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Are Hernando de Soto's views appropriate to South Africa?

P&DM

Graduate School of Public and Development Management

University of the Witwatersrand, Johannesburg, South Africa

Occasional Paper Series no 1

DBSA

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Foreword

THIS PUBLICATION is the first of a series to be published as an outcome of intellectual enquiry at the Graduate School of Public & Development Management (P&DM) of the University of the Witwatersrand.

It arose from a colloquium, co-hosted with the Development Bank of Southern Africa, which focused on issues of title, land, housing, asset creation, and credit.

During the 1990s P&DM successfully provided housing education, including a Housing Certificate course, and hosted the International Housing Finance Programme based at the Wharton School of the University of Pennsylvania. The colloquium and this publication represent a revival of that earlier interest, which will be broadened to include land issues as well as housing.

P&DM academics and associates are engaged in academic and research activity in two focus areas, namely management and service delivery, and public policy and governance. The new occasional paper series will be used as a vehicle for publishing their work as well as the views expressed in the course of future engagements.

Prof Francis Antonie
Director, Graduate School of Public and Development Management (P&DM)
University of the Witwatersrand

September 2007

About the contributors

Ben Cousins is professor of development management at the University of the Western Cape (UWC), and director of its Programme for Land and Agrarian Studies (PLAAS). bcousins@uwc.ac.za

Tessa Cousins is director of the Association for Water and Rural Development. tessa@mail.ngo.za

Ebrahim-Khalil Hassen is an independent policy analyst and a research associate of the Employment, Growth and Development Initiative at the Human Sciences Research Council. ekhassen@gmail.com

Donna Hornby works for the Association for Rural Advancement (AFRA). donna@icon.co.za

Rosalie Kingwill is a consultant at Mbumba Development Services. rosei@mbumba.co.za

Scott McKinney is professor of economics and Latin American studies at Hobart and William Smith Colleges in Geneva, New York. mckinney@hws.edu

Lauren Royston is a principal of Development Works. laurenr@devworks.co.za

Kecia Rust is theme champion of Housing Finance at the FinMark Trust. kecia@iafrica.com

Dr Stefan Schirmer is a senior lecturer in economics at the University of the Witwatersrand. Stefan.Schirmer@wits.ac.za

Warren Smit works for the Development Action Group. warren3@telkomsa.net

Mary R. Tomlinson is a visiting research fellow at the PD&M. mtomlinson@telkomsa.net

Kingwill, Cousins, Hornby and **Royston** are also involved in the Leap Project, a learning approach to promoting tenure security for the poor and vulnerable in South Africa.

The second economy and 'dead assets':

Why we must think beyond de Soto

Ebrahim-Khalil Hassen

In South Africa at least, the connection between formalisation and participation in the economy is far from assured

THE SOUTH African government – and specifically the Presidency – argues that the country has a 'first' and second' economy, and that ways should be found of bridging the divide between the two. In line with this, the Accelerated and Shared Growth Initiative for South Africa (AsgiSA) states that:

> A final set of Second Economy interventions is centred on the challenge of realising the value of *dead assets* – land, houses, livestock, skills, indigenous knowledge, and other assets that have intrinsic value not currently realised (The Presidency, 2005 – author's emphasis).

The government's proposals for addressing the problems surrounding the 'second economy' include attempts to provide the poor with improved access to credit, notably via the Financial Sector Charter. It is also focusing on formalising land tenure in the informal sector, as well as assisting informal traders.

The concept of 'dead assets' and the strategies being adopted to put them to productive use can be traced to the work of the Peruvian economist Hernando de Soto. Support for de Soto's work in South Africa is not a shallow or fleeting phenomenon; there is evidence that his ideas have profoundly influenced the thinking of government officials. For example, the Deputy Minister of Finance, Jabu Moleketi, recently declared that the informal sector had a major role to play in attaining the goals of halving poverty and unemployment by 2014 (Moleketi 2007).

De Soto's thesis has an intuitive appeal. Surely, his supporters argue, having a title deed for an informal house is better than not having a title deed at all. This argument has some merit, but also an important limitation: it assumes that once people who own property informally are given title deeds, they will use them for productive purposes. However, in South Africa at least, the connection between formalisation and participation in the economy is far from assured. On the contrary, a ground-breaking study on the township residential property market has found that low-income township households are not using their property to generate income, either through rentals or for business purposes. The study thus argues that:

> Consequently, houses in black townships are 'dead assets' – contributing towards households' housing needs but not contributing towards economic empowerment (FinMark Trust 2004).

