

Was development assistance a mistake?

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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 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.

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, the evolution of Conventional Wisdom was as follows (see also Lindauer and Pritchett (2002), the World Bank (2005) and Rodrik (2006)). In the 50s through the 70s, development (i.e. economic growth) was a simple matter of raising the rate of investment to GDP, including 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 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 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, 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” then gave way to “Second Generation” reforms that stressed the importance of institutions like property rights, contract enforcement, democratic accountability, and freedom from corruption.

Although each shift in the Conventional Wisdom was provoked by the failure of the previous Conventional Wisdom, the argument was usually that previous recommendations were “necessary but not sufficient.” 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 “sufficient conditions” for development, and of thus making the Conventional Wisdom non-falsifiable.

A lot of these shifts were provoked by broad stylized facts and compelling country examples rather than by formal empirics. 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) pointed out that 145 different right hand side variables were significant as determinants of growth in various studies with around 100 degrees of freedom. When the problems of unrestricted specification were reduced by 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 World Bank (2005) was either giving up or offering instantaneous non-falsifiability: “different policies can yield the same result, and the same policy can yield different results, depending on country institutional contexts and underlying growth strategies.” Similarly the Barcelona Development Agenda (2004) agreed a Who’s Who of 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.”

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.”

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. Economists are reasonably confident that some combination of free markets and good institutions 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 institutions, 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 judgment 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 2005). 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 list of 145 statistically significant variables appearing in growth regressions). Aid and control variables have included such exotic species as $aid^2 * policy$ and Ethnic Fractionalization* Assassinations. Not surprisingly, positive aid and growth results have not proven robust.

The early expectations that aid would raise growth failed to pay attention to 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 Peter 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 used to justify aid in the past 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. 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 or aid, and aid may have even undermined policy reform. 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.

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:

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) 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 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 provision of domestic public goods in democracies, the recipient of aid-financed public services has no ability to register dissatisfaction through voting. With little or no feedback from the poor, there is little information as to which aid programs are working. Nor is there much incentive for the aid agency to find out what works with little accountability (see Easterly (2006)). 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 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.

3. We know who “we” are

Despite the frequency of statements like “we must end world poverty,” it is seldom clarified who is this “we” taking responsibility for world poverty. Is it World Bank or UN officials? National government leaders? Celebrities? Perhaps “development experts” is the most likely in writings by “we” development experts. The expert tradition is so strong that the World Bank’s (2005) 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.

The other possibility, that development 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; after all, development experts played no role in the development of the developed countries. Anne Krueger (2007) notes:

“Development economics was a new field ... because earlier economic growth in the developed countries had more or less ‘just happened’: while development of roads, railroads, education systems ... had been undertaken by governments, it had not been done as part of a conscious ‘development’ policy.”

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 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 (see Dixit (2003)).

Yet “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 20th century’s 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, all the way back to the French Revolution, 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, focusing on problems such as inflation stabilization, financial regulation, or red tape facing businesses, they probably have a lot to offer. Economists also still have a more general role making the case for individual freedoms that allow the spontaneous, bottom-up processes to work.

The inability of the experts and the aid donors to provide the answers to development fortunately has not stopped development from “just happening” on its own anyway. Economic growth 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, generally involving homegrown, gradual movement towards freer markets. Even though some of these success stories could later flop, history suggests their place will be taken by new permanent exits from poverty. This should be enough to reassure those who care about world poverty to have some hope rather than despair.

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