tied with its domestic production capacity and that “buying British” helps to maintain this. However, the actual benefits the UK draws from its domestic defense industry are questionable. Research reveals that opening up MoD procurement choices to international competition can result in far greater cost savings than those noted above.

Allowing foreign firms to compete for MoD equipment orders will likely yield significant cost savings, with estimates ranging from 15 percent to 40 percent—saving the taxpayer anything from £2,100- £5,600 million a year (Hartley and Hooper 1987; Martin 1999).<sup>4</sup> Such potential savings would inevitably outweigh the benefits of commercial pragmatism and, hence, should interest the British government, which is currently slashing costs by reducing its defense personnel by 42,000 (Direct Gov 2010).

In conclusion, if one assumes that the MoD must “buy British,” the promotion of defense exports does lower equipment costs. However, the MoD could secure more significant savings in its defense equipment budget by opening its contracts up to international competition (Martin 1996). More research is required to assess the wider impact of such a change of procurement policy, however, current evidence suggests that it would be more consistent with the UK’s economic interests (Hartley and Hooper

1987). Unfortunately, little research exists on buying internationally, but existing studies do suggest that international competition could not only generate equipment cost savings but also promote efficiency within the UK defense industry (Hartley and Hooper 1987; Ministry of Defense 2002; Walker and Gummett 1989).

This cost-savings rationale links to a wider argument about the alleged strategic military advantages that the UK derives from an indigenous defense industry. While unfortunately beyond the scope of this paper, this claim merits reconsideration. I would contend that the growing interdependence of the global arms industry increasingly renders the concept of a “domestic” defense industry redundant (Bitzinger 1994; Martin 1999; Dunne et al. 2003; Batchelor et al. 2000).

## CONCLUSION

The intellectual foundations of commercial pragmatism are shaky. In analyzing the four key economic rationales behind this policy approach I have found that the economic benefits Britain derives from the commercial pragmatist approach to defense exports are highly overstated. The alternative would involve a reduction in current government support for the industry, reduce direct investment and/or redirect investment towards the civilian economy, lower high-profile promotion of sales, end MoD’s “buy British” procurement policy, and tighten regulation of export deals.

The UK should shift investment away from the defense export sector and towards the wider civil economy. The transfer of subsidies from the defense sector to the areas of clean energy, health care, and education would potentially produce far greater economic benefits and higher employment, a healthier balance of trade, faster technological progress, and also reduce defense equipment costs.

In order to limit some of the transition costs that may result from a reduction in defense export sector employment, a temporary job-training program should be introduced for those that lose their jobs. I estimate that this would cost approximately £112.8 million in total.<sup>5</sup> Policymakers must also be acutely aware of the fact that growing competition in the defense export market is likely to further erode any economic benefits the country does draw from its involvement. These conclusions should prove relevant not just to Britain but to a number of other governments with similar arms industry policies, including the United States, Russia, Germany, France, and China. Given the weakness of the economic arguments in favor of commercial pragmatism, further research is now needed to assess the strategic military justifications for the policy. The significant impact

that this policy approach is having, both in Britain and in the areas of the world to which it sells arms, makes this a matter of considerable urgency.