There is thus an important disjuncture between the formalisation of property ownership on the one hand and the ability to use such assets to earn an income or secure business loans on the other. This disjuncture is examined in this paper. It argues that, given the structural nature of poverty and inequality in South Africa, alleviating poverty and stimulating the 'second economy' requires far more than formalising the existing assets of the poor; in fact, what is required is a comprehensive asset-building strategy for poor households. To this end, it starts with a brief review of South Africa's development challenge. Next, it discusses the de Soto thesis, focusing on the concept of 'dead assets' and the role of the state in 'bringing them to life'. Following this, it examines alternative explanations of the role of assets in development. Finally, it makes some policy recommendations that link assets to poverty reduction more strongly than the mechanisms proposed by de Soto.

Democratisation has not yet provided the poor with ways of exiting out of poverty

The developmental challenge

The Presidency has released a set of development indicators which acknowledge that the structural nature of poverty, inequality and unemployment in South Africa are still binding constraints on realising the goals of halving poverty and unemployment by 2014 (The Presidency 2007).

First, the report shows that high levels of inequality are entrenched, and are in fact increasing. The data shows a complex picture of continuity and change. On the one hand, income inequality has remained virtually unchanged between 1993 and 2006, suggesting that democratisation has not succeeded in reducing inequality.

In fact, South Africa's Gini Coefficient – a measure of inequality in a given society – increased slightly from 0,67 in 1993 to 0,68 in 2006, with 0 representing perfect equality and 1 perfect inequality. In 2006 the richest 10 per cent of South Africans received a staggering 55,9 per cent of all income, while the bottom 10 per cent only received a paltry 0,6 per cent. On the other hand, there are changes in income shares based on race: inequality between racial groups has declined, but inequality within racial groups has increased. In 1993, 61 per cent of inequality was between race groups, but by 2006 this had declined to 40 per cent. This suggests that inequality in South Africa is now more class-based than race-based. This is unsurprising, given the black middle class is growing at an estimated 20–35 per cent a year. At the same time, incomes of wealthy households have grown far more than those of poorer households. The overriding picture is that democratisation has not yet provided the poor with ways of exiting out of poverty. More worryingly, if assets – not just income – are included, levels of inequality are probably much higher, and might reveal high levels of indebtedness among the black middle class. Consequently, South African society might in fact be more unequal than is suggested by looking at income statistics alone.

Second, the estimates of poverty suggest a decline in the poverty head count from 50,1 per cent in 1993 to 43,2 per cent in 2006. While the actual numbers are disputed, the trend is encouraging. However, caution is needed, as the poverty line used to measure these trends is R250 per person per month, which is hardly enough to buy basic foodstuffs and other necessities. The National Treasury puts the poverty line at R322 for 2000, which would change the picture dramatically. This is especially true as the incomes of black households – who are the majority of poor households – are clustered around the poverty line. This is important, as a mere R35 increase in the poverty line adds 2,6 million people to those in poverty. The most significant policy question arising from this is that even if people were above the poverty line, any household or economy-wide shock would result in a significant increase in poverty rates.

The development indicators for poverty, inequality and poverty suggest that the structural pattern of poverty remains entrenched

Third, the official statistics on unemployment suggest a decline in unemployment from 2001 to 2006; however, in the same period 1,6 million jobs were created. Whilst there are major disputes about the definition of a job, the median income for employed Africans in 2005 was more than R1 500 a month (COSATU 2007). This median income would place households with one person working slightly above the poverty line used by the Presidency, but would put a household of four below the R430 poverty line estimated by the National Treasury for 2006. The implication is that, assuming that there is no overcounting of informal sector subsistence activity as jobs, many wage-earning households live below the poverty line.

However, since 1999 Statistics South Africa has included more informal sector workers and subsistence farmers as being employed (Makgetla and Van Meelis 2002). This has a significant impact on counting the number of jobs. In an important analysis of the number of unemployed, Casale, Muller and Posel (2004) argue that about 175 000 jobs a year have been created between 1995 and 2003, rather than the reported 270 000. The difference is partly accounted for by excluding 'survivalist' activities. This is an important observation, as de Soto argues that it is the informal sector – especially self-employment – that, once formalised, will offer an exit route out of poverty.

However, taken together, the development indicators for poverty, inequality and poverty suggest that the structural pattern of poverty remains entrenched. This is evidenced by rising levels of inequality, poverty reduction that will probably be eroded by any national shock, and low median wages. The question that arises is whether de Soto's proposals would enable a break from structural poverty, or whether bolder initiatives are required. We turn to this issue in the following sections.

