

# ADB DISTINGUISHED SPEAKERS PROGRAM

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on

## **Planners vs. Searchers in Foreign Aid**

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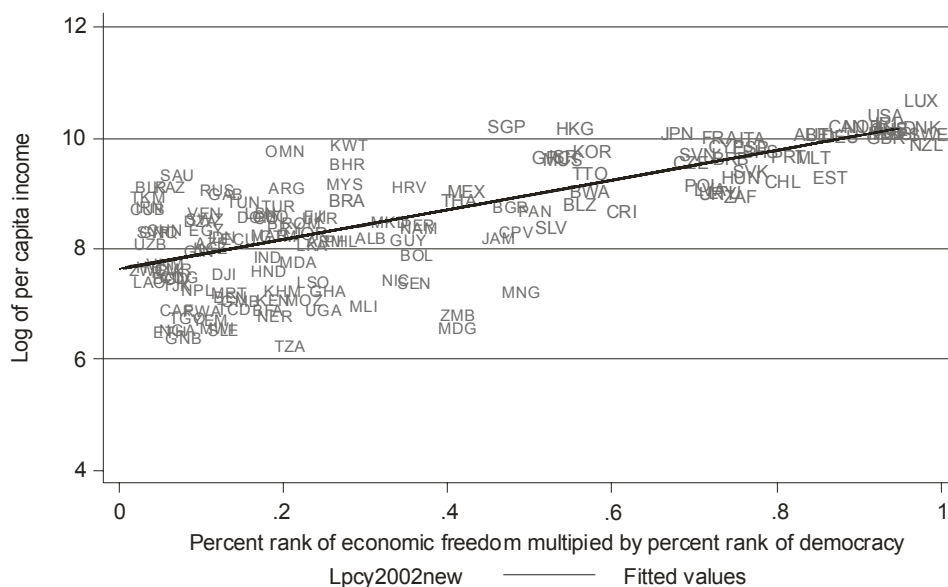
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## I. Introduction

Seventeen years after the fall of the Berlin Wall, there is only one major area of the world in which central planning is still seen as a way to achieve prosperity – countries that receive foreign aid. Behind the Aid Wall that divides poor countries from rich, the aid community is awash in plans, strategies, and frameworks to meet the very real needs of the world’s poor. These exercises only make sense in a central planning mentality in which the answer to the tragedies of poverty is a large bureaucratic apparatus to dictate quantities of different development goods and services by administrative fiat. The planning mindset is in turn linked to previously discredited theories, such as that poverty is due to a “poverty trap,” which can only be alleviated by a large inflow of aid from rich country to poor country governments to fill a “financing gap” for poor countries. The aid inflow is of course administered by this same planning apparatus.

This is bad news for the world’s poor, as historically poverty has never been ended by central planners. It is only ended by “searchers”, both economic and political, who explore solutions by trial and error, have a way to get feedback on the ones that work, and then expand the ones that work, all of this in an unplanned, spontaneous way. Examples of searchers are firms in private markets and democratically accountable politicians. There is a robust correlation (0.73) between economic and political freedom, on one hand, and economic development, on the other hand (figure 1).

Figure 1: Per Capita Income against a Multiplicative Index of Democracy and Free Markets



Of course, there are hard questions about direction of causality and exactly which attributes of political and economic freedom are most crucial for development. However, to deal with the first problem, since researchers know a little bit about the determinants of bad government, studies can explore whether bad government causes poverty, rather than (mainly) the other way around. We can take the part of bad government induced by the factors identified in the literature – such as commodity and natural resource endowments, historical colonization strategies, etc. – and

see if that part is associated with poverty. If so, that suggests that bad government causes poverty. We can also test whether these non-economic factors affect poverty directly, or only through bad government. Most of the research that takes this line finds that bad government does indeed cause poverty, and that the influence of the non-economic factors is only through bad government, not directly on poverty.<sup>1</sup>

The research is less successful at identifying which aspect of bad government matters, such as democracy versus corruption versus economic freedom. Different dimensions of good government tend to come together in packages, so it is hard to tell which is causing economic development. This last issue is much harder to resolve, but the correlations are at least supportive of strong theoretical priors that democratic and market accountability go with economic success, not to mention the vast historical and case study literature that supports this conclusion.

Another striking feature of the above graph is that the variance of outcomes is much higher at low levels of political and economic freedom than at high levels. For countries with nearly complete freedom, all of them are rich within a narrow range. For countries with intermediate levels of freedom, there is a vast range of development outcomes. The oft noted exceptions of Singapore and Hong Kong, who attained prosperity without democracy, lie in this middle range. However, so do very poor nations such as Madagascar, Mongolia, and Zambia. If we take cross-country evidence seriously, then the suggestion is that nations that fall short of freedom COULD become rich if they are lucky enough to have benevolent autocrats; however, they also COULD remain very poor. Democracy and free markets are ways to reduce the variance of outcomes as well as to improve the average outcome. Freedom is an investment with lower risk and higher returns than non-freedom, which should qualify it as an attractive investment opportunity. I argue here that this is because democracy and free markets create fertile territory for creative searchers, while autocracy and government interventionism gives power to ineffective planners.

What are some of the characteristics of planners and searchers? With free markets and democracy, economic and political searchers find products and public services that satisfy the customers and voters. In autocratic, centrally planned societies, planners produce shoddy goods consumers don't want, and heavily rationed and inferior public services that satisfy no-one, not to mention environmental disasters.

What is the counterpart in foreign aid? Here, Planners announce good intentions but don't motivate anyone to carry them out; Searchers find things that work and get some reward. Planners raise expectations but take no responsibility for meeting them; Searchers accept responsibility for their actions. Planners determine what to supply; Searchers find out what is in demand. Planners apply global blueprints; Searchers adapt to local conditions. Planners at the Top lack knowledge of the Bottom; Searchers find out what the reality is at the Bottom. Planners never hear whether the Planned got what they needed; Searchers find out if the customer is satisfied.