## NOTES

- <sup>1</sup> Original figure has been converted into an equivalent for the year 2011, utilising the following website: <http://www.measuringworth.com/ukcompare/relativevalue.php> (accessed 27th February 2013). This process has been used for all financial figures quoted throughout this piece.
- <sup>2</sup> This figure is calculated by summing the total governmental arms sales promotion costs involved with: The Defense Export Services Organisation (DESO), the Armed Forces, Embassies and Defense Attaches, the Defense Assistance Fund (DAF), Official Visits, and the Missile Defense Centre and the Export Credits Guarantee Department (ECGD).
- <sup>3</sup> I take the £18,000 figure for the current subsidisation of defense export sector jobs, and the estimate that comparable investment in education would produce 140 percent more jobs, to calculate that savings to the taxpayer in terms of subsidy cost per job could be as much as £11,500:  $\text{£18,000} - (\text{£18,000}/2.4) = \text{£11,500}$ .
- <sup>4</sup> These figures are calculated using the Ministry of Defense's own equipment budget estimate of £14,000,000,000. It can be found on their website: Ministry of Defense. 2013. "Defense Equipment and Support." Accessed 5 March. <https://www.gov.uk/government/organisations/defence-equipment-and-support>.
- <sup>5</sup> I assume that 25 percent of the 105,000 jobs directly dependent on the arms trade would be lost in the short term due to the withdrawal of subsidisation. I advocate a work-training program to be offered to these individuals to enable them to develop skills that would be transferable to alternative industries. The estimate for the work-training program is based upon the model currently employed in Scotland. Official statistics suggest that this could increase employment rates to over 50 percent at a cost of £1,075 per person (or £112.8 million in total) (Provider Central 2013). The figure of £1,075 is calculated by summing the cost of the "Start and Training Payment" and the mean of the two "Job/Self Employment Outcomes" (Provider Central 2013).

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## CERVICAL CANCER IN THE DEVELOPING WORLD: POLICY RECOMMENDATIONS FOR A COMPREHENSIVE PREVENTION, SCREENING, AND TREATMENT PROGRAM IN TANZANIA

*Gloria Twesigye*

This article argues that the Tanzanian Government should prioritize the adoption and integration of cervical cancer prevention and treatment programs. Cervical cancer cases disproportionately affect women in the developing world. Women with HIV/AIDS also have cervical cancer at significantly higher rates than HIV-negative women; it is critical to go beyond antiretroviral treatments and proactively screen HIV-positive women for associated preventable diseases (WHO 2006). This article recommends that the Tanzanian Ministry of Health establish a comprehensive program to prevent, screen, and treat all women and begin by targeting those with HIV and other immunocompromising diseases.

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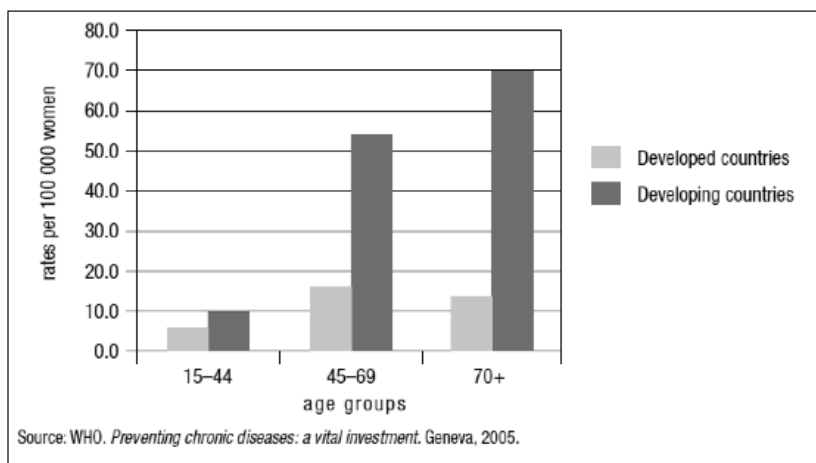
*Gloria Twesigye graduated in 2013 from the Master in Public Affairs program at Princeton University's Woodrow Wilson School of Public and International Affairs, where she concentrated on international development and health policy. Gloria can be reached at [gloria.twesigye@alumni.princeton.edu](mailto:gloria.twesigye@alumni.princeton.edu).*

