

# Can foreign aid end world poverty?

Institute of Developing Economies  
Symposium, “Poverty Reduction and Beyond:  
Development Strategies for Low-Income  
Countries”, Tokyo, Japan, November 2007

William Easterly  
NYU  
Brookings

# Outline

- Aid advocates reject free markets as a solution to world poverty, suggesting a state-led Big Push through Foreign Aid to break a Poverty Trap
- Evidence is that Big Pushes of Foreign Aid have not worked to end poverty
- Making again the case for the free market in the 21<sup>st</sup> century as the best hope of the poor

# Aid economists who reject market solutions for poverty

- “Trade is more likely to lock {the bottom billion} into natural resource dependence than to open new opportunities.” (Collier 2007)
- “There are roughly one billion people around the world ...{who are} too ill, hungry or destitute even to get a foothold on the first rung of the development ladder.” Sachs 2005

# Sachs and Collier non-market solutions

- “Although introductory economics textbooks preach individualism and decentralized markets, our safety and prosperity depend at least as much on collective decisions ... {we must} act in unison to help the poorest of the poor...Collective action..., as well as foreign assistance ... underpins economic success.” (Sachs 2005)
- “Africa should rightly stay on the G8 agenda until the bottom billion are decisively freed from the development traps. This book sets out an agenda for the G8 that would be effective... {Breaking the traps} are not tasks that these societies can readily accomplish by themselves.” Collier 2007

# Poverty reduction strategy papers by IMF and World Bank

- Administrative approach to poverty reduction through governments, international agencies, and aid funding as explained in the World Bank's 1,260 page *Sourcebook for Poverty Reduction Strategies*.
- PRSPs – calling for state-directed development by states least able to direct

What these PRSP reports have in common: they are afraid to even mention the words “free markets”

- 2005 World Development Report *A Better Investment Climate for Everyone*
- the IMF’s 2002 *Review of the Poverty Reduction and Growth Facility: Issues and Options*,
- the World Bank and IMF’s 2005 *Review of Poverty Reduction Strategies*,
- the IMF’s 2005 report, *Strengthening the IMF's Support for Low-Income Countries*,
- the 2005 Blair Commission for Africa report, *Our Common Interest: Report of the Commission for Africa*, and
- the World Bank and IMF’s *Global Monitoring Report 2006: Millennium Development Goals: Strengthening Mutual Accountability, Aid, Trade, and Governance*.

The Millennium Development Goals Plan to end world poverty through aid money and bureaucracy...

- Has 52 international donor agencies and 97 recipient government bureaucracies collectively responsible for meeting 48 different targets (Millennium Development Goals)
- nobody is individually responsible for any one result, unlike in markets, so results are not achieved

# Free markets have lost the war of ideas

- Naomi Klein's bestseller (2007) notes that the "grim assessments" of the case for free markets upon the death of Milton Friedman in November 2006 "did not begin to encompass the state of disarray in which the case for unfettered capitalism found itself."
- Backlash against free markets in Latin America, Africa, Middle East, even Europe.
- Free markets thought to be of limited value as development strategy for low income countries.

The evidence and historical  
record on aid and markets

## Unfortunately, previous attempts at an Aid Big Push have not Ended Poverty: the 100% solution

- JFK advisor Walt Rostow called for doubling foreign aid in 1960
- World Bank President McNamara called for doubling aid in 1973.
- WB called for doubling aid with end of Cold War in 1990.
- G-8 Summit in July 2005 agreed to double aid to Africa.
- China announced doubling of its aid to Africa in November 2006.
- George W. Bush is implementing an increase US aid of 50 percent.
- Obsession with **amount spent in the future** substitutes for asking whether **money spent in the past** actually ended poverty.

# Evidence against Sachs and Collier

- 50 years of previous “Big Pushes” have not worked, or else Sachs and Collier wouldn’t have to propose a new Big Push in foreign aid and G8 interventions.
- Quarter of countries with highest average aid over last 42 years (average 16 percent of GDP for 42 years)...
- ...Have 0.4 percent growth of income per head per year over last 42 years.
- \$568 billion in aid went to Africa, zero rise in living standards over the last 42 years.

