

THE WAR OF IDEAS IN ECONOMIC DEVELOPMENT: A HISTORICAL PERSPECTIVE

Sebastián Edwards

University of California, Los Angeles

In the early 1970s, when he had barely turned thirty years old, Vittorio Corbo was already a legend of sorts among development economists. His dissertation at M.I.T. became an instant classic, a work that had to be read by anyone interested in understanding the dynamics of inflation in developing nations. It was published in 1974 by North Holland as “Inflation in Developing Countries: An econometric study of Chilean inflation.” In many ways it was a book that stood side by side with the most influential works on the subject, such as Felipe Pazos’ celebrated volume on the persistence of inflation in Latin America.

I met Vittorio for the first time in the mid 1970s when he visited Chile and gave a lecture in an econometrics course being taught by Patricio Meller, another giant of Chile’s economics profession. It was immediately evident to my classmates and me that Vittorio was a great economist, a rare breed that combined intuition with great rigor and insight. But more important than that, we rapidly realized that he was a generous person, a prominent academic willing to dispense advice to young economists to be. That has been a constant with him: his unselfishness and capacity to mentor and help the younger generations.

In the late 1970s and early 1980s Vittorio Corbo played an important role in helping shape a fundamental change in development economics as a field. His many scholarly contributions on macroeconomic adjustment, exchange rates, inflation and reform had great impact in the academic world, and helped promote a view of economic development

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that emphasized trade openness, markets, productivity growth, and macroeconomic stability. From today's perspective all of this seems to be quite evident. However, in the early 1980s espousing those views was still a rarity.

Vittorio, however, was not satisfied with being an “ivory tower” economist. For him economics has always been an applied discipline, one that affects people's wellbeing and contributes to building and strengthening the social fabric of a nation. In 1984 Vittorio accepted an offer from the World Bank and joined a team led by Anne Krueger that helped define the intellectual backbone that guided the Bank's new structural adjustment programs. He later became the Chief in the Bank's Macroeconomic Division, and from that post he put together an influential and ambitious research program on a number of issues related to economic reform and transition. A few years later Vittorio was appointed governor of the Banco Central de Chile, and became instrumental in the consolidation of Chile as a low inflation nation, as a country that would be frequently cited as an example of how to run macroeconomic policy. In 2006 and as recognition of his brilliant work he was named “Central Banker of the Year” by *Global Finance Report Card* magazine.

Vittorio Corbo has been both a witness and a player in many of the intellectual battles of the last four decades: first as a student, then as an academic, later as an official at the World Bank, and more recently as one of the most respected central bankers in the Americas. In this paper I provide a review of these policy debates and I discuss how thinking on economic policy in emerging nations has evolved since the 1950s. The discussions center on three issues: (1) the most important tenets of the “planning approach” that was dominant from the end of World War II until the early 1980s; (2) the ascendancy of the market-oriented and pro-competition view in the 1980s, a view sometimes referred to as “the Washington Consensus.” And (3) policy and academic debates on the efficiency of foreign aid to emerging nations.

1. THE PLANNING APPROACH TO ECONOMIC DEVELOPMENT

During the 1960s and 1970s there were competing views on economic development; indeed, it is not an exaggeration to say that there was a “war of ideas.” On one hand, a large group of economists didn't trust markets, and believed that in poor countries planning had

to guide resource allocation. According to this view, which was in vogue when Corbo was an undergraduate student in the 1960s, protectionist policies provided the most effective way of fostering industrialization and encouraging growth. Most economists that supported the planning perspective believed that the state should own large firms, banks, and trading companies. Some key representatives of this approach included Ragnar Nurkse, Paul Rosenstein-Rodan, and Albert Hirschman. In Chile, the main representatives of this school of thought were Anibal Pinto and Osvaldo Sunkel.¹ On the other hand, a smaller group of thinkers, including Hungarian-born Peter Bauer and T.W. Schultz from the University of Chicago, believed that market forces and competition provided the best institutional arrangement for developing countries, and that openness and export expansion were essential for achieving rapid productivity gains and sustained growth. In the Latin America of the 1960s some of the very few economists in this camp worked at the Universidad Católica de Chile, the institution where Vittorio would later spend much of his own academic career.

The planning approach became particularly influential in Africa, a continent that during the 1960s was slowly beginning to emerge from a long colonial period. Many of the independence leaders were educated in the United Kingdom and were highly influenced by Fabian Socialist ideas. For example, Julius Nyerere, from Tanganyika, attended the University of Edinburgh; Jomo Kenyatta, from Kenya, and Seewoosagur Ramgoolam, from Mauritius, went to both University College and the London School of Economics; and Kwame Nkrumah, from Ghana, was enrolled in the London School of Economics. However, not all Fabian socialists in Africa were exactly alike; in each country different policies were implemented at different times. In Kenya and Zambia, for example, planning was light and, at least until the late 1970s, market signals were allowed to operate in most sectors. In contrast, and as Ndulu (2008) has pointed out, Tanzania, Mozambique and Ethiopia, followed from early on a more intense form of planning where markets were repressed significantly and the state played a growing role in the productive, investment, and distribution spheres. In these countries most large firms, banks and insurance companies were nationalized.²

1. Of course, there were significant differences among the representatives of what I have called the “planning perspective.” This was anything but a uniform group.

2. As Ndulu (2008) points out, Mauritius’s Ramgoolam followed a pragmatic path, and never succumbed to the promises of full-fledged planning.

The planning approach was also popular in other parts of the world. In India, Nehru strongly believed that the state should control most decisions regarding production, investment, and distribution. Indian planning efforts were developed by Professor P.C. Mahalanobis, who during the late 1950s became a legend of sorts among development practitioners from around the world. In Latin America, as noted, it saw its heydays during the 1960s. Indeed, after President John F. Kennedy announced the Alliance for Progress in 1961, planning became a fundamental component of policy formulation. In fact, having a well-functioning Department of Planning was a precondition for obtaining aid under the Alliance guidelines. Planning in Latin America, however, was significantly lighter and less intrusive than in Africa and India. Planning was also important in forging economic policies in Sukarno's Indonesia and in Razak's Malaysia.

1.1 Unlimited Supplies of Labor, Market Failures, and Protectionism

At the core of the planning view of development was the notion that the accumulation of physical capital was the main source of economic growth, and that the availability of labor was not a major constraint to economic expansion. These beliefs were based on two theoretical frameworks that had become popular in the 1950s: the Harrod-Domar model that emphasized the roles of the capital-output ratio and the saving rate in determining long-term growth, and the Arthur W. Lewis (1954) unlimited supplies of labor model that assumed that enormous quantities of labor were available at very low (almost zero) wages. According to these models, policies aimed at raising the aggregate saving and investment ratios were fundamental components of any successful development strategy. In countries where domestic saving was very low, it would be supplemented with foreign saving in the form of foreign aid. At the same time, the government would make efforts to generate (or "mobilize") additional resources to finance capital accumulation. These resources, in turn, would come from "surplus" generated by the primary (agricultural, timber, and mining) sectors.

A central assumption of the planning approach was that markets didn't work well, and that if left on their own they would generate undesirable outcomes. These "market failures" were the result of a combination of factors, including the absence of competition

due to the small scale of operation of most firms, consumers' ignorance, incomplete information, politicians that were captured by multinational and large domestic corporations, and the exploitation of poor countries by rich ones. Another key belief of the planning perspective was that poor countries' terms of trade would experience a secular deterioration. According to this view, promoted by Hans Singer and Raul Prebisch, among others, the global demand for developing countries' exports (commodities) had a low income elasticity, while advanced countries exports (manufactured goods) had a high elasticity. As a consequence, the relative prices of poor nations' exports were destined to decline through time. This called for a rapid industrialization process, which had to be encouraged through an array of subsidies, preferential treatments, protective import tariffs, licenses and quotas, outright prohibitions, and mandatory allocation of credit.