## INTRODUCTION: CERVICAL CANCER IN THE DEVELOPING WORLD

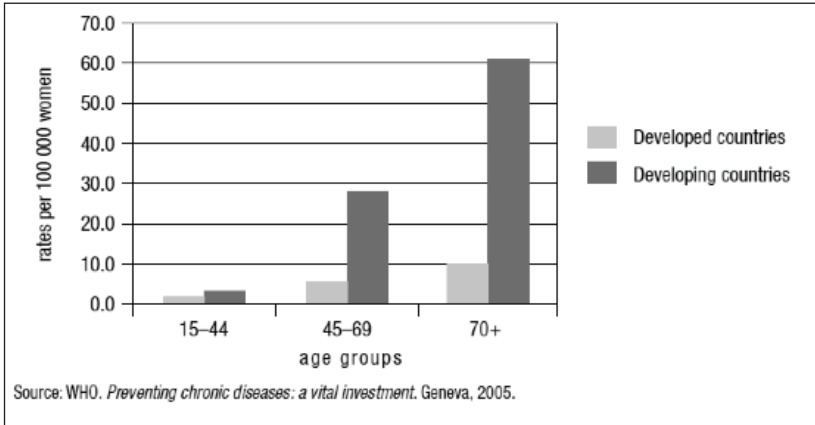
Cervical cancer is the second most commonly occurring cancer among women in the world after breast cancer (WHO 2013). It has been the primary cancer-related cause of death among women in Sub-Saharan Africa for decades and now constitutes 25 percent of all regional female cancer cases (WHO 2013).

However, researchers and policy makers now widely recognize that the human papillomavirus (HPV), the most common sexually transmitted infection, causes cervical cancer. Thus, unlike many forms of cancer, cervical cancer is highly preventable with cost-effective screening and treatment. Screening for precancerous cervical lesions using conventional techniques, such as the Pap smear, has successfully reduced the incidence of cervical cancer in industrialized countries (Figure 1). However, such screening is rare in the developing world due to low levels of health infrastructure, human capital, and financial resources. Women in developing countries rarely seek treatment until later stages of the disease, contributing to a disproportionately high number of cervical cancer fatalities in this part of the world (Figure 2); of the estimated 500,000 new cases of cervical cancer per year, 80 percent are in the developing world (Louie et al. 2009).

**Figure 1: Age-Standardized Incidence rates of cervical cancer in developed and developing countries, 2005**



**Figure 2: Age-Standardized mortality rates of cervical cancer in developed and developing countries, 2005**



### *The links between HPV, cervical cancer, and HIV*

HPV is the most common sexually transmitted virus in the world (WHO 2013). Most infectious strains are low risk and more than 90 percent of infections clear spontaneously (Castellsagué 2010). Two high-risk HPV strains cause 70 percent of all cervical cancers (Castellsagué 2010).

The health community broadly accepts that HIV and cervical cancer have a symbiotic relationship (WHO 2006). Researchers believe that HIV immunosuppression undermines the body's ability to control specific cancer-causing proteins, resulting in a significant correlation between HIV and invasive cervical cancer (Kahesa et al. 2008). There is currently no conclusive evidence of how antiretroviral therapy usage affects the cervix.

The Pink Ribbon Red Ribbon Initiative (PRRR) is a public-private partnership created in 2011 that intends to expand breast and cervical cancer awareness and interventions throughout Sub-Saharan Africa and Latin America, primarily through the public health infrastructure created through the President's Emergency Plan for AIDS Relief (PEPFAR). Since its inception in 2003, the United States has injected over \$46 billion dollars into PEPFAR to reduce HIV/AIDS incidence, provided funding for antiretroviral treatment, and worked bilaterally with governments to strengthen their health care delivery systems (PEPFAR 2012). Recognizing it is counterproductive to put HIV-positive women on antiretroviral treatment if they remain susceptible to other preventable diseases, PRRR intends to work from PEPFAR's platform to increase breast and cervical