# Nobody is too poor to be free

- Data reject the concept of “poverty trap” – **poor economies grow at same rate as rich economies.**
- For the same degree of free market orientation, they tend to grow faster (“conditional convergence”)
- For example, poor countries like India and China have had no trouble escaping “poverty traps” through access to free markets

# Evidence against bureaucratic state-led approaches like PRSPs and MDGs

- Many bureaucracies, few aid successes.
- We already know the MDGs will not be achieved in Africa by 2015...
- ...just as many previous UN goals (universal access to water and primary education by 1990, or by 2000) were not achieved.
- The inescapable conclusion – collective UN goals are ineffective at achieving results.

# The paradox

- The evidence is that foreign aid does not end poverty, free markets end poverty
- So why are free markets losing the war of ideas to non-market solutions like foreign aid, PRSPs, and MDGs?

# Free markets are undermined by both their friends and their enemies

- Friends over-promise the short-run growth payoff from free market reforms
- Enemies reject free markets because these expectations are not met.
- Both sides are wrong to expect a large and predictable **growth** payoff from free market reforms
- Free markets should be judged as a development strategy for its **long run performance**, as reflected in **LEVELS** of per capita income

# Growth Failures that fueled the anti-market backlash

- The failure of “structural adjustment” or the “Washington Consensus” to generate strong growth in Africa, Latin America, and the Middle East in 80s and 90s.
- The failure of “shock therapy” to achieve a smooth transition from Communism to capitalism in the former Soviet Union.

# Why free markets is losing the war of ideas

Success under free markets is:

- Unpredictable
- Uneven
- Gradual
- The non-market solutions promise (1) predictable, (2) even, (3) rapid results, but the historical evidence does not support this!

Growth is unpredictable

# Unpredictable growth: Economists admit they don't know how to raise growth!

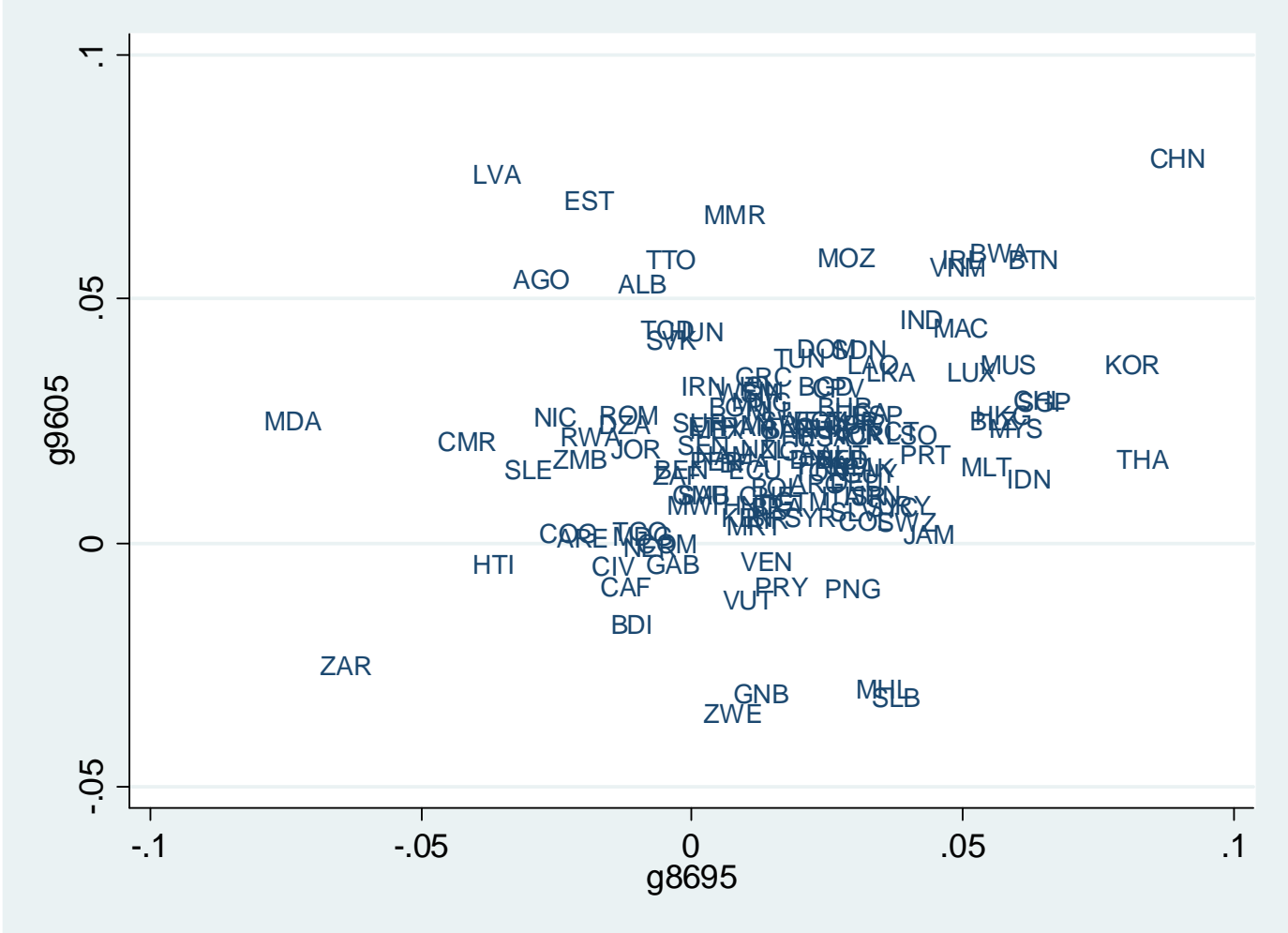
- “when you get right down to business, there aren't too many policies that we can say with certainty deeply and positively affect growth.” (Arnold Harberger 2003 (quoted in Rodrik 2006))
- “there is no single set of policies that can be guaranteed to ignite sustained growth..” The Barcelona Development Agenda (2004) {a consensus of leading economists like Blanchard, Calvo, Fischer, Frankel, Krugman, Rodrik, Sachs, and Stiglitz}

