Was development assistance a mistake?

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"More than half the people of the world are living in conditions approaching misery… For the first time in history, humanity possesses the knowledge and the skill to relieve the suffering of these people." Harry S. Truman, Inaugural Address, 1949

"We have the opportunity in the coming decade to cut world poverty by half. Billions more people could enjoy the fruits of the global economy…And for the first time, the cost is utterly affordable." United Nations Millennium Project, 2005

The repetition of virtually the same language after more than half a century and $2.5 trillion worth of development assistance (in today's dollars) is not encouraging for its promise to achieve the reduction of poverty and misery. This paper argues that development assistance as originally conceived and still largely conceived today, was a mistake. This is not based on any original research undertaken for this paper, it is just drawing the natural implication of a large body of literature quickly surveyed here.[1] The conclusion of the paper will argue that foreign aid could still accomplish some good things for poor people, even if it cannot fulfill the purpose of "development assistance."

Development assistance is the combination of money, advice, and conditions from rich nations and international financial institutions like the World Bank and International Monetary Fund designed to achieve economic development in poor nations. This is broader than the usual definition of "foreign aid," including such categories as structural adjustment loans, or even repeated stand-by loans from the IMF to low income countries at concessional rates. This article argues that development assistance was based on three assumptions that, with the benefit of hindsight (although a wise few also had foresight), turned out to be mistaken:

1. We know what actions achieve economic development.
2. Our advice and our money will make those correct actions happen.

[1] This paper draws upon a much larger manuscript, Easterly (2006)

3. We know to which individuals "we" and "our" refer.

I turn to each of these in turn.

1. We know what actions achieve economic development.

Development economists have long known the answers on how to achieve development. The only problem is that those answers have kept changing over time.

To oversimplify considerably, the evolution of Conventional Wisdom was as follows.[2] In the 50s through the 70s, development (then, and to a lesser extent now, mostly equated with economic growth) was a simple matter of raising the rate of investment to GDP, including both public investments -- like roads, dams, irrigation canals, schools, electricity -- and private investment. However, private investment was usually not trusted to do enough or do the right things, and so there was a strong role for the state to facilitate and direct investment, guided in turn by the development experts.

Unfortunately, the debts accumulated to finance these investments turned out not to be repayable, so there were two debt crises in the 1980s. The middle-income countries had borrowed at commercial banks at market rates; the low-income countries had loans from official agencies at concessional rates. Both entered into a long process of rescheduling and writing off that led to a lost decade for both groups of debtors. Understandably inferring that unrepayable loans were a sign of unproductive investments, especially in Latin America and Africa, development wisdom shifted away from mobilizing and guiding capital accumulation. Attention shifted toward the success of the East Asian tigers, who combined export orientation and macroeconomic stability. This became the inspiration for structural adjustment packages of the IMF and World

[2] This chronology of conventional development wisdom is itself conventional and can be found in many places, such as the World Bank's World Development Report in 1991, Easterly (2001), Lindauer and Pritchett (2002), the World Bank (2005) report on Lessons from the 1990s, and Rodrik (2006).

Bank and the “Washington Consensus,” which called for removing price distortions, opening to trade, and correcting macroeconomic imbalances (mainly budget deficits). The slogan of the new wave was “adjustment with growth.”

Alas, loans to finance structural adjustment met the same fate in the low income countries as the earlier loans to finance investment – there was little or no growth, the loans couldn’t be repaid, and the low income debt crisis stretched out into the new millennium with every year a new wave of debt forgiveness (most recently, the 100 percent cancellation of the structural adjustment loans and other official debts in the Multilateral Debt Relief Initiative of 2006). In the middle income countries of Latin America, there was for the most part adjustment and debt repayment (albeit with large capital market crises in Mexico in 1994 and Argentina in 2001), but little growth compared to expectations in the 1990s. The hope that the “East Asian miracle” could be replicated elsewhere with the same policies proved illusory.

The “Washington Consensus” gave way to “Second Generation” reforms that stressed the importance of institutions like property rights, contract enforcement, democratic accountability, and freedom from corruption (actually the Washington Consensus was already Second Generation after the emphasis on state-directed investment, so Second Generation was really Third Generation). An alternative to the latest Conventional Wisdom is Sachs’ (2005) emphasis on making the right investments in things poor people need, which is really a throwback to the First Generation of planned investments.

Although each shift in the Conventional Wisdom was provoked by the failure of the previous Conventional Wisdom, the evolution was often presented as the addition of

previously "missing" elements, so the Conventional Wisdom was always incomplete rather than wrong. As Dani Rodrik (2006) points out, this has the effect of placing all the blame on the recipient rather than on the development experts, of making ever longer the list of "pre-requisites" for development (and conditions on aid), and of making the Conventional Wisdom almost non-falsifiable (every answer was right, it just needed all the successive answers). Yet even this was not non-falsifiable enough, as institutionally deficient but rapidly growing countries like India, China, and Vietnam have already exposed the weaknesses of the new Conventional Wisdom.