Marxist and neo-Marxist thinkers provided a more extreme version of this view that emphasized the fact that poor countries "depended" on rich nations for markets, capital equipment, consumption goods, and financing. Dependency theorists, including Samir Amin and André Gunder Frank, argued that poor countries had to sever economic and commercial ties with rich nations, including, in particular, former colonial powers. This required political will, as well as the implementation of "South-South" trading arrangements. Other dependency theorists, including Fernando Henrique Cardoso and Enzo Faletto in Latin America, stayed away from doctrinal or "vulgar" Marxism, but still emphasized the relations of dependency between the center and the periphery.

Some supporters of the import-substitution strategy—and most notably Albert O. Hirschman—argued that in order for this policy to succeed, two conditions were required. First, protectionist measures had to be temporary, and import tariffs had to be lowered through time. More generally, import tariffs and other restrictions on international trade had to be sufficiently high as to protect the targeted industry, and low enough as to act as a "pressure mechanism" that forced producers to improve productivity. And second, only selected industries should be protected. This recommendation was part of Hirschman's conviction that a healthy and successful growth process was always "unbalanced," and that some industries and sectors were to grow faster than others for prolonged periods of time. Hirschman contrasted his "unbalanced growth" view with the indiscriminate creation of large state-owned manufacturing

firms, and massive and blanket protection. This latter perspective was associated with the “big push” approach to industrialization, supported by Paul Rosenstein-Rodan, an early advocate of large, ambitious, and detailed plans to forge comprehensive development strategies.

According to Hirschman’s theory—which became very popular in academic and policy circles—trade restrictions should be used to protect and encourage those sectors with strong “forward and backward linkages.” That is, protection should be provided to those industries whose expansion would, at the same time, feed into other promising industries, and demand inputs and materials from deserving sectors. During the 1960s and 1970s steel was usually mentioned as an example of an industry with significant forward and backward linkages. On one hand, steel mills required iron ore and coke coal, and, on the other, the finished product could be used in the manufacturing of white goods, automobiles, trucks and tractors, and in construction. The proper implementation of this model required a remarkable amount of fine tuning and very precise and detailed knowledge of the economy; indeed, it required the type of knowledge that no government official—not even the best trained, most cable and well informed ones—was likely to have, or ever acquire. Which industries had the greatest linkages? By how much should they be protected? And, for how long? What was the combination of import tariffs, quotas and licenses that would provide the adequate “pressure mechanism” to force firms to become efficient? And, more important, how to make sure that policy makers were not captured by lobbyists (either from the private or parastatal sectors) that claimed that their specific sector had extremely high linkages and was utterly deserving of protection? As Columbia University Professor Carlos F. Díaz-Alejandro put it, the problem with Hirschman’s linkages approach was that its policy implications were extremely complex and were likely to become “dangerous in the sloppy hands of mediocre followers.”³

As it turns out, in most poor countries—including Latin American and African nations—protection became general and massive, subsidizing industries with a high degree of linkages, low linkages, and no linkages at all. In many countries it took the private manufacturing sector no time to capture policy makers and

3. Díaz-Alejandro (1984), p. 113.

to convince them that their particular industry was exceptional, had great promise, contributed to the process of technological transfers from the advanced world, was essential for bettering social conditions, and deserved to be protected by tariffs, quotas and even straight prohibitions. In other countries managers of state-owned enterprises played a similar game, and were able to convince policy makers to erect high protective walls around their specific industries. But that was not all. The maze of regulations became so intricate that it paid to obtain exemptions. Of course, those that managed to become sole importers at low (or zero) import duties made fortunes in very short periods of time. Tariff books throughout the Third World became huge monsters that detailed import duties for tens of thousands of goods, described the extent of restrictions and regulations, presented sliding tariffs' schedules, detailed the coverage of prior licenses and the levels of surcharges, and specified a number of exemptions. In many countries the granting of import duties and tax exemptions led to severe corruption and governance problems.

1.2 Elasticity Pessimism and the Dread of Devaluation

Supporters of the planning perspective assumed that in poor countries producers and consumers' responses to price incentives were limited. In that regard, there was a generalized "elasticity pessimism." A particularly important consequence of this view was the belief that peasants' efforts were not significantly affected by changes in crop prices. This view was particularly prevalent among many development economists that worked in Africa. As a result, it was thought that governments could use marketing boards with monopsony power to pay peasants a low fraction of international prices for their crops, and use the resulting "surplus" to finance the industrialization effort.⁴

Planners were especially skeptical and pessimistic regarding the role of exchange rate changes in the adjustments process. They strongly believed that trade elasticities were low and that the "structure" of the economy was more important than price incentives in foreign trade. According to the Marshall-Lerner condition, if the sum of the price elasticities of demand for imports and of the supply for exports is less than one, currency devaluation would fail

4. In Africa, marketing boards were a legacy of colonial times.

to improve the balance of trade. Planners' resistance to devaluation was also based on the idea that under certain conditions devaluations could be contractionary, reducing the level of aggregate demand, a point made by Hirschman in 1949, and emphasized with great force by Díaz-Alejandro in 1963.⁵

In addition, supporters of the planning view believed that currency devaluations were passed onto domestic prices rapidly and fully, thus fueling inflation and reducing real wages in the urban sector. The "structuralist" views on exchange rates were in contradiction with those developed at the IMF, where it was thought that a properly implemented devaluation—that is, one accompanied by a reduction in aggregate expenditure or absorption—would succeed in improving the balance of trade. According to the Mundell-Fleming model developed at the IMF, devaluations are expansionary, resulting, under most circumstances, in an increase in aggregate demand. Throughout his career Vittorio Corbo has undertaken a number of research projects related to the general topic of exchange rate adjustment, resource allocation, and inflation. For example, he deals with these issues in chapter 3 of his 1974 book, and again in his celebrated article in the 1985 *Review of Economics and Statistics*.

Economists that subscribed to the planning view had great faith in their models' abilities to calculate accurately the "requirements"—both direct and indirect—for achieving certain development targets. These figures were obtained by manipulating, in different ways, input-output matrices. A byproduct of these exercises was the computation—as the dual to the planners' optimizing problem—of shadow prices. These accounting prices were supposed to reflect the true value of different goods—and, thus, took into account the distortions created by "market failures"—, and were to be used in making investment and other decisions. A serious problem, however, was that in many developing countries (and in particular in Africa), for many years there were no data to construct input-output matrices, and in those countries where they existed they were often outdated, and did not incorporate the latest technological developments in the production process. As a result, calculations in most five-year plans in Africa were made using less sophisticated techniques. This did not imply that these plans were less ambitious or demanding than those elaborated in countries that did have detailed input-output matrices, such as some Latin American nations.

5. Hirschman (1949), Díaz-Alejandro (1963). See also Edwards (1989).

1.3 Light Planning

Of course, not all enthusiasts of the planning approach were alike; there were many variants of this economic perspective. Some believed that what poor countries needed was “indicative” or “light” planning that would provide broad guidelines to the private sector. This, for example, was the view implicit in the Alliance for Progress in Latin America. According to this approach the economy would be organized around three productive sectors: a small sector comprised of state-owned enterprises, mostly in heavy industries and natural monopolies; a “mixed-sector” where firms would be jointly owned by the state and private investors; and a private sector made up of small and medium size firms, and retail trade. Light planning was also the dominant view in the 1960s, 1970s and 1980s in Kenya. Other economists, however, supported a greater involvement of the public sector, through highly detailed plans and heavy government intervention in the form of price controls, investment licenses, controlled credit, and the imposition of import and export quotas. In this variant the state owned a very large proportion of the means of production, and government officials were largely free to control and regulate economic activities.