# Unpredictable growth

- “the experience of the last two decades has frustrated the expectations of policy advisers who thought we had a good fix on the policies that promote growth.” (Rodrik 2007)
- “The forces behind sustained growth are not fully understood, however. ... Successful countries have followed remarkably diverse growth strategies.” (World Bank, Spence Commission on growth and development 2007)

# Policies are stable across time, while growth is not...

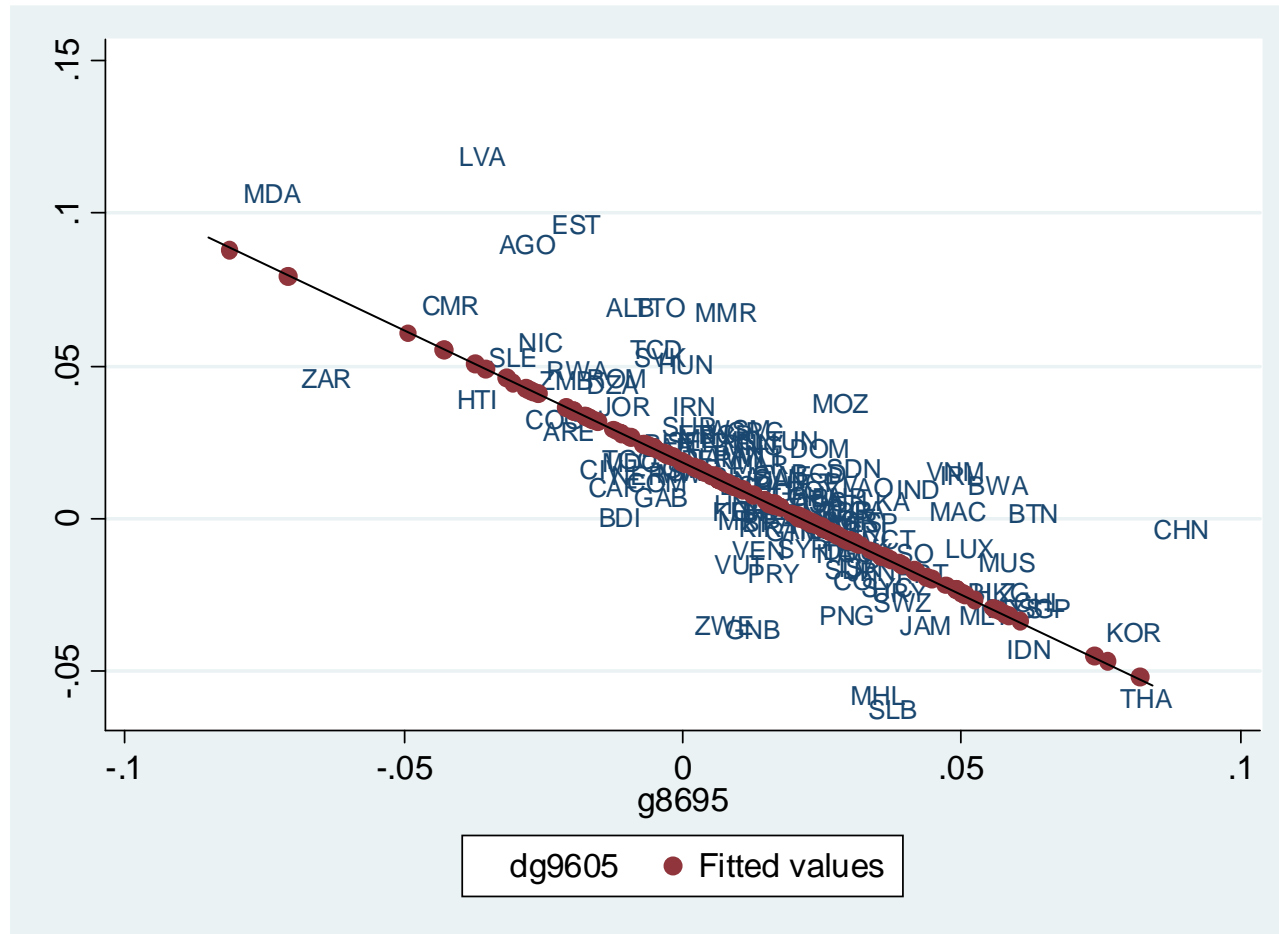
Per capita growth 1996-2005



Per capita growth 1986-1995

# ...so there is very strong mean reversion in growth (including East Asia!)

Change in growth from 1986-95 to 1996-2005



Previous growth rate (1986-95)

# We overreact to growth rates in devising policy formulas

- As Dixit (2006) says,
- “At any time, some country is doing well, and academic as well as practical observers are tempted to generalize from its choices and recommend the same to all countries. After a decade or two, this country ceases to do so well, some other country using some other policies starts to do well, and becomes the new star that all countries are supposed to follow.”

Success under free markets is  
uneven

# Export success is uneven: driven by a small number of “Big Hits”

**Share of # of products at 6-digit level indicated in total manufacturing export value within each country, 2004**

*Average for cross-country sample*

*Share of:*

top 3 products	34.7%
top 1 percent of products	51.5%
top 10 percent	87.0%
top 20 percent	94.3%