'Dead assets' and the role of the state

'Dead assets' is a key phrase in de Soto's work. By this he means that the poor own assets which they cannot utilise because their ownership of those assets has not been formalised. In his writings, 'dead assets' include housing, transport, informal business and land, and they have this status because households are unable to use them to access credit. At their core, de Soto's arguments are similar to those about credit market imperfections. In other words, 'dead assets' are dead because they cannot generate a flow of income or credit, and they cannot do so because they have not been included in the recording process central to a capitalist system.

De Soto's central proposal is therefore that, if informal markets were formalised, the poor would be able to use their assets to generate additional income, or access business loans. This, in turn, would help them to exit out of poverty, as they would be able to diversify their income and create new income flows through the utilisation of credit.

These proposals have received widespread attention, and have influenced the strategies of various countries to overcome poverty. However, as Sachs (2005) argues, they are tantamount to a 'silver bullet'; a single, one-size-fits-all solution that ignores a number of important modalities, and fails to recognise contextual variations.

Yet providing titles for housing in South Africa has not incorporated the poor into the formal economy, or allowed them to extract capital flows from housing

Redistributive combines and power

Another central concept in the de Soto system is that of 'redistributive combines' – interest groups that pressure policy-makers into making laws or regulations that favour them economically without regard to the broader effects of these measures on society (de Soto 2002:190). De Soto and his collaborators describe these sorts of measures as 'bad laws', and identify 'redistributive combines' as their cause. In *The Other Path*, de Soto writes that:

> There are of course differences between right-wing mercantilism and left-wing mercantilism; the former will govern to serve foreign investors or national business interests, while the latter will do so to redistribute well-being to the neediest groups. Both, however, will do so with bad laws which explicitly benefit some and harm others. Although their aims may seem to differ, the result is that in Peru one wins and loses by political decisions. Of course, there is a big difference between a fox and a wolf but, for the rabbit, it is the similarity that counts (2002:239).

The concept of 'redistributive combines' recognises the important idea that the absence of a transparent and inclusive property system makes it easier for politicians to distribute favours and privileges to various interest groups. Capitalism does, of course, produce winners and losers, and this is partly explained through the existence of these kinds of networks. However, as the above passage shows, de Soto argues that left- and right-wing governments both attempt to satisfy interest groups, resulting in similar outcomes. Embedded in this argument is a recognition that changes in power are central to achieving more inclusive economic arrangements. However, both the strategy being advanced to reconfigure those power relations and the underlying argument are open to substantive criticisms.

The strategy of formalisation assumes a causal effect on the livelihood strategies of households. Yet providing titles for housing in South Africa has not incorporated the poor into the formal economy, or allowed them to extract capital flows from housing. The weakness of de Soto's argument is that it assumes that existing power relations – embedded in credit markets, for instance – would see value in extending credit for informal or low-income housing, which requires the provision of title deeds. In South Africa, the Financial Sector Charter is an explicit recognition that credit provision to poor households is very weak, and that credit in itself can be exploitative. This has resulted in the government overhauling the credit system via the National Credit Act 34 of 2005.

Moreover, credit (with interest) is a double-edged sword for household livelihood strategies. Current rates of household indebtedness suggest that the South African consumer is already overborrowed. In 2006 the Monetary Policy Committee stated that:

The notion of assets as an important aspect of development strategy resonates across ideological divides

> … the ratio of household debt to disposable income had risen to just below 66 per cent in the final quarter of 2005. The cost of servicing this debt, while still low, nevertheless increased from 6,75 per cent of disposable income in the third quarter of 2005 to 7 per cent in the fourth quarter. (http://www.sarb.gov.za).

Importantly, the figure of 7 per cent refers to debt servicing only – without any redemption of the principal loan amounts. Households with working members therefore face the danger of landing in debt traps. While debt might be raised for buying a house, or paying for children's education,

> The figures on incidence of debt may be substantially under-reported because many people do not want to admit to their level of borrowing. Although only 11% of South African adults claim to have a personal loan, there are factors that raise the red flag of concern. First is the tendency of a high proportion of people to claim that they will get into debt for an item they desire rather than saving up to buy it. Even more worrying is that 7% of the population claims they have incurred or would get into more debt to pay off existing debt, leading many into a debt spiral. This, coupled with the fact that only 23% of the population claim really to understand what interest rates are, emphasises the continued need for financial education to allow better financial decision making, and ultimately financial health. (FinMark Trust 2006).

Consequently, there is both a linearity in de Soto's proposals, as well as a weak causal effect between formalising and breaking down structural poverty. The proposals are linear in that the downside of credit – notably its ability to trap households in a debt spiral – is not acknowledged. Consequently, the effects of formalising access to credit and addressing poverty are much more contingent than advanced by de Soto.