One of the most influential supporters of the planning perspective in Africa was René Dumont, a French agriculturalist and development expert that, with time, forged very close relations with most African leaders. His book “A False Start for Africa,” originally published in 1962 as *“L’Afrique Noir est mal partie,”* and translated into English in 1966 with an introduction by Thomas Balogh, was highly influential. In it he argued against the excessive use of foreign experts, and pointed out that for a poor country to develop, political organization and political will were more important than the technical aspects of the plan. Dumont was also a great supporter of rapid industrialization behind a wall of import tariffs, licenses, quotas and prohibitions. According to him, “[i]ndustrialization is...a symbol of economic progress... Giving priority to agriculture alone is a typically reactionary position... Custom protection on a national level, and later on the creation of the African Common Market, itself protected, will be virtually essential... Accelerated agriculture development will be more of a corollary... to this necessary but difficult industrialization” (Dumont 1966, p. 103-4). With time, however, Dumont became rather disillusioned with the turn of events in Africa and deplored the bureaucratization of economic policy in general, and planning in particular.

2. THE MARKET APPROACH TO ECONOMIC DEVELOPMENT: FROM THE “WASHINGTON CONSENSUS” TO THE GLOBAL FINANCIAL CRISIS

The war of ideas intensified during the late 1970s, as more and more developing countries in Latin America, Africa and parts of Asia experienced (very) low growth and deteriorating social conditions. This war reached an inflection point in the early 1980s when a growing number of academics—including Vittorio Corbo and some of his coauthors—began to question the dominant planning paradigm. In Latin America the inflection point came with the Mexican crisis of 1982 and the realization that every country in the region had become extremely vulnerable to external shocks. In Africa the early signs that views on development were changing came with the release of the “Berg Report” by the World Bank in 1981 (see the discussion below for details). Political developments in the advanced nations, and in particular the elections of Ronald Reagan in the U.S. and Margaret Thatcher in the U.K., also affected thinking about development. As the 1980s unfolded, views that emphasized the role of openness, competition, export growth, macroeconomic stability, and markets became increasingly influential. Many of these ideas—or more modern variations of them—were the bases for the reforms supported by the multilateral institutions, and in particular by the World Bank, and eventually undertaken in country after country around the globe after 1982. Once again, Vittorio played an important role in this process. This time, however, it was not from the academic trenches, but as a senior World Bank official holding different influential positions in World Bank operations and research departments.

In table 1 I present a schematic comparison of the main beliefs of the planning and market perspectives to economic development. The table covers five policy areas: (1) policies to enhance growth; (2) industrialization; (3) trade policy and openness; (4) incentives and resource allocation; and (5) policies towards alleviating poverty and improving the distribution of income. For each of these broadly defined policies I discuss the most salient proposals within each perspective.

2.1 Openness, Competition, and Growth

Research undertaken by a number of academics on the effects of protectionism on efficiency and economic performance was

particularly influential in helping change the views on development policy. Among these works, books by Little, Scitovsky, and Scottt (1970) and Balassa (1971) led the way by pointing out that protective structures could range from a highly negative degree of protection (mostly in the agricultural sector) to several hundred (and even thousand) percent in some industries. These findings were confirmed and expanded by a large and ambitious National Bureau of Economic Research project on protection and economic performance led by Bhagwati (1978) and Krueger (1978). This multi-country study showed that in most poor countries the tariff configuration generated a severe “anti-export” bias. Further, Bhagwati and Krueger showed that in the presence of quantitative restrictions to trade (import quotas and licenses), a devaluation reduced the anti-export bias significantly. A subsequent project, also directed by Anne Krueger, on the labor market consequences of alternative trade regimes confirmed the results from the NBER studies. Vittorio Corbo, jointly with Patricio Meller, wrote a brilliant paper on the Chilean experience for this effort.

The contrast between successful East Asian “tigers,” on one hand, and the Latin America countries, on the other, also influenced the switch in paradigm in development economics. By the late 1970s most nations in Latin America had come to a standstill, and many experts talked about the end of the “easy phase” of import substitution. In most countries productivity growth was extremely low, or even negative. Worse yet, after decades of planning and protectionist policies poverty had not declined and the region’s dismal income distribution had not improved. In the early 1980s Mexico was affected by a major external crisis that rapidly spread to the rest of Latin America: the so-called “lost decade” was about to begin. The years that followed were years of sorrow, frustration, and soul searching. As time passed, and more and more countries returned to democratic rule, a broad rethinking of economic strategy took place. By the early 1990s almost every country in Latin America—the main exceptions being Cuba and Haiti—had initiated a reform program that followed the blueprint of what has been called the “Washington Consensus.”⁶

6. For a detailed discussion on the policies of the Washington Consensus see Williamson (1990). Edwards (2010) analyzes the results of these reforms and argues that ill conceived exchange rate policies and the lack of proper bank regulation and supervision resulted in deep crises in a number of Latin American countries during the second part of the 1990s and the early 2000s.

Table 1. Main Elements of the “Planning” and “Markets” Approaches to Economic Development in the 1960s

	<i>Planning Approach</i>	<i>Market-Based Approach</i>
(1) Determinants and mechanics of growth	-Based on Harrod-Domar model; capital accumulation as main source of growth. -Emphasis on savings and investment ratios (Nurkse). -Labor availability not an issue; labor is assumed to be in “unlimited supplies” (Lewis, Ranis-Fei). -Foreign aid key to supplement domestic saving. -Competing views on mechanics of growth and takeoff: “big push” (Rosenstein-Rodan) vs. “unbalanced growth” (Hirschman).	-Productivity growth as important as factor accumulation (Solow). -Substitution between capital and labor (Solow). -Labor and “human capital” accumulation important source of growth (Schultz). -Productivity growth not exogenously given; affected by policy; excessive distortions reduce it; rate of innovation (and imitation) tends to be endogenous (Stigler). -Productivity growth and technological progress may be capital saving or labor saving (Viner).
(2) Industrialization and the sector composition of output	-Prices of natural resources-based exports subject to secular decline (Prebisch-Singer); industrialization is fundamental for development; only way to increase income per capita substantially (Kuznets). -Industrialization to be financed through “surplus” generated by primary sectors (agriculture and/or mining) and by foreign aid (Kuznets). This surplus, in turn, is captured by marketing boards that are by law sole buyers of crops. -Private sector unable to “mobilize resources” in the scale needed for industrialization; state has to do it. -Investment tightly controlled by the government at firm level, to avoid “wasteful variety” of goods (Feldman-Mahalanobis). -Sectors with strong “forward and backward linkages” to be promoted (Hirschman).	-Comparative advantage should determine what to produce and export (Viner; Little, Scitovsky, Scott). -Forced industrialization generates distortions and discriminates against exports (Balassa). -“Picking winners” generates dual economy with “protected and unprotected” sectors, and high equilibrium unemployment (Harris-Todaro). -“Financial repression” results in resource misallocation and slower growth (McKinnon, Shaw). -Freely determined prices should be main signal to allocate resources. -International competition and openness provide main antidote against monopoly power (Stigler).