Bottom 50 percent	0.8%

# Amazing unevenness as to what product will succeed: examples of “big hits”

- the Philippines has captured 71% of world trade in electronic integrated circuits, and this single product out of more than 3000 6-digit manufacturing categories accounts for 33 percent of Filipino manufacturing exports.
- Egypt gets 30 percent of its manufacturing exports from bathroom ceramics, of which 93% goes to Italy.
- For non-manufacturing exports, surprise “hits” like pineapples in Ghana and cut flowers in Kenya.

# Just as in Hollywood, we can't predict what will be a hit

- “Nobody knows anything...Why did Paramount say yes {to Raiders of the Lost Ark}? Because nobody knows anything. And why did all the other studios say no? Because nobody knows anything. And why did Universal, the mightiest studio of all, pass on Star Wars?....Because nobody, nobody – not now, not ever – knows the least goddamn thing about what is or isn't going to work at the box office.”

# “Big Hits” lead to very uneven distribution of success

- Because some individuals, regions, firms, ethnic groups find “Big Hits” and the rest don’t, success is very uneven:
- Across individual incomes within a country (high income inequality under markets)
- Across regions (from Chinese interior to coastal provinces, from Appalachia to New York city in US)
- Across ethnic groups (surprising success of Chinese diaspora in SE Asia, Indians and Lebanese in Africa, particular African tribes)
- Across firms (a few gigantic firms, many failures)