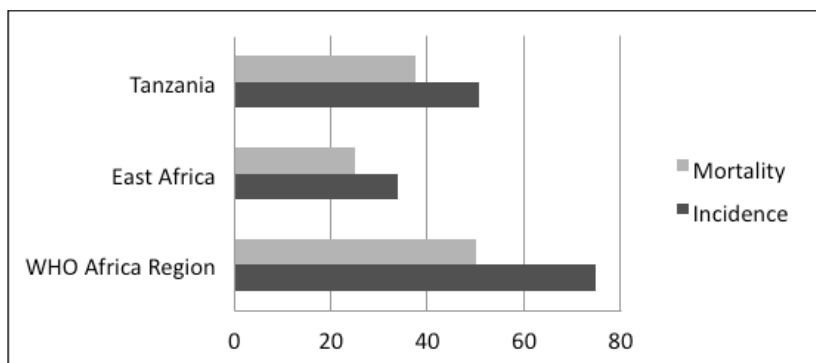
cancer awareness, screenings, and available treatment and to offer HPV vaccinations for adolescent girls.

### *Cervical cancer in Tanzania*

Tanzania has the highest prevalence of HPV in East Africa (WHO 2010) and cervical cancer is the leading cause of cancer-related morbidity and mortality (Kahesa et al. 2008). HIV/AIDS further complicates the challenge. Tanzania's adult overall HIV prevalence rate is 5.8 percent and 6.8 percent for women aged 15 to 49 (UNAIDS 2012). Researchers found that HIV-positive women in Tanzania have a higher risk of HPV infection relative to HIV-negative women (Kahesa et al. 2008, Dartell 2012). These studies also concluded that women with cervical cancer had higher odds of being HIV-positive.

Although Tanzania lacks a thoroughly developed health care infrastructure, the national government has several options for efficacious, cost-effective prevention and treatment in the primary care setting. The country has developed a solid HIV infrastructure with support from PEPFAR and other donors. Since Tanzania has some of the highest HPV and HIV prevalence rates on the continent, implementing a national comprehensive cervical cancer prevention program could offer lessons to other African countries with high rates of HPV and HIV.

**Figure 3: Estimated age-standardized incidence and mortality rates for cervical cancer per 100,000, 2008**



Source: International Agency for Research on Cancer, GLOBOCAN 2008

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## POSSIBLE SOLUTIONS IN DEVELOPING COUNTRIES

### *Prevention options: Vaccines Gardasil and Cervarix*

Cervical cancer is one of the few cancers that is highly preventable, chiefly because of the availability of two prophylactic vaccines. Gardasil by Merck & Co. Inc. was the first FDA-approved HPV vaccine, guarding against four of the HPV strains that cause the majority of cervical cancer and genital warts (NCI 2011). Cervarix, the second available HPV vaccine, is produced by GlaxoSmithKline and protects against the two highest-risk HPV strains that cause cervical cancer. Both are administered in a series of three doses over a six-month period. It is also recommended that individuals have the full treatment before becoming sexually active; the vaccines are therefore mainly targeted towards adolescent girls.

The cost of prophylactic vaccines remains a barrier for many of the countries most affected by cervical cancer. The Global Alliance for Vaccine and Immunization (GAVI) aims to increase HPV vaccination in low-income countries and in 2011 made an agreement with Merck & Co. Inc. to reduce the price of Gardasil from its retail price of USD\$130 (CDC 2012) to USD\$5 per dose (GAVI 2011). Low-income countries eligible for GAVI support have successfully demonstrated their ability to vaccinate adolescent girls with multi-dose vaccines. GAVI will then co-finance a national vaccination program, with recipient countries paying only 20 cents per dose. GAVI support substantially reduces the financial barriers of a national vaccination program, but governments must first prove they are able to vaccinate adolescent girls. This can be a more difficult challenge than vaccinating young children because adolescent mobility complicates follow up.