A lot of these shifts are provoked by broad stylized facts and compelling country examples rather than by formal empirics. As Dixit (2005) says,

At any time, some country is doing well, and academic as well as practical observers are tempted to generalize from its choices and recommend the same to all countries. After a decade or two, this country ceases to do so well, some other country using some other policies starts to do well, and becomes the new star that all countries are supposed to follow.

Of course, development knowledge could draw upon more formal empirics like growth regressions. However, the hope that arose in the early 1990s that the New Growth Literature could at last empirically find the answers eventually collapsed from a surplus of answers. Durlauf, Johnson, and Temple (2005) have pointed out that 145 different right hand side variables have been found to be significant as determinants of growth in a sample that is usually around 100 degrees of freedom. When the problems of unrestricted specification were reduced by specifically testing the outcomes of the key Washington Consensus variables on growth, the results tended to confirm the casual empiricism described above – countries as a group moved towards "better policies," yet average growth for that group declined for unknown reasons (Easterly 2001).

In the new millennium, a remarkably broad group of academics and policymakers seem to agree that, after all that, maybe we don't know how to achieve development, although reluctant to say so exactly. The most surprising member of this group was the World Bank (2005) itself, which issued a report so scathing about the previous Conventional Wisdom that Rodrik (2006) said "the reader has to remind himself that the book he is holding in his hands is not some radical manifesto, but a report prepared by the seat of orthodoxy in the universe of development policy." The World Bank (2005) did indeed throw up their hands: "different policies can yield the same result, and the same policy can yield different results, depending on country institutional contexts and underlying growth strategies." These statements are plausible, but they are even more notable for once again protecting the previous Conventional Wisdom from ever being falsified. Similarly the Barcelona Development Agenda (2004) agreed by many of the world's leading economists concluded that:

> there is no single set of policies that can be guaranteed to ignite sustained growth. Nations that have succeeded at this tremendously important task have faced different sets of obstacles and have adopted varying policies regarding regulation, export and industrial promotion, and technological innovation and knowledge acquisition.

Nor are practical business consultants doing any better. After pouring scorn on the above-documented economists' failure to achieve development, the McKinsey Global Institute (2006, p. 2) comes up with the "one certain way" to raise GDP per capita in a poor country: "increase levels of labor productivity among individual firms." (Economics training is useful at least for avoiding tautology.)

Lindauer and Pritchett (2002) call it most honestly:

> it seems harder than ever to identify the keys to growth. For every example, there is a counter-example. The current nostrum of one size doesn't fit all is not itself a big idea, but a way of expressing the absence of any big ideas.

As they point out and as these other authors also note, this does not mean that economists know NOTHING about development, or know nothing about the many little pieces that contribute to development. Good economic analysis of problems in finance, macroeconomics, taxation and public spending, health, agriculture, etc. has held up well. As far as overall development, economists are reasonably confident that some combination of free markets and good government has an excellent historical track record of achieving development (as opposed to, say, totalitarian control of the economy by kleptocrats). It is just that we don't know how to get from here to there, which specific actions contribute to free markets and good government, how all the little pieces fit together, that is how to achieve development.

2. Our advice and money will make those correct actions happen.

By the same standards of judging by stylized facts and country cases that has guided the evolution of the conventional wisdom, development assistance has failed to achieve development. $568 billion in today's dollars flowed into Africa over the past 42 years, yet per capita growth of the median African nation has been close to zero. The top quarter of aid recipients (heavily overlapping with Africa) received 17 percent of their GDP in aid over those 42 years, yet also had near-zero per capita growth. Successful cases of development happening due to a large inflow of aid and technical assistance have been hard to find – South Korea is often cited, but took off after aid was reduced and the Koreans disregarded the advice of the aid donors (see Fox 2000). Other more recent examples frequently cited (Ghana, Uganda, Mozambique) were cases of recovery after steep collapse, and depend on rapid growth episodes that usually prove to be temporary (Hausman, Rodrik and Pritchett 2004). Botswana might be a better example of a long-

term success story initially financed by aid, although the most well known case study of Botswana (Acemoglu, Johnson and Robinson 2004) doesn't even mention foreign aid. The cases of rapid growth currently most celebrated -- India, China, and Vietnam -- receive little aid as percent of their GDP.