# The poor can find “big hits” in markets too (but too few if the whole system doesn't favor markets)

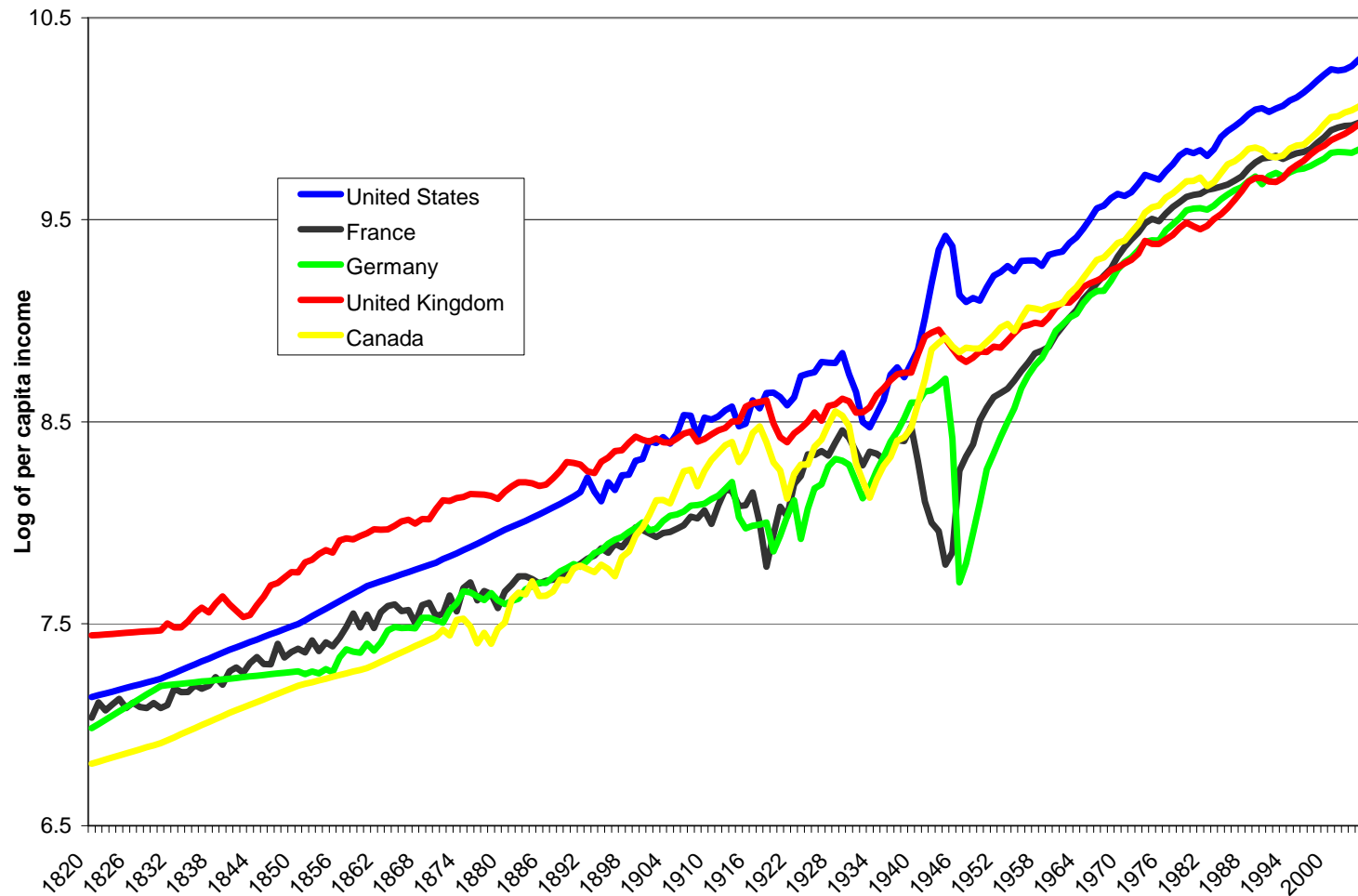
- Entrepreneur Alieu Conteh started building a cellular network in the Congo (former Zaire) when it was still in the midst of its brutal civil war in the 1990s. He couldn't get a foreign manufacturer to ship cellular towers into the country with rebel soldiers around, so he got local men to weld scrap metal into a makeshift tower. Demand exploded for his phones, and in 2001 he formed a joint venture with the South African firm Vodacom. One fisher-woman who lives on the Congo River, illiterate and without electricity, relies on her cell phone to sell her fish. She can't put the fish in a freezer, so she keeps them live on a line in the river until customers call to place an order. Vodacom Congo now has 6 million subscribers and has a market value of \$1 billion

A free market system is the only one that can generate a steady supply of big hits, because it is the only system in which there is total freedom where and to whom Big Hits will happen! This leads to GRADUAL progress out of poverty