Assets are not linear

The notion of assets as an important aspect of development strategy resonates across ideological divides. Michael Sheridan, one of the leading thinkers about asset-building, argues that:

> Income only maintains consumption, but assets change the way people think and interact with the world. With assets, people begin to think in the long term and pursue long-term goals. In other words, while incomes feed people's stomachs, assets change their heads ... welfare policy has gone off track in becoming almost exclusively preoccupied with the income protection of the poor. Policy should seek to empower as well as to protect. Especially policy should take into account the critical role of asset accumulation in economic and social well-being ... 'implicitly we seem to believe not only that the poor have no wealth, but that they *can* have no wealth' (1992:6–9).

In some sectors – notably agriculture – formalisation can play an important role in maintaining or improving livelihoods

This process has been termed the 'asset effect'. Broadly speaking, it is aimed at improving income security and resilience to shocks; advancing strategies for social mobility; and improving social capital and spatial connectivity.

The weak linkages between the formalisation of property ownership and the 'asset effect' were discussed earlier in this paper. At this point, the focus is on understanding why these effects have not occurred despite a significant roll-out of low-income housing as well as other processes of formalisation.

A study of Meadowlands in Soweto has found that older residents in particular have not used the titles they have received to access credit, or put their hoes to produce use in other ways (Parnell et al 2003). Thus, even if we assume that broader society is conducive to leveraging assets, some new title holders are not inclined to start small business or take any risks.

In addition, the formalisation of various kinds of businesses often entails increased costs. For example, many taxi operators remain in the informal sector in order to evade paying taxes. Recent attempts to widen the tax net have included tax amnesty for small businesses, provided they register. Taxi owners have been quick to take advantage of this, suggesting that they would be prepared to formalise provided all punitive measures were withdrawn – a strategy which de Soto supports. However, many taxi operators will remain inside the informal economy, and outside the tax net. Significantly, then, formalisation might work for some businesses but not for others.

However, in some sectors – notably agriculture – formalisation can play an important role in maintaining or improving livelihoods. The process of extending tenure to farm workers has been an important one for the South African government. Furthermore, minimum wages have been introduced in the sector. These are progressive measures aimed at reforming the apartheid systems of labour exploitation and land use. However, these processes have resulted in a million farm worker households being evicted from farms (Nkuzi Development Association 2005). Wegerif summarises the impact of these evictions as follows:

> Many of those evicted from farms had been producing for themselves, with 44 per cent having livestock and 59 per cent growing their own maize. Now less than 10 per cent of the evicted households have livestock and they are left with small stock, such as chickens, whereas they previously owned cattle. Only 26 per cent now produce maize for themselves and in smaller quantities than they did when on farms (2006:10).

Moreover, attempts to expand services in rural areas have run in tandem with what Seekings and Nattrass refer to as de-agrarianisation. They note that:

> Farm workers continued to be evicted from commercial farms in large numbers, there was no programme of land reform resettling families into smallholdings, so these largely unskilled families were pushed into the most disadvantaged positions in a labour market characterised by massive unemployment (2004:15).

Building the assets of the poor remains central to resolving structural poverty and inequality; however, important issues surrounding service delivery and assets need to be addressed

The implications of de Soto's thinking for the agricultural sector are discussed more fully elsewhere in this publication (see PLAAS paper**). The central point here is that formalisation creates winners and losers – which de Soto does not fully acknowledge. The agricultural example demonstrates the importance of the role of the state in ensuring that asset transfers achieve their intended objectives. Without deliberate state intervention, market mechanisms are likely to result in current owners adopting strategies to compensate for a loss of income.

Building the assets of the poor remains central to resolving structural poverty and inequality; however, important issues surrounding service delivery and assets need to be addressed. Service delivery should not be confused with creating an asset base for the poor, or creating an environment for doing so. The most influential measure of asset poverty, utilised by the Development Policy Research Unit (DPRU) at the University of Cape Town, does not really measure assets but services. For example, it includes sanitation and electricity as assets (Bhorat et al 2006), but this is incorrect, as they cannot be regarded as sources of income, or a cushion in times of crisis. The study adds to our understanding of non-income welfare transfers, but does not adequately measure asset poverty. May (2006) adopts a different approach to measuring asset poverty, including education, land and savings.

Most services are in fact not aimed at creating assets, but rather at extending access. For instance, yard taps, which are widely installed, might satisfy households' water needs, but cannot be used for irrigation. Nonetheless, delivery would have been achieved, and the case added to delivery statistics. This is not to downplay the importance of the delivery of water: water is associated with higher levels of health, improved nutritional status, and the elimination of disease. The same is true of electricity, which has significant social multipliers. However, improving access to services without implementing livelihood strategies as well do not feed into a system of delivery that reduces poverty. A central missing link in policy has been the inability to link access to service, thus reducing the input costs of businesses.