Table 1. (continued)

	<i>Planning Approach</i>	<i>Market-Based Approach</i>
(2) Industrialization and the sectoral composition of output	-Low interest rates encourage investment and industrialization. -Input-output analysis essential for determining capital and other requirements of selected industrial sectors (Leontief). -Food prices to be kept low in urban sector, as a way of reducing manufacturing costs (Sunkel, Singer). -There are two possible constraints to growth, “the two-gap approach”: a saving gap and a foreign exchange gap.	-Comparative advantage should guide production and trade (Viner; Little, Scitovsky, Scott, Balassa). -Relative prices matter, especially “tradables to non-tradables” (Salter-Swan). -Trade elasticities high; external sector responds to incentives (Harberger, Laursen, Metzler). -Protectionism generates perverse incentives; usually discriminates against agriculture; effective rates of protection may be negative in some sectors (Corden). -Real exchange rate overvaluation at center of poor trade performance and external imbalances (Bhagwati, Krueger). -Avoiding anti-export bias encourages growth (Bhagwati, Krueger). -Lobbying for protectionism is wasteful, generates “rent seeking,” and reduces welfare (Bhagwati, Krueger).
(3) Openness and trade orientation	-Protectionist policies required to shield nascent manufacturing sector; “infant industries” argument (Prebisch). -Protection and South-South agreements needed to deal with poor countries <i>dependency</i> on foreign capital and advanced markets (Amin, Sau, and dependency theorists). -Tariff structure to exercise appropriate “competitive pressure” (Hirschman). -In order to avoid dependency from foreign capital and markets, poor countries to aim at “self-reliance” (Amin, Wellerstein). -Exports do not respond to exchange rate changes; “elasticities pessimism” (Singer). -Low currency values in order not to pressure wage good prices (Singer).	

Table 1. (continued)

	<i>Planning Approach</i>	<i>Market-Based Approach</i>
(4) Incentives and resource allocation	-“Planning” should be the main mechanism for allocating resources and making investment decisions (Lange, Lerner). -Planners should decide what is produced; this is best way for avoiding “wasteful diversity and variety of goods.” -Low response of agricultural sector to price incentives; mostly affected by land property structure (Sunkel). -Smallholders unable to export; marketing boards required to lower costs. -Poor countries plagued by “market failures”; government intervention required to tackle them (Nurkse). -Market prices are distorted; “shadow prices” should guide resource allocation (Little). -If let on their own, markets will result in underinvestment and wasteful production; state ownership of means of production required for effective growth policies. -Agricultural cooperatives provide a good way for reducing costs of farming.	-Resources should be allocated through markets (Hayek). -Firms should produce what consumers want to consume; “consumer sovereignty” is important (Friedman). -Peasants and poor people respond to relative prices and other incentives: elasticities tend to be large (Tax, Schultz). -Market prices tend to provide appropriate signals; if distortions are too high “shadow prices” should be used (Harberger, Little). -Public sector investment projects should be subject to strict evaluation; only those with high “social rate of return” should be implemented. -“Government failure” more pervasive and important than “market failures”. -Bureaucracy, excessive regulation and “red tape” stifle growth and productivity (Krueger).
(5) Poverty, social conditions, and income distribution	-Reducing poverty requires direct “anti-poverty” programs; growth is an ineffective way of reducing poverty. -Socialism is the most effective system for reducing poverty, improving social conditions and reducing inequality.	-Informality in labor markets fundamental cause of poverty; informality direct consequence of industrialization policies. -Providing right incentives for agricultural production is one of best ways of reducing poverty. -Human capital accumulation – especially at the primary level – powerful tool for reducing poverty (Mincer).

Table 1. (continued)

	<i>Planning Approach</i>	<i>Market-Based Approach</i>
(5) Poverty, social conditions, and income distribution	Land reform reduces inequality and poverty; cooperatives provide a good way of organizing the agricultural sector after the reforms. -The agglomeration of peasants in villages reduces costs of providing social services and reduces poverty. -Since there are “unlimited supplies of labor” in the agricultural sector, the most effective way of increasing wages is through industrialization.	

Sources: See discussion in the text and references to the authors mentioned in the table.

2.2 New Views on Africa

In 1981 two major and highly influential publications presaged the change in views regarding economic development in Africa: The World Bank's *Accelerated Development in Sub-Saharan Africa: An Agenda for Action*, universally known as “the Berg Report” after its main author, Elliot Berg, and Robert Bates's *Markets and States in Tropical Africa: The Political Basis of Agricultural Policies*. Although very different in terms of their genesis and objectives, these two books made a simple and yet powerful point: the poor performance of the African economies was mostly (but not exclusively) the result of bad policies that put bureaucrats interests ahead of those of the people, and that had stifled incentives for growth, innovation, and productivity improvements. Also, both works pointed out that, in contrast to what planning models assumed, African governments were far from being benign institutions that tried to maximize society's welfare. Bates and Berg argued that government bureaucrats—including the managing echelons of parastatals, marketing boards, and state-owned banks—had captured the state apparatus and were using it for their own benefit as well as for that of their immediate supporters, families, and friends.

Bates's analysis was rooted in the “rational choice” perspective developed by political scientists—sometimes referred to as the “new political economy”—, and concentrated on which interest groups benefited and which ones lost from certain policy options. He pointed out that in Africa government policy taxed farmers through several channels: the low producer prices paid by marketing boards, the overvalued exchange rate, and the high prices of consumer goods that farmers consumed. The latter was the consequence of the protectionist policies aimed at promoting industrialization. At the same time, in many countries government policies tended to help farmers through the subsidization of inputs and capital goods. Bates persuasively argued that the final net effect, however, was significant taxation, and a strong discouragement of agricultural activities.

By looking at the problem from a “rational choice” perspective, Bates went beyond explaining the effects of certain policies, and discussed *why* those policies were undertaken, even if they were detrimental for society as a whole. One of the most important conclusions of the rational choice perspective is that policy decisions are the result of distributional struggles, and reflect the structure of power in a particular country. Learning that certain policies are

technically inferior to other policy options is not enough for changing the course of action. In his concluding chapter Bates argued that the costs of anti-agricultural policies were rapidly climbing. This meant that political support for the ruling coalition was eroding, and that political change looked possible. The nature of this change, however, was uncertain, and depended on the specific characteristics of each country. According to Bates a serious obstacle for deep and meaningful reform was that eliminating the anti-rural bias required major devaluations, which were strongly opposed by urban-based interest groups.

As most World Bank documents, the Berg Report went beyond an evaluation of past performance, and made a number of recommendations for future policy changes. In many ways the reforms undertaken in Tanzania starting in 1986 were (partially) based on the suggestions made in this report. Broadly speaking, it called for drastically reducing the role of the state in economic activities, encouraging private sector participation, reducing protectionism to the industrial sector, eliminating fiscal imbalances, devaluing overvalued currencies and making sure that these stayed in line with fundamentals, encouraging agriculture, introducing new cultivation methods, and reforming (or better yet, dismantling) parastatals. The Report also called for reforming aid. In particular it recommended greater flexibility in terms of funds' use, increased coordination across donors, and a major increase—a doubling—of aid in real terms.

The "Berg Report" generated a strong reaction among African governments and their supporters. There were two fundamental criticisms. First, it was argued that the Bank disassociated itself from the policies undertaken in Africa in the past, pretending that it had played no role in their formulation. In that regard the critics were right, and the Bank's position was, to say the least, disingenuous. For example, for years the World Bank was enthusiastic about Tanzania's development strategy, including its devastating agricultural policies, the cruel villagization process that forcefully moved more than 10 million peasants from their homes, and the reliance on protectionism to encourage industries with forward and backward linkages. Similar stories could be told of other African nations. As Loxley (1983) argued, the Bank should have recognized that two decades of "misguided" policies in Africa were, at least in part, the consequence of its own "misguided" advice.

The second criticism of the Berg Report had to do with its claim that Africa's economic failure was (almost exclusively) due

to policy mismanagement, and that external factors had played a minor role in the continent's dismal performance. In particular, World Bank critics were incensed by the assertion that "trends in the terms of trade cannot explain the slow economic growth in Africa in the 1970s because for most countries... the terms of trade were favorable or neutral."⁷ According to the critics this conclusion depended on which years were used as a base to calculate changes in terms of trade. The Berg Report insistence that external factors were unimportant was also at odds with the position espoused by the African nations in the "*Lagos Plan of Action for Economic Development of Africa*," a document released in 1981 (but signed a year earlier). The *Plan for Action* attributed the region's penuries to the external shocks and the instability of the world economy. This long and all-encompassing document called for African countries to step up efforts for industrialization and self-reliance, and proposed the creation of a common market that would eventually lead to the formation of an African Economic Community. In addition, it stated that former colonial powers were trying to impose their own policies to the African nations: "Africa was directly exploited during the colonial period and for the past two decades; this exploitation has been carried out through neo-colonialist external forces which seek to influence the economic policies and directions of African States."