Success is GRADUAL under  
free markets

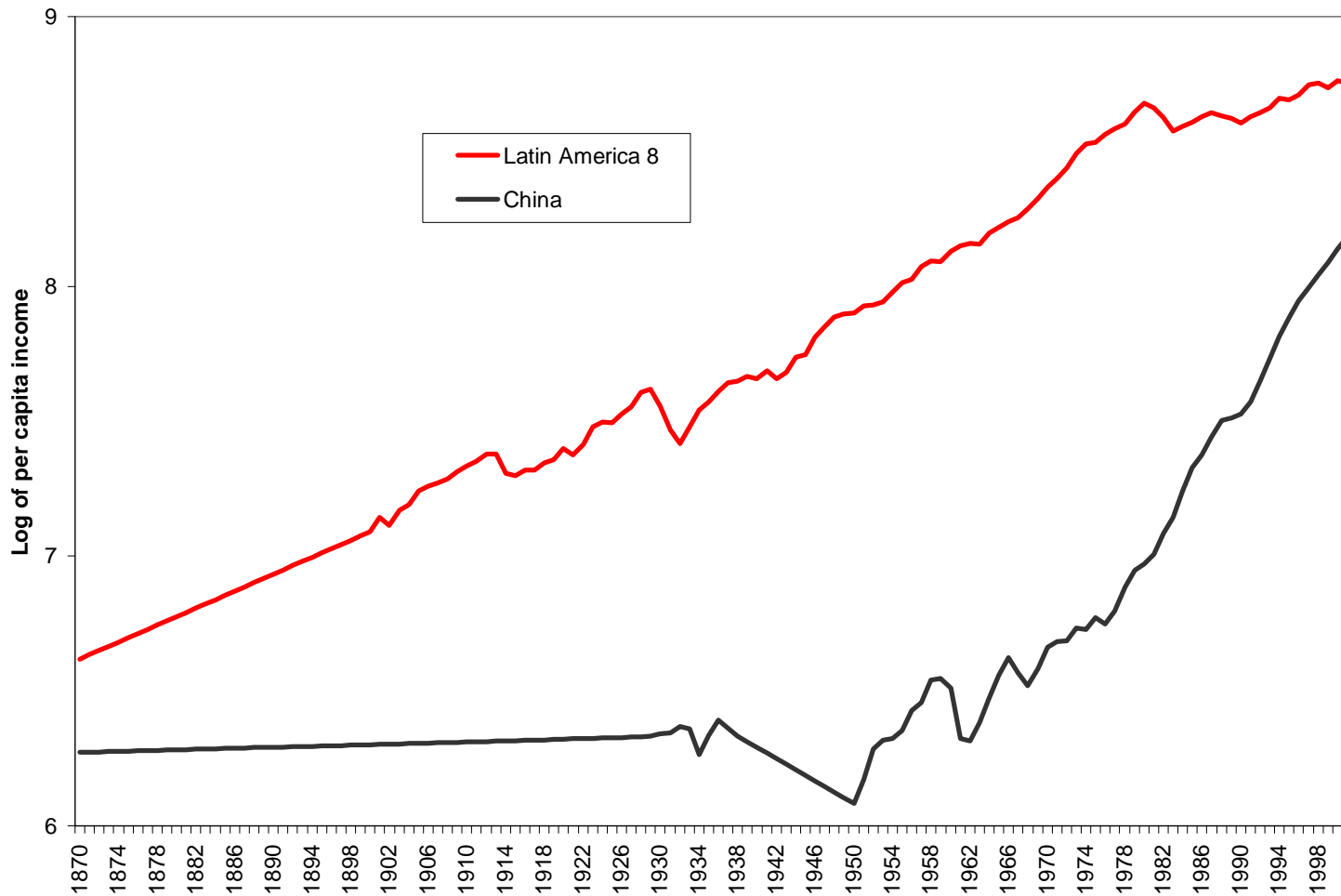
# Success under free markets is gradual but steady