### *Screening options: Visual inspection methods and HPV DNA testing*

Although the Pap smear remains the gold standard for cervical cancer screening, new technologies offer several feasible alternatives for low-resource care settings. The first is visual inspection with acetic acid (ordinary table vinegar) or Lugol's iodine. Swabbing the cervix with these widely available solutions causes precancerous cells to change color within minutes, making them easily visible to the naked eye. This method requires less than two weeks of training and relatively little medical expertise such that mid-level providers—nurses, midwives, and technical assistants, for example—can administer it. Since the results are available within minutes, this method could reduce the time for follow up treatment and create opportunities for

same-day treatment. Drawbacks include the risk of false positive diagnoses and the inability to take samples for storage and further analysis. Another disadvantage is that this method is not advisable for women over the age of 50 (WHO 2006).

The second option is HPV DNA testing. This screening method can detect high-risk strains of HPV before and after abnormal cells appear. It also detects HPV and precancerous cells better than visual inspection or the Pap smear (NIC 2011). A new version of this test, *careHPV*, was developed specifically to work in low-resource settings without sacrificing test quality. It can be reliably administered by mid-level providers or through self-sampling, which may increase usage among women unable or hesitant to undergo clinical screenings. As such, increasing screenings with *careHPV* is cost effective and attractive; it would not add pressure to health care systems.

### *Treatment options for precancerous lesions: Cryotherapy and LEEP*

There are currently two non-invasive outpatient treatment options for precancerous cells that are feasible and effective in developing health care settings. The first is cryotherapy, which involves applying extremely cold liquid nitrogen to destroy abnormal tissue. Cryotherapy has a 94 percent success rate at removing precancerous tissue (Sauvaet et al. 2012). Another major advantage is that it can be applied the same day of screening results, decreasing the amount of time between receiving tests results and delivering treatment. Cryotherapy is relatively simple to administer, requires only local anesthesia, and can be done by mid-level personnel. It is considered the safest, most cost-effective, and easiest to implement treatment option in low-resource settings, provided the care facilities are able to properly store and maintain liquid nitrogen.

The second option is the loop electrosurgical excision procedure (LEEP). LEEP is administered in an outpatient setting using local anesthesia and a heated wire to remove abnormal cells from the cervix. It is considered 90 percent effective (WHO 2006). Though LEEP is also a simple procedure, it requires a referral to a secondary hospital. Requiring additional visits beyond the primary care setting makes women less likely to undergo treatment.

## RECOMMENDATIONS

Tanzanian clinics and hospitals have already adopted a range of screening and treatment techniques, but they are not yet carried out in a coordinated



fashion. The country should draw from its cervical cancer prevention and control needs assessment and five-year framework to adopt a comprehensive cervical cancer program. This should include aspects that address prevention, screening, and treatment. Increasing cervical cancer awareness is critical to reduce incomplete follow up from patients, and to establish referral mechanisms for women who need more advanced treatment.

*Utilize the Pink Ribbon Red Ribbon Initiative as a framework for a comprehensive strategy*

The PRRR partnership could leverage PEPFAR's platform, resources, and experience of scaling up HIV prevention and treatment programs to offer decentralized medical services and a national HPV vaccination campaign. The PRRR model would allow the Tanzanian Ministry of Health to consult technical and programmatic experts while maintaining control of the program. Co-locating HIV treatment and cervical cancer screenings would both target HIV-positive women and extend services to the broader female population. Since PEPFAR has identified cervical cancer as a component of its sustainable global health strategy, this partnership would also offer resources to finance the steep start-up costs of a new program and bring in additional funding for existing HIV programs. Finally, the PRRR program would respond to calls by international donors to provide a clear strategy and support for horizontally integrating HIV/AIDS into other health programs.

A PRRR program is contingent on the agreement of U.S. agencies, particularly the Centers for Disease Control and Prevention (CDC), the United States Agency for International Development (USAID), and PEPFAR; the implementing program partners; and various ministries within the Tanzanian government, including the ministries of education and community development, women, and children. If the Ministry of Health indicates a willingness to co-lead this initiative, the PRRR can assist in bolstering the country's health system with a direct impact on the incidence and mortality rates of cervical cancer.