During the first half of the 1980s these two contrasting views on economic development would coexist and battle with each other. However, as economic conditions deteriorated throughout Sub Saharan Africa, the support for the "planning approach" and the Lagos Plan of Action gradually eroded. By the mid-1980s it was clear that the war of ideas had taken a significant turn, and that the previously unpopular "market approach" was gaining more and more supporters.

2.3 The "Washington Consensus"

The fall of the Berlin Wall in 1989 accelerated the decline in the degree of popularity of planning and generated increased interest among politicians in development strategies based on competition and export expansion. The experience of the East-Asian Tigers with export-led growth attracted considerable attention, and a number of works were penned on the policies followed by those nations. One of

7. World Bank (1981, p.19).

the messages that emerged from these case studies was that avoiding currency overvaluation—and, in some cases, deliberately encouraging undervaluation—had helped develop a vibrant export sector. Of course, that was exactly the opposite of what had happened throughout most of Africa and Latin America where the reluctance to adjust currency values, even in an environment of high domestic inflation, had resulted in significant real exchange rate overvaluation, losses in international competitiveness and eventually in very severe currency crises.

In the late 1980s and early 1990s a move towards economic reform swept through the developing world. This phenomenon had its origins in Latin America, and rapidly spread to other nations, including Central and Eastern Europe, the former Soviet Union, and India. The reform movement also affected Africa, although it moved at a slower pace, and faced stiffer opposition from the elites and those groups that during decades had benefited from the planning approach to development.

The early market-oriented reform agenda became known as the “Washington Consensus,” a name that suggests that these policies originated in the multilateral agencies—the World Bank and the IMF—and in the U.S. Department of the Treasury. This, however, was not the case. In Latin America, for example, the reforms were largely homegrown, and were the response to more than ten years of a generalized crisis—the so-called “lost decade”—that had erupted in the early 1980s. An analysis of the relevant documents and archives shows that the Washington institutions were skeptical, and in some cases openly opposed, to some of the most daring reform proposals in many parts of the world, including in many of the Latin American nations. In Argentina, Brazil, Chile, Colombia and Mexico, to mention just a few countries, reform programs were developed by local economists that had acquired significant political power. These economists-turned-politicians were often referred to as “technopols.” Also, in many former Warsaw Pact nations local pro-reform technocrats accumulated substantial political power and pushed reform programs that were often at odds with the more tentative agenda of the multilateral institutions. Both in Latin America and in the former Communist countries local economists were often advised by Western academics. Some prominent names among external advisors included Arnold C. Harberger, Rudi Dornbusch, Andrei Shleifer, Stanley Fischer, and Jeffrey Sachs.

In a highly influential article published in 1990, English economist John Williamson summarized the main goals of the Washington Consensus as follows:

- Achieve fiscal balance, as a way of reducing inflationary pressures, and stabilize prices.

- Target public expenditures towards the poorer groups in the population. Priority should be given to government expenditures aimed at improving social conditions and reducing poverty; generalized subsidies, which benefit mostly the middle class, were to be avoided.

- Implement deep tax reforms, in order to reduce evasion, increase government income and eliminate perverse incentives to production and investment.

- Modernize the financial sector. Interest rates had to be market determined, and not set by government officials in an arbitrary fashion. A well functioning capital market would help allocate scarce capital to the most productive uses.

- Avoid artificially strong currencies that discourage exports. By staying away from currency overvaluation the probability of major, and very costly, crises would be greatly reduced. This measure would also encourage production in the agricultural sector.

- Reduce the extent of protectionism and rationalize trade policy. That is, the irrational structure of protectionism that had evolved over half a century—and that was documented above—has to be dismantled and replaced by lower import tariffs.

- Encourage foreign direct investment.

- Privatize inefficient state-owned enterprises.

- Deregulate business transactions including investment decisions. Red tape had to be cut, barriers to entry in key industries eliminated, and competition encouraged.

- Improve legal protection of property rights, as a way of securing higher investment by both foreigners and nationals.

These ten policies—and the name “Washington Consensus” for that matter—acquired a life of their own, and were soon considered to be an official pronouncement of what the countries in the emerging world should do and what they should not do. This was unfortunate, since a number of analysts have evaluated reform efforts through the lenses provided by this list, and, thus, have missed many of the subtleties and complexities of the actual individual country stories.

During the first half of the 1990s different nations emphasized different aspects of the market-oriented reforms. In some countries—and particularly in Latin America—results were quick and impressive. Inflation declined abruptly, exports increased, and real wages recovered at a rapid clip. But in many countries these early accomplishments

hid important weaknesses: privatization of public utilities—including energy, water, sanitation, and telecommunications—was implemented without putting in place proper regulation and competition policies. As a result, in a number of cases state-owned monopolies were replaced by privately-owned monopolies, and in many instances privatization was surrounded by corruption and giveaways, where insiders—including government officials in charge of public enterprises and their sale—ended up buying large blocks of shares at conveniently low prices. At the same time, most countries in every region of the world failed to move forward in the creation of strong and modern institutions that would encourage the rule of law, protect property rights, and reduce the extent of corruption. In many Latin American nations the situation was even worse, as policy makers used fixed (or rigid) exchange rates as a way of controlling inflation. With time, currencies became overvalued—a well-known problem in Africa—and severe external imbalances developed.⁸

During the 1990s and early 2000s a succession of external crises erupted in a number of countries that had either embarked on the reform path and/or were considered as premier examples of outward orientation: Mexico (1994-95); Thailand, Malaysia, Indonesia, the Philippines, and South Korea (1997-98); Russia (1998); Brazil (1999); Turkey (2001); Argentina (2001-02); and Uruguay (2002). These crises resulted in significant income loss, increased poverty, lower wages, and spikes in unemployment. In most countries the crises generated political upheaval, and in some they paved the way to populist politicians that reversed the reforms, nationalized foreign companies, and implemented protectionist measures—Argentina and Venezuela being the most salient examples. The crises also generated an intellectual backlash against the Washington Consensus. Chief critics of the simple version of market orientation and reform included Nobel laureates Joseph Stiglitz and Paul Krugman.⁹

A number of lessons on macroeconomic management emerged from the currency collapses of the 1990s and early 2000s. They included the benefits of having flexible exchange rates, the dangers of short-term speculative capital movements—and, thus, the merits of some controls on capital inflows—the importance of having a “reasonable” stock of international reserves, and the value of labor market flexibility, openness, and countercyclical fiscal policies. There

8. See for example Edwards (2010).

9. See for example Krugman (1995) and Stiglitz (2003, 2008).

were also important lessons for social policies and governance, including the need to have a safety net to protect the poor and disadvantaged from the vagaries of the global economy. Other lessons referred to the importance of having a modern tax system that raised enough revenue to finance transfers to the poorest groups and to finance social programs.

During the second half of the 2000s most of these lessons were incorporated into specific policies in different countries; the process was gradual and without much fanfare. Many countries took a pragmatic approach towards reforms and modernization, discarded the rigid tenets of the Washington Consensus and moved towards their own versions of market and outward orientation. Overly doctrinaire positions were abandoned and whatever worked—including maintaining (majority) government ownership of some companies, and implementing some controls on capital mobility—was incorporated into the policy framework. In fact, many observers—including the critics of market-orientation and reform—didn't notice the extent to which many emerging countries had improved macroeconomic management. This became evident, however, with the collapse of Lehman Brothers in 2008. This time, things were really different. Instead of being the victims of contagion and crumbling as so many times in the past, the emerging nations as a group continued to grow. Emerging countries in Asia, Latin America, and Africa showed remarkable resilience. These developments were helped by two important factors: high commodity prices, propelled by China's remarkable expansion, and significant liquidity in world financial markets. The latter was the result of the very permissive policies followed by the advanced countries' central banks—including the Federal Reserve's "Quantitative Easing" policies—and contributed to the strengthening of many emerging countries currencies.