Long run growth in rich countries, 1820-2005



# Long-run vs. Short Run: The Latin American success and the China failure?

Per capita income in China and Latin America, 1870-2001



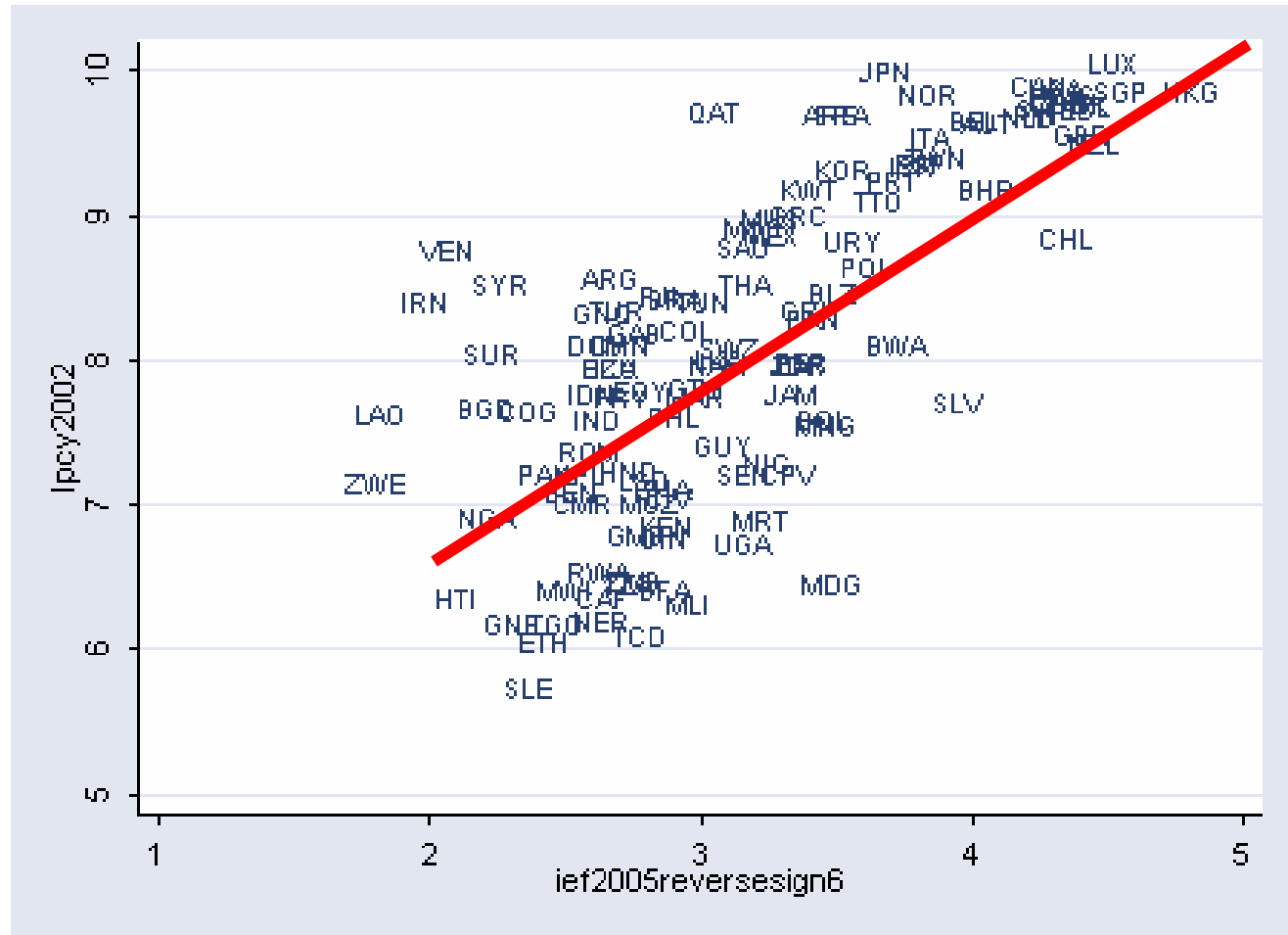
# Rapid sustained growth like the East Asia tigers is very rare