With aid, one has an even more serious problem than with other growth regressions of endogeneity of the right hand side variable – it's very likely that low growth countries got more aid because they had low growth. This calls for more formal econometric methods to disentangle the aid outcome from the counterfactual, utilizing instruments such as population size and geo-strategic factors. Unfortunately, more formal empirics on the effect of aid on growth has suffered from the same problem as other growth regressions – too many possible specifications and not enough observations (to begin with, aid did not even make Durlauf, Johnson, and Temple 2005's comprehensive list of 145 statistically significant variables appearing in growth regressions, nor does it appear in Sala-i-Martin et al.'s (2004) millions of regressions). Aid terms have been linear and in logs, gross or net, repayments included separately or not, interacted with other variables or not, aggregated or disaggregated into different kinds of aid, to say nothing of the other non-aid control variables that make almost any result possible. The most famous aid and growth result, of Burnside and Dollar 2000, confirmed Boone 1996's celebrated finding that aid has no unconditional effect on growth or investment, but Burnside and Dollar found that aid does raise growth in a good policy environment. This finding appeared just in time for economists' collapse of confidence that anyone knows what a good policy environment is, and anyway the finding itself turned out not to

be robust to the simple test of adding new, more recent data (Easterly, Levine and Roodman 2003).

The early expectations that aid would raise growth failed to pay attention to the most elementary economics – that a lump-sum transfer does not change the incentives at the margin to invest in the economy. With today's globalized financial markets, the paradox first pointed out by P.T. Bauer (1976) is more compelling than ever – any poor country where incentives to invest are attractive does not need aid, while a poor country without incentives to invest will not have aid go into investment. The international capital market imperfections and alleged inevitability of low savings rates in poor countries have not held up well in today's world with private capital flowing into Zambian government bonds and with Chinese peasants saving far more than Americans.

Nor was there much better news on development assistance (money cum advice) changing the policies that were supposed to raise growth in Conventional Wisdom II. Burnside and Dollar 2000 found no evidence that aid changed policies, a result that did not receive much attention although it has held up better than their more celebrated finding. Easterly 2005 found that structural adjustment lending also had no effect on the kind of macro policies and price distortions that it was supposed to correct. Van de Walle (2001, 2005) provides case study evidence that African countries did little reform in response to structural adjustment packages. As noted earlier, there was a general worldwide trend towards better policies (as judged by Conventional Wisdom II), but the degree of movement across countries was not correlated with the intensity of aid or structural adjustment lending in those countries. Svensson (2003) points out that aid

agencies emphasis on disbursing aid funds makes their promises to withhold funds not credible even if aid conditions are not met.

There has also been surprisingly insufficient attention in aid agencies to the political incentives facing recipient governments, as Moss, Pettersson, and Van de Walle (2007) suggest:

> If donors are providing the majority of public finance and governments are primarily accountable to those external agencies, then it may simply not be possible to also expect a credible social contract to develop between the state and its citizens. Using the current terminology, aid may undercut the very principles the aid industry intends to promote: ownership, accountability, and participation…Large aid flows can result in a reduction in governmental accountability because governing elites no longer need to ensure the support of their publics and the assent of their legislatures when they do not need to raise revenues from the local economy, as long as they keep the donors happy and willing to provide alternative sources of funding.

Djankov et al (2006), Brautigam and Knack (2004), and Knack (2001) in fact find empirically that aid worsens democracy, bureaucratic quality, the rule of law, and corruption.

The confidence that aid would raise growth was also naïve about the knowledge and incentive problems that afflict the foreign aid agencies. Foreign aid is a transaction involving a public entity spending the money of rich people on the needs of poor people. Unlike most market transactions, the recipient of the aid goods has no ability to signal their dissatisfaction by discontinuing the trade of money for goods. Unlike provison of domestic public goods in well-functioning democracies, the recipient of aid-financed public services has no ability to hold the public entity accountable for good or bad performance. The poor intended beneficiaries control neither the money nor the votes affecting aid agency behavior, which creates both knowledge and incentive problems. With little or no feedback from the poor, there is little information as to which aid

programs are working. With no accountability, there is little incentive for the aid agency to find out what works (notwithstanding the idealism and altruism of aid workers, idealism usually works better when reinforced by incentives – especially for the aid organization as a whole which understandably values its self-preservation).[3] These problems may account for many of the more well-documented foibles of the aid system – an emphasis on aid loans made rather than results of those loans, a surplus of reports that nobody reads, a fondness for grand frameworks and world summits, moral exhortations to everyone rather than any agency taking responsibility for any one thing, foreign technical experts to whom nobody is listening, health clinics without medicines, schools without textbooks, roads and water systems built but not maintained, aid-financed governments more attuned to the needs of donors rather than to those of their own people, aid-financed governments that stay in power despite corruption and economic mismanagement, and so on.