3. INTERNATIONAL AID: POLICIES AND CONTROVERSIES

During the last four decades foreign aid has been a central element of the "war of ideas." Interestingly, however, this is a relatively new topic in economics. The classics—Smith, Ricardo, and Stuart Mill—didn't address the subject in any significant way. In fact, if anything, classical economists thought that the colonies would catch up—and

even surpass—the home country quite rapidly.¹⁰ In Chapter VII of “The Wealth of Nations,” Adam Smith provides a detailed discussion on the “causes of the prosperity of the new colonies.” In many ways this analysis is remarkably modern. Smith argues that the main reason why the English colonies of North America had done significantly better than the Spanish dominions of South America was that “the political *institutions* of the English colonies have been more favorable to the improvement and cultivation of this land than those of the [Spanish colonies].”¹¹ This, of course, sounds remarkably similar to the ideas developed in the last few decades by Douglas North, Daron Acemoglu, James Robinson, Simon Johnson, and others. Smith goes on to list a number of policies implemented by the British—including tax, inheritance, and trade policies—that, in his view, explain the economic success in what was to become the United States; in parallel, he discusses how poor policies enacted by the Dutch and the Spanish—and to a lesser extent by the French—stifled growth and progress in their dominions. Although this chapter runs for almost 100 pages, there is not even a mild suggestion that the home nation should provide systematic financial assistance to its colonies.

The first legal statute dealing explicitly with official aid was passed by Parliament in the United Kingdom in 1929. The *Colonial Development Act* created the *Colonial Development Fund* with resources of one million pounds sterling per year. Although this Act intended to improve the social conditions in the colonies—especially in the rural sector—, its main objective was to promote British exports at a time when the Great Depression had hit the country particularly hard.¹² Until the passing of this legislation the colonies were supposed to be, largely, self-financing, and any aid was confined to emergencies. In 1940 and 1945 new laws dealing with aid to the colonies were passed in the United Kingdom. These Acts increased

10. The analysis in this section doesn’t pretend to be exhaustive. I don’t attempt to deal with every aspect of aid-related controversies. Readers interested in the intricacies of international assistance may consult some of the very thorough surveys on the subject, including two comprehensive articles by Radelet (2005, 2006) and the extensive literature cited therein.

11. Smith (1776), Cannan Edition, published by the University of Chicago Press, 1976. Emphasis added.

12. At the time the Act was passed, Sidney Webb—one of the founders of the London School of Economics and a prominent Fabian Socialist—was the Colonial Secretary. During his tenure as Secretary he fought, with limited success, to reinstate the policy of “native paramountcy” in East Africa. See Barder (2005) for a succinct history of foreign aid in the United Kingdom.

the amount of funds available and made commitments for longer periods of time—for up to ten years in the *Colonial Development and Welfare Act of 1945*. More important, the Act of 1945 established that aid plans had to be prepared “*in consultation* with representatives of the local population.”¹³

The question of how much to involve recipient governments and populations in designing aid packages would become a recurrent theme in aid policy debates. For example, the issue was of paramount importance in Tanzania. Through time the terms used when referring to local involvement evolved from “consultation,” as in the *Colonial Act* of 1945, to “participation,” as in the influential Pearson Report in 1969, to “ownership,” as in the Helleiner Commission on aid in Tanzania in 1995.¹⁴

In the United States the first law dealing with foreign assistance came quite late, with the adoption of the Marshall Plan in 1948.¹⁵ In his inaugural speech on January 20th, 1949—the so-called *Point Four Speech*—President Harry Truman put forward, for the first time, the idea that aid to poor nations was an important component of U.S. foreign policy. He said that one of the goals of his administration would be to foster “growth of underdeveloped areas.” He then added that “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.”

In spite of Truman’s vehement allocution, aid commitments to poor countries were considered temporary. In 1953, when Congress extended the *Mutual Security Act*, it explicitly stated that economic aid to U.S. allies would end in two years; military aid was to come to a halt in three years. In the early 1960s—and largely as a result of the escalation of the Cold War—the United States revised its position regarding bilateral assistance, and, jointly with other advanced countries, founded the Development Assistance Committee (DAC) at the newly formed Organization for Economic Cooperation and

13. Barder (2005, p. 3), emphasis added.

14. The Pearson Commission was appointed in 1967 by George Woods, then World Bank president, “to study the consequences of development assistance.” The first section of chapter 1 was titled “Crisis in Aid,” indicating that, at least in the minds of some, official aid has been in crisis mode for almost half a century. There were eight commissioners, and the Staff of the Commission added to 27 people. See Pearson (1969).

15. The Marshall Plan, which was announced by U.S. Secretary of State George C. Marshall in a speech at Harvard University on June 5, 1947, played an important role in defining U.S. policy towards foreign aid. Congress, however, was slow in passing the Plan. It was only done in 1948, after the Soviets took over Czechoslovakia.

Development (OECD). The main objective of the DAC was—and continues to be—to coordinate aid to the poorest countries.¹⁶

During the early post World War II years there were recurrent discussions on whether aid should be allocated, mostly, towards projects geared at accelerating economic growth, or towards programs aimed at improving social conditions and reducing poverty. In the 1960s, and as the neoclassical model of growth developed by Solow made inroads in the economics profession, a greater emphasis was given to the formation of human capital. This decision was also influenced by the increasing evidence that the developing countries lacked the “absorption capacity” required to implement many of the aid projects. Training professionals and improving skills among the indigenous populations was seen as a key contribution to growth itself, as well as a step towards making aid more effective. It was not until the late 1960s and early 1970s that the “basic needs approach” became popular, and the improvement of social conditions became the central goal of the majority of official programs. The World Bank, under the leadership of former U.S. Secretary of Defense Robert S. McNamara, played an important role in the move in this direction.¹⁷

Since the end of World War II, most donors have followed a two-prong approach to aid. On one hand they have relied on their own bilateral programs, which are run by national bureaucracies that often operate at the ministerial level; on the other hand, they have supported the work of the multilateral organizations, such as the World Bank and the regional development banks. In addition, they have used the OECD’s DAC as a mechanism for achieving some level of coordination. This dual mechanism has allowed most advanced nations to be selective (in terms of which countries they assist directly), and, at the same time, to join forces with other donor nations in supporting broader initiatives. The Nordic countries have been particularly active in using this approach: through their own agencies (*Sida*, *Norad*, *Danida*, *Finida*) they have assisted a small number of countries, while at the same time they have devoted

16. The original name of DAC was Development Assistance Group, while the original name of the OECD was Organization for European Economic Cooperation. In 1946 France created its first aid agency (FIDES), which in 1963 was replaced by the Ministry of Cooperation. The Nordic countries created their own aid agencies in 1962.