## Historical growth experiences 1820-2001

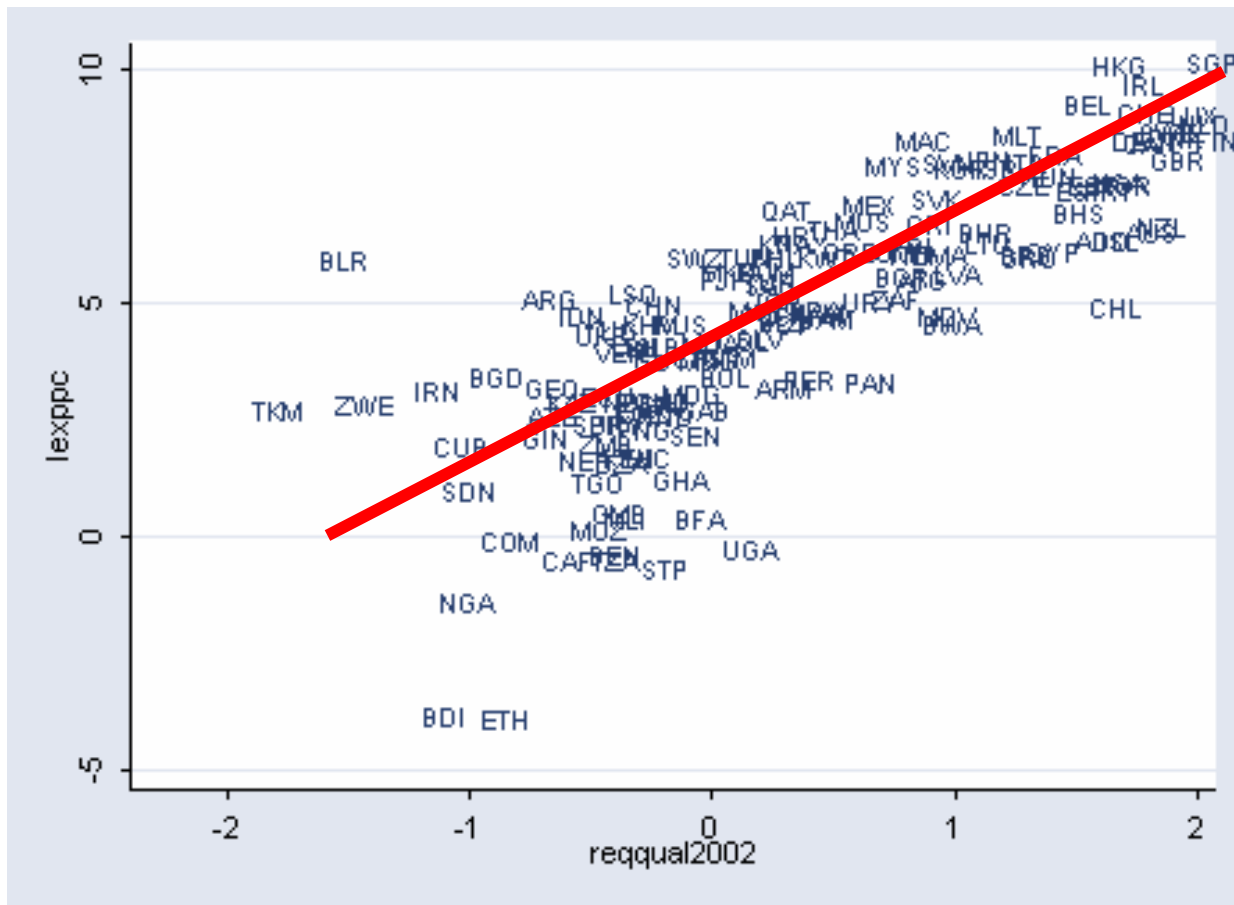
Average per capita growth over approximately 50 year period	fraction of sample above this growth rate for pooled sample of half centuries, 1820-2001	fraction of sample above this growth rate for 1950-2001
1%	40.6%	67.2%
2%	15.0%	43.7%
3%	5.8%	16.2%
4%	2.1%	6.0%
5%	0.7%	1.9%

# The Case for Free Markets is a long run case

Log per capita income



# Freedom from regulation and manufacturing exports per capita



# The free market is the optimal response to “nobody knows anything” (F.A. Hayek)

- “The interaction of individuals, possessing ... different views, is what constitutes the life of thought. The growth of reason is .. based on the existence of such differences. ... its results cannot be predicted, that we cannot know which views will assist this growth and which will not ... To “plan” or “organize” ...progress .. is a contradiction in terms. Individualism is ... an attitude of humility before this social process and of tolerance to other opinions and is the exact opposite of that intellectual hubris which is at the root of the demand for comprehensive direction of the social process.” .

# Aid

- There is a role for aid to heal the sick, educate the uneducated, and feed the hungry...
- ...which it could do a lot better if aid faced the same standards of accountability for results that private firms in the free market face...
- ...but the evidence does not give much hope that it is AID that will achieve the end of poverty.

# Markets

- Despite the disappointment with how UNPREDICTABLE, UNEVEN, GRADUAL are free markets, evidence for markets' poverty-reducing effect is far stronger than that for aid and bureaucracy.
- Free market capitalism must be the worst way to reduce poverty...
- ...except for all the other ways ever tried.