Having development be the goal of development assistance made these incentive and knowledge problems worse for the aid agencies than if they had focused on more specific tasks like, for example, combating childhood diseases. With many aid agencies operating in each country, and with development of that country depending on many other factors besides aid agencies, and with the inability to map actions to development anyway, it was very hard to hold an individual aid agency accountable for a good or bad development outcome. Hence, development assistance as it is now conceived is inherently unaccountable and unable to process feedback. With development assistance operating so much in the dark, it seems particularly risky to have it operate on a large

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[3] For further development of the feedback and accountability problems see Martens et al (2002), and for a non-technical treatment, see Easterly (2006)

scale, as it clearly does in some small, poor economies. Why do a massive intervention when you don't know whether its effects are going to be positive or negative?

3. We know who "we" are

Despite the frequency of statements like "we must end world poverty," the identity of the plural persons included in "we" remains a mystery. Who is this "we" taking responsibility for world poverty? Is it World Bank or UN officials? Is it national government leaders (and is it those from rich countries or poor countries)? Is it Development Experts? Perhaps the latter is the most likely in writings by "we" development experts. The expert tradition is so strong that the World Bank's response to the failure of expert analysis on how to achieve development is to intensify the use of expert analysis on how to achieve development:

> A vital lesson for policy formulation and policy advice is the need to be cognizant of the shadow prices of constraints, and to address whatever is the *binding constraint* on growth, in the right manner and in the right sequence. This requires recognizing country specificities, and more economic analysis and rigor than does a formulaic approach to policy making. (World Bank 2005)

It seems quite a stretch to believe that development economists, who were unable to find general determinants of development, can do the much harder task of finding what are "shadow prices" and "binding constraints" in each individual economy.

The other possibility, that development experts (or any other experts) are greatly overrated as a means to achieve development, goes against the self-interest of everyone in this profession (including this author). Yet maybe it is true. Economists should not find so hard to take the idea of a spontaneous bottom-up order emerging out of the decentralized actions of many actors, as opposed to a great strategic vision offered by a few experts. The invisible hand may operate in other areas besides the free market – institutions may emerge much more from the social norms and spontaneous arrangements

of many actors than from the diktat of some expert from above (for a great recent treatment of such possibilities, see Dixit (2003)). Even government actions may emerge more from the decentralized activity of many players at the bottom than from the decisions of great leaders advised by wise experts. Development in the countries that are now developed was arguably achieved by such bottom-up processes, not by development experts and not by development assistance (did George Washington have a Development Strategy?).

Yet the faith in the revolutionary experts is unlikely to die out soon, as people see tragic problems and want someone to take action. "What must we do?" is a question that people can't help asking about a problem so tragic as world poverty, and experts are the ones who say they have the answers. The first development economist may have been Lenin, who wrote a famous pamphlet in 1902 called "What is to be done?," and said that the revolutionary intelligentsia had the answer. A long line of such diverse thinkers as Edmund Burke, Karl Popper, Friedrich Hayek, Isaiah Berlin, and James C. Scott have criticized the idea that experts can re-design society, and the catastrophic outcomes of the more extreme attempts to do so supported these criticisms. Yet the unquenchable demand for experts who can call tell "us" the right answers shows no sign of ending soon.

Conclusion

In sum, we don't know what actions achieve development, our advice and aid doesn't make those actions happen even if we knew what they were, and we are not even sure who "we" are that is supposed to achieve development. I take away from this that development assistance was a mistake.

Yet it doesn't necessarily follow that foreign aid should be eliminated. Once freed from the delusion that it can accomplish development, foreign aid could finance piecemeal steps aimed at accomplishing particular tasks for which there is clearly a huge demand – to reduce malaria deaths, to provide more clean water, to build and maintain roads, to provide scholarships for talented but poor students, and so on. It could seek to create more opportunities for poor individuals, rather than try to transform poor societies. The knowledge and incentive problems for each such focused effort seem more solvable than that of "development assistance," although not exactly easy. As far as the experts, they would also do well to remember the principles of division of labor and gains from specialization. If they focused on very specific problems such as inflation stabilization, financial regulation, or red tape facing businesses, they probably have a lot to offer. They won't get anywhere if they continue to "specialize" in "how to achieve development."

As far as what will achieve development, the inability of the experts and the aid donors to provide the answers fortunately has not stopped development from happening on its own anyway. Homegrown development without much influence by experts or much contribution by foreign aid is happening around the world in places like China, India, Chile, Botswana, Turkey, and Vietnam. Individual success stories are always fragile and could become tomorrow's failures. However, that there have already been and likely always will be a significant number of success stories posting irreversible escapes from poverty for hundreds of millions of people. This should be enough to reassure those who care about world poverty to have some hope rather than despair.

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