17. In some donor countries, however, the objective of alleviating poverty was central from early on. This was the case, for instance, of Sweden, where Proposition 1962:100 explicitly established that the objective of aid was to raise the living standards of the poor.

approximately 50% of their (quite large) foreign aid budget to support the multilateral organizations.¹⁸

Already in the 1950s and 1960s a number of market-oriented economists—including Milton Friedman and Peter Bauer—argued against the provision of foreign aid beyond humanitarian relief. According to them, official assistance created the wrong incentives, especially when it distorted markets and encouraged protectionism. The response from early supporters of aid, such as W. Arthur Lewis and Paul Rosenstein-Rodan, was that international aid supplemented domestic saving, and allowed poor countries to accumulate capital and develop a key manufacturing sector. In their view, rapid industrialization through import substitution was required in order to achieve sustained growth and reduce poverty. As noted, in the 1980s and early 1990s there was a major shift in the views regarding international assistance in general, and aid to Africa in particular. As a result, aid became more narrowly focused, the number of capital intensive projects was greatly reduced, and social programs were expanded; at the same time, aid was increasingly conditioned on certain actions by the recipient nations, including the adoption of market oriented policies and trade liberalization. During these years a large number of bilateral development agencies—including those in the Nordic countries and Japan—went through thorough evaluations of their programs, and decided that there was a need to be both more selective, in terms of which programs to support, and more demanding with respect to the recipient countries' contribution to their overall development strategy.

In September 2000, the United Nations Assembly adopted the “Millennium Declaration” that set forward a new set of targets—the so-called *Millennium Development Goals (MDG)*—for the development community to be achieved by 2015. These goals included: (1) halving extreme poverty and hunger; (2) achieving universal primary education; (3) promoting gender equality, especially in the educational system; (4) reducing under-five child mortality by two thirds; (5) reducing the maternal mortality ratio by two thirds; (6) halting and reducing by one half the incidence of malaria, as well as halting and reversing the spread of HIV/AIDS; (7) ensuring environmental sustainability; and (h) developing a global partnership

18. To be sure, the Nordic countries not always agreed with the specific policies undertaken by the multilateral organizations. In the early 1970s, for example, the Swedes were particularly critical of the World Bank's support to South Vietnam.

for development.¹⁹ In March 2002, at the *Monterrey Conference* on development, most advanced countries signed a declaration that called for making “concrete efforts towards the goal of 0.7 percent of gross national product (GNP) towards official development assistance.”²⁰ The focus on ownership and performance is mostly aimed at dealing with the “double principal agent” problem that has affected aid since its beginnings in the 1920s (see the discussion in Section III.3.2 below; see, also, Radelet, 2006).

The Millenium Declaration and Monterrey Conference led to a (somewhat) new view on aid policy. This perspective, subscribed by over 100 countries in the Paris Declaration on *Aid Effectiveness* of March 2005, emphasizes the recipient country’s “ownership” of programs. There was also a renewed focus on linking aid to both economic performance and the implementation of anti-corruption measures (see Edwards, 2014, for details). This new approach required developing a battery of tools to monitor whether specific projects and programs had “performed appropriately”. Since the early 2000s academic economists have made important progress towards developing a methodology for evaluating whether social programs achieve their predetermined goals. Possibly the most important component of this new perspective is the use of “randomized field experiments”.²¹

3.1 The Inconclusiveness of Econometric Studies

Trough time, a number of authors—both in academia and in the aid community—have used a battery of econometric methods to analyze whether (or under what circumstances) aid is effective, in the sense of generating higher growth and better economic outcomes.²² Some of these studies have tried to tackle issues of reversed causality, and have used a series of instruments—some

19. See <http://www.un.org/millenniumgoals/>

20. See www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf. The UN tracks progress towards achieving the MDGs by following 21 targets and 60 indicators. By mid 2012, and according to a report by the United Nations Secretary General, three of the eight goals—on poverty, water and slums—had been met for the developing world as a whole. At the same time, the data shows that most of MDG’s would be missed in Sub-Saharan Africa.

21. For a discussion on the emerging “new aid model” see Bourguignon and Sundberg (2007). On randomized trial experiments see, for example, Banerjee and Duflo (2011).

22. See, for example, Johnson and Subramanian (2005), Rajan and Subramanian (2008), and Bourguignon and Saunders (2007), and the literature cited therein.

more convincing than others—in an attempt to deal with the fact that slower growth (in very poor countries) may attract additional aid. Other works have analyzed whether aid only works under certain conditions, or whether a minimal degree of institutional development is required for international assistance to bear fruit. These studies have considered nonlinear functional forms, and have investigated if there are meaningful interactions between aid and other variables, such as the degree of literacy, the level of corruption, the extent of macroeconomic stability, institutional strength, the quality of overall economic policies, and geography. The majority of these studies has used GDP growth as the performance variable of interest, have relied on cross-country or panel data, and have attempted to distinguish between short- and long-term effects.

Overall, the results from this large body of research have been fragile and inconclusive. Indeed, after analyzing 97 studies, Doucouliagos and Paldam (2005) concluded that, in the best of cases, it was possible to say that there was a small positive, and yet statistically insignificant, relationship between official aid and growth. This conclusion was also reached by Rajan and Subramanian (2008) in an analysis that corrected for potential endogeneity problems, and that considered a comprehensive number of covariates. In particular, according to this study there is no clear relation running from more aid to faster growth; this is true even in countries with better policy environment and stronger institutions.

Bourguignon and Sundberg (2008) have argued that one should not be surprised by the inconclusiveness of studies that rely on aggregate data. According to them, aid affects economic performance, directly and indirectly, through a variety of complex channels. Thus, treating all aid as homogeneous—independently of whether it is emergency assistance, program aid, or project-based aid—is misleading. In their view it is necessary to break open the “black box” of international aid, and deconstruct the causality chain that goes, in intricate and non-obvious ways, from aid to policymakers, to policies, and to country outcomes. This type of analysis would focus on a number of specific ways in which international assistance may impact economic performance. In particular, studies that try to determine the impact of aid on growth should consider issues related to technical assistance, conditionality, level of understanding of the economy in question, and the government ability to implement specific policies.

3.2 The Bitterness of Recent Controversies

In spite of its intensity, the academic debate on the relationship between aid and performance pales in comparison with recent policy controversies on the subject. On one side of recent battles are aid critics such as William Easterly and Dambisa Moyo.²³ On the other side of this divide are Jeffrey D. Sachs—possibly the most vehement supporter of increasing the volume of official aid—and his associates. The level of animosity in this veritable war is illustrated by the following quote from a Sachs’ article published in 2009: “Moyo’s views [are] cruel and mistaken... [Moyo and Easterly are] trying to pull up the ladder for those still left behind.”²⁴ Easterly’s reply, also from 2009, was equally strong: “Jeffrey Sachs [is]... the world’s leading apologist and fund-raiser for the aid establishment... Sachs suffers from [an]... acute shortage of truthiness...”²⁵

In a number of articles, as well as in a blog and in a bestselling book, Easterly has argued that aid agencies are bureaucracies that, in a typical monopolistic fashion, charge too much and deliver too little services.²⁶ Worse yet, according to him these agencies have formed a “cartel” that prefers “aid coordination” to “competition.” As most monopolies, aid bureaucracies innovate slowly and are overly risk averse. As a result, they have developed safeguards that avoid creative solutions to economic problems; the main goal of these bureaucracies is to steer clear of “failures.” But this is not all: according to Easterly and his supporters international assistance also suffers from a “double principal agent problem,” where those with the greatest interest in the success of the programs—aid recipients in the poor countries, and tax payers in donor nations—are far from the decision making process. As is often the case when the principal agent problem is severe, officials in donor and receiving countries tend to “capture” the aid organizations, and run them according to their own interests, values, and goals. Worse yet, states Easterly, many of the efforts to tackle this agency problem—including conditionality, consultation, and matching funds—have not worked, and have added to the bureaucracy. Easterly, Moyo, and other aid-skeptics have vehemently argued that the official donor community

23. Robert Klitgaard’s “Tropical Gangsters,” published to great acclaim in 1991, provided an early criticism, from the field, of the way in which official aid was provided in Africa.

24. Sachs (2009).

25. Easterly (2009).

26. See, for example, Easterly (2002, 2003, 2006).

uses the wrong yardstick to measure performance and success: instead of focusing on outcomes that are important for the poor, they emphasize the amount of funds spent in particular countries or regions.