Moreover, the price of urban land near jobs and services has risen significantly, resulting in the well-documented inability of housing to catalyse local economies and support labour-intensive growth (see Hassen 2001). Therefore, providing assets without altering the market itself will not create the 'asset effect' envisaged in government policy.

Why build assets?

What, then, is the argument for focusing on assets? First, economic growth will not resolve structural poverty. Haroon Bhorat (2006) offers an interesting review of labour market performance compared with GDP growth (see table 1).

Further increases in economic growth could catalyse significant growth in employment

Table 1: Simple GDP elasticity of employment

Annual percentage change in:			
	Total employment	**GDP**	**Elasticity**
1990–1995	0.13%	0.80%	0.16%
1995–2005	2.60%	3.27%	0.80%

The data points to a close link between economic growth and employment; as levels of economic growth have increased, employment has also grown (leaving aside questions surrounding the quality of jobs). This suggests that further increases in economic growth could catalyse significant growth in employment. However, while the economy has shown an ability to create jobs, the labour force has grown more rapidly than employment, and restructuring has resulted in retrenchments. While there are many arguments about what needs to be done to create jobs, research by the Employment, Growth and Development Initiative at the HSRC has shown that even if the government achieves its goal of halving unemployment by 2014, the number of unemployed people will still be very large.

Second, greater equality is important for long-term economic growth and the eradication of poverty. Several studies have shown that high levels of initial inequality – or, more accurately, the absence of an initial redistributive strategy – are closely correlated with low levels of economic growth and poverty reduction. This suggests a complementary relationship between rising equality and sustained economic growth. More specifically, tenure reform will facilitate the transfer of land to more productive rural households by enhancing the fluidity and depth of the agricultural land market.

By contrast, asset and endowment dependency reinforces inequality and low levels of economic growth. A distinction must be drawn between the impact of income inequality on growth and the impact of asset inequality on growth. There is broad consensus about the positive impact of equal access to education and productive farmland on economic growth, and that asset equality is a foundation for reducing income inequality (World Bank 2006, quoted in Hassen, forthcoming)

Third, in a society with a long history of oppression, social justice is the most important policy objective, and it is this objective that underpins the ANC's commitment to addressing the issues facing 'blacks in general, and Africans in particular'. This normative commitment is further reflected in the historical ANC position of the working class as the motive force and primary beneficiary of democracy – a subject debated at its 2007 policy conference. However, achieving this goal in practice is never only a forward march, as democratic government was established at a time when capitalism was triumphant, and orthodox macroeconomics on the rise.

In a society with a long history of oppression, social justice is the most important policy objective

Asset-building: some key questions

This paper has primarily focused on assessing the relevance of de Soto's ideas to the South African situation, and has argued that the state has to change its approach to asset-building if assets are to play a significant developmental role. But some important questions remain:

- Why focus on 'efficient redistribution' when, to paraphrase Keynes, in the long run we will all be dead?
- Being cautious about redistribution on the basis of sustainability, intergenerational costs, and long-term negative consequences might be the prudent governance choice, but does this not replicate the systems that perpetuate inequality and poverty?
- Redistribution might frighten the markets. Under what conditions will powerful private sector stakeholders accept a redistributive programme from government?
- If one accepts that, in the long run, incomes will converge to the mean as a result of growth, it can be argued that time is the biggest ally in the fight against poverty. However, if a bifurcation of incomes is observable now, will time not erode even the modest assets and incomes of the poor?
- Even if one agrees that the government needs to play a significant redistributive role, what will be redistributed: assets and/or incomes? And which specific programmes would achieve the desired outcomes?
- Most demanding of all: given that, in the light of given South Africa's history, the government has a duty to transform material conditions – to use the Marxist catch phrase once fashionable in South Africa – why do the intrinsic arguments for equality always fall short on the criterion of feasibility? Is it not time to dream

again? Will impatience worsen the conditions of the poor, as programmes are implemented in chaotic fashion, under the banner of redress?

These questions ask us to not to search for the silver bullets, including those dressed up as a coherent development strategy. Instead, it asks us to look at the means for breaking through the patterns of structural poverty in South Africa. Assets are a key part of addressing structural poverty. However, de Soto's thinking has shortcomings, and may even inadvertently worsen poverty and inequality traps in South Africa.

This paper reflects work in progress towards a master's dissertation on asset redistribution to be submitted to the Graduate School of Public and Development Management of the University of the Witwatersrand.

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