*Prioritize screening and treatment for HIV-positive women*

Given that Tanzania has limited resources and staff, the Ministry of Health should adopt a triage model of screening. Since HIV-positive women are at higher risk of invasive cervical cancer, the Ministry of Health could concentrate its resources on this particular group before expanding services to the broader female population. Goldie et al. (2005) found that the overall most cost-effective screening and treatment approach is conducting

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screening and administering cryotherapy in the same visit. The program could simultaneously screen with either visual inspection methods or *careHPV* and treat women with precancerous cells. Additionally, this approach would allow the Ministry of Health to use already existing avenues for contacting HIV-positive women through care and treatment centers, as well as through antenatal care clinics. This tactic could also increase the numbers of HIV-positive women seeking regular care at clinics if it becomes known that they can also have access to other health care services.

### *Screen and treat all women over 30 years*

Since incidence and mortality rates of cervical cancer rise with age (WHO 2006), the Ministry of Health should also consider implementing a program that initially screens only women over 30 years old. Similar to targeting HIV-positive women, this is another triage approach directed at those most at risk. Goldie et al. (2005) further found that one visit using visual inspection reduces a 36-year-old woman's lifetime risk of invasive cervical cancer between 30 to 36 percent, while a woman who has three screening and treatment visits reduces her lifetime risk by up to an additional 15 percent. Though additional screenings decreased a woman's lifetime risk, the authors found multiple visits to not be as cost-effective compared to one visit using visual inspection. They also reported that when a woman was screened at ages 35 and 40, her risk reduces by 40 percent. Tanzania should direct its limited resources at those most at risk until the health system is more able to widely provide screening and treatment services to all women.

### *Lay the groundwork for a national HPV vaccination campaign*

Ultimately, vaccinating girls would have the greatest impact on reducing cervical cancer. Merck and the Tanzanian government have agreed that the company will donate Gardasil for three years to initiate a national vaccination campaign. Since Tanzania qualifies for GAVI support, they will likely be able to share financing after the donation period expires. Vaccination demonstrations have already shown that it is feasible to vaccinate adolescent girls in both rural and urban schools, but effectiveness could vary based on school attendance by girls. Tanzania has an average school attendance rate of 75 percent for girls 10 to 15 years (Burke and Beegle 2004). A cost analysis for establishing a national vaccination program in Tanzania over five years in a school setting showed that the financial costs per fully immunized girl was USD\$5.77, excluding the vaccine cost (Hutubessy et

al. 2012). The study highlighted that though service delivery, sensitizing and mobilizing communities were the most expensive cost components, they were essential for complete vaccine uptake.

## CONCLUSION

The Tanzanian government could pursue several options to reduce the impact of cervical cancer. Although a PRRR partnership is not the only way to implement a comprehensive cervical cancer prevention and control strategy, the Tanzanian Ministry of Health must create a coordinated effort similar to that of PRRR in order to provide women with services and care they ought to have, as well as protect future generations of girls from unnecessary illness and death.

One of the major barriers to comprehensive implementation is that the treatment options for invasive cervical cancer in the development setting remain incredibly limited. Very few low- or middle-income countries have the resources to provide the necessary surgeries, chemotherapy, or radiation therapies to treat women with invasive cervical cancer or to offer palliative care. Another major barrier to implementation is the low number of medical providers. To truly build a comprehensive strategy, governments must build the necessary infrastructure: recruit, train, and retain medical providers and purchase the equipment to treat invasive cervical cancer. Fortunately, the Tanzanian government and international aid donors are in the process of increasing the number of medical providers at various levels of expertise.

Despite limitations, it is certainly possible for the Tanzanian government to combat cervical cancer with currently available options. Additionally, policy makers and aid donors are continuing to recognize the need to stem the increase in non-communicable diseases, and have shown increased willingness to fund approaches that address them (UN 2011). Successful implementation of a cervical cancer prevention, screening, and treatment program will undoubtedly save lives and also perhaps provide further creativity in reducing disease in low-resource settings.

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