Of course, most of the critics recognize that throughout the years the aid community has had some successes, including the improvement of health and education indicators in a large number of countries. But, overall, they believe that aid channeled through bureaucratic and monopolistic government agencies is largely destined to be ineffective and wasteful. At the risk of oversimplifying a bit, the view of aid critics may be summarized with the following quote from Easterly: “[F]oreign aid works for everyone except for those whom it was intended to help, with results such as the aids agencies’ calculation that it takes \$3,521 in aid to raise a poor person’s income by \$3.65 a year.”²⁷

During the last two decades or so, Jeffrey D. Sachs has become one of the most steadfast and vocal defenders of foreign aid channeled through official channels. Other prominent supporters of official assistance include Joseph Stiglitz and Paul Krugman. Their support, however, is not unconditional; as most economists that believe that official assistance funds should increase, they recognize that some reforms in the management of aid programs are in order. For example, Sachs and his colleagues do not defend traditional, top-down, bureaucratic assistance; on the contrary, their view is quite critical of the way in which aid has been dispensed in the past. But, at the same time, they strongly argue that, if properly provided, and if channeled towards combating particular ills—including diseases such as malaria and HIV-AIDS, the lack of potable water, and the inadequate infrastructure that isolates poor communities—, official assistance can help eliminate poverty in a relatively short period of time.

According to Sachs and his supporters—and there are many of them—most aid programs should concentrate on what they have called the “Big Five development interventions”: improved agricultural inputs; investment in basic health—including antimalarial bed nets—; investment in education; the provision of power, transport and communication services; and making safe and drinking water available to everyone. When presented on their own, these interventions are unlikely to generate excitement, enthusiasm, or optimism. Indeed, all of them have been fixtures of conventional development assistance for decades. What makes Sachs’ view different,

27. Easterly (2002).

however, is the way in which assistance is to be provided. His is a holistic approach that begins with a community-specific diagnosis—what he calls “clinical economics”—, and the formulation of programs that capture the peculiarities of each community. Sachs’ most important argument comes from the results obtained in a number of villages across Africa—the *Millennium Villages*—, where a modest amount of aid (about USD 120 per person, per year), coupled with the Big Five interventions have resulted, according to him, in significant improvements in agricultural output, reduced malaria cases, improved health, and better school achievements. However, and not surprisingly, the Millennium Villages Project (MVP) has had its critics. For example, Rich (2007) has argued that although the project has improved a number of indicators in the villages where it has operated, it has not solved some of Africa’s most serious problems, including the domination of particular clans or tribes, corruption, dependency, and poor governance. A key question raised by these critics is whether the impact of the MVP will be sustained through time, or whether the communities where it has been active will revert to poverty and destitution once the aid workers leave.

To a large extent, the Easterly-Sachs debate has generated public attention because it has been couched in simple terms. These are, indeed, simple narratives based on ethnographic arguments and specific anecdotes that resonate with large segments of the general public. But behind the different positions there are hundreds of academic studies—most of them based on advanced econometric techniques—that have tried to determine the extent to which foreign aid is effective. The problem, as noted, is that much of this body of empirical work has resulted in fragile and inconclusive evidence.

For an increasing number of economists the issue of aid effectiveness is neither black nor white. Indeed, a number of authors have taken intermediate positions. For example, in an influential book that deals with the plight of the poorest of the poor, Paul Collier from Oxford University, has argued that both critics and staunch supporters of official aid have greatly exaggerated their claims and distorted the empirical and historical records. His analysis is based on a large body of empirical work undertaken by him and a number of his associates. Collier’s reading of the evidence is that over the last 30 years official assistance has helped accelerate GDP growth among the poorest nations in the world—most of them in Africa—by approximately 1% per year. This is a nontrivial figure, especially when one considers that during this period the poorest countries have had an aggregate rate of per capita growth of zero. That is, in the absence of official assistance,

the billion people that live in these nations—the so-called “bottom billion”—would have seen their incomes retrogress year after year.

However, and as Collier points out, aid is subject to decreasing returns. Thus, doubling its volume, while maintaining the way in which it is disbursed, would not add another 1% to the squalid rate of growth in this group of countries. In order for additional aid to truly impact the lives of the bottom billion it needs to be reformed. Collier looks at this issue through the lenses of the four poverty traps that, according to him, have hampered development in these nations: the conflict trap, the natural resources trap, the landlocked trap, and the bad governance trap. His empirical results indicate that while additional official assistance can do little to free societies from the first two traps, it can be quite effective in addressing the problems arising from the landlocked and bad governance traps.²⁸

Collier, however, believes that in order for this to happen there needs to be a major change in the way aid is disbursed. He is particularly critical of *ex-ante* conditionality—the type of policies used extensively during the 1980s and early 1990s—, and argues that technical assistance is particularly important in helping countries change course and move towards growth and progress. According to Collier’s empirical analysis, aid is more effective when it is provided at the beginning (during the first four years) of a reform process leading to an economic turnaround. Also, official assistance would become much more effective if a larger proportion is devoted towards improving the skills of the local population, including those of government officials involved in the implementation of development programs. Collier also calls for creative solutions, such as aid agencies teaming up with civil society and NGOs to build parallel institutions to provide basic services such as education and health.

In a recent book, Banerjee and Duflo (2011) have argued that there is need for a “radical rethinking of the way to fight poverty.” In their view, the acrimonious debate between the Easterly and Sachs factions has missed the boat. Banerjee and Duflo join a growing group of researchers in arguing that this controversy cannot be solved in the abstract, by using aggregate data and cross-country regressions. The evidence, in their view, is quite simple: some projects financed by official aid work and are effective in reducing poverty and moving the domestic populations towards self-sufficiency and prosperity,

28. He does argue, however, that aid can be very effective in helping countries in the post-civil conflict period. See his discussion in pages 105-107.

while other projects (and programs) fail miserably. The question is not how aggregate aid programs have fared in the past, but how to evaluate whether specific programs are effective.

Like Bourguignon and Sundberg (2008), Banerjee and Duflo urge economists and other social scientists to “think in terms of concrete problems that can have specific answers, rather than foreign assistance in general.” They go on saying that “the lack of a grand universal answer might sound vaguely disappointing.” This doesn’t mean, however, that particular and circumstance-specific answers are not useful. In fact they are. Taking the lessons from concrete policies seriously would go a long way towards improving aid programs; it would help millions of people to get out of their poverty traps. Banerjee and Duflo have been among a group of economists that in recent years have introduced “randomized control trials” as a way of evaluating the effectiveness of different policy interventions.²⁹ In these experiments randomly selected individuals are subject to a treatment—they receive anti-malaria nets, for example—, while other randomly selected individuals conform the control group. A comparison of the outcome of this intervention provides evidence on whether the treatment is effective, and on the magnitude of the effects.

According to Banerjee and Duflo (2011) and Deaton (2010), among others, randomized control trials provide valuable information that can guide reforms and aid programs at the margin. Overall, their view is that details matter. Poverty and underdevelopment are not so much the result of geography, politics or grand conspiracies that resulted in failed “institutions,” as they are consequences of policies that go wrong due to their complexity, incomplete information, and missing markets. Official assistance, if properly provided, can make a huge difference; “small changes can have big effects.” The key is to know how to dispense official aid properly. In Banerjee and Duflo’s world, evidence from randomized control trials is an essential tool for obtaining that knowledge, for using aid funds wisely, and, thus, for moving forward in the quest for reducing poverty.

29. The Poverty Action Lab at M.I.T., founded in 2003 by Banerjee and Duflo, has been on the forefront of the random trial experiment work. See for example Banerjee and Duflo (2009) and the survey by Deaton (2010), and the works cited there.

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