A Planner thinks he already knows the answers; he thinks of poverty as a technical engineering problem that his answers will solve. A Searcher admits he doesn't know the answers in

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<sup>1</sup> Daron Acemoglu, Simon Johnson and James A. Robinson, 2004, Institutions as the Fundamental Cause of Long-Run Growth, forthcoming in P. Aghion and S. Durlauf, Handbook of Economic Growth. April 2004W. Easterly and R. Levine, "Tropics, germs, and crops: the role of endowments in economic development" Journal of Monetary Economics, 50:1, January 2003. D. Rodrik, A. Subramanian, and F. Trebbi, "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development" Journal of Economic Growth, vol. 9, no.2, June 2004. Note that some of the results by Acemoglu et al. were challenged on the grounds of faulty data in some excellent work by David Albouy at Berkeley. However, studies that do not use this data still find a causal link between good government and income.

advance; he believes that poverty is a complicated tangle of political, social, historical, institutional, and technological factors. A Searcher only hopes to find answers to individual problems by trial and error experimentation. A Planner believes outsiders know enough to impose solutions. A Searcher believes only insiders have enough knowledge to find solutions, and that most solutions must be homegrown.

In foreign aid, Searchers could find ways to make a specific task work, like getting medicines to dying children, if they could concentrate on that task instead of Big Plans. They could test whether a specific task has a high payoff for the poor, get rewarded for achieving high payoffs, and be accountable for failure if it didn't work. We will see some areas where Searchers have already achieved tangible benefits, but the Searchers have had little chance to deliver because foreign aid has been dominated by the Planners.

The Planners have the rhetorical advantage of promising great things, the end of poverty. The only thing the Planners have against them is that Plans didn't (and don't) work to help the world's poor. Poor people die not only because of the world's indifference to their poverty, but also because of ineffective efforts on behalf of those who do care. To escape the cycle of tragedy, we have to be tough on the ideas of the Planners, even while we salute their good will.

Searchers look for any opportunity to relieve suffering, like say the cash for school program that has worked well in Mexico and Bangladesh, and don't get stuck on infeasible grand objectives, like Ending World Poverty. One of the key predictions about Planners that we will see confirmed in this paper is that the Planners keep pouring in resources at a fixed objective, despite many previous failures at reaching that objective, despite the models that guide the Plans being rejected by the data, despite a track record that suggests the objective is infeasible or the plan is unworkable. They fail to search for what does work to help the poor. Yet Searchers in aid are already finding things that help the poor, and we will see that they could find many more if the balance of power in aid were shifted from Planners to Searchers.

Two key elements that make searches work, and the absence of which is fatal to plans, are FEEDBACK and ACCOUNTABILITY. Searchers only know if something works if the people at the bottom can give feedback. This is why successful Searchers have to be close to the customers at the bottom, rather than surveying the world from the top. Consumers tell the firm "this product is worth the price" by buying the product, or decide the product is worthless and return it to the store. Voters tell their local politician that "public services stink" and the politician tries to fix the problem.

Lack of feedback is one of the most critical flaws in existing aid. It comes about because of the near-invisibility of efforts and results by aid agencies in distant parts of the world. To oversimplify a little, the needs of the rich get met because they give feedback to political and economic Searchers, and they can hold the Searchers accountable for following through with specific actions. A corporate head or government leader who doesn't satisfy the customers will lose his job. The needs of the poor don't get met because they have little money or political power with which to make their needs known and to hold somebody accountable to meet those needs. – they are stuck with Planners. Foreign aid is neither a democracy nor a free market.

Why are Planners so popular in foreign aid? In any human endeavor, the people paying the bills (or voting to pay the bills) are the ones to keep happy. The big problem with foreign aid is that the people paying the bills are rich people who have very little knowledge of poor people. The rich people demand Big Actions to solve Big Problems, which is understandable and compassionate. The Big Plans at the Top keep the rich people happy that Something Is Being Done (SIBD) about such a tragic problem as world poverty. Alas, if ineffective big plans allow SIBD

catharsis and take the pressure off the rich to help the poor, then the effective piecemeal actions will not happen.

More ineffective approaches survive in foreign aid than would if results were more visible. The Big Plans are attractive to politicians, celebrities, and activists who want to make a big splash, without the Western public realizing that the Big Plans at the top are not connected to reality at the bottom.

The working level people in aid agencies or non-governmental organizations (NGOs) are more likely to be Searchers than Planners. Unfortunately the political realities of rich countries just mentioned foist on these workers Big Plans, taking money, time, and energy away from the doable actions that workers discover in their searching.

## II. The Night of the Planners

The desire of the international aid community to estimate “aid needs” itself reflects how planning has taken over foreign aid. The terminology of “planning,” along with its synonyms of “framework” and “strategy” increasingly dominates aid discourse. The direct inspiration for this seems to be the Millennium Development Goals (MDGs) exercise. Lest you think I exaggerate, consider the following quote from Jeffrey Sachs and the UN Millennium Project on how to assess aid needs for the MDGs:

a needs assessment is a key input to... a policy *plan*... The second stage of the *planning* process will be for each country to develop a long-term (10-12 year) *framework* for action for achieving the MDGs... This MDG *framework* should include a policy and public sector management *framework* to scale up public spending and services, as well as a ... financing *strategy* to underpin the *plan*. The third stage of the *planning* process will be for each country to construct its medium term (3-5 year) poverty reduction *strategy* (PRS) based on the long term MDG *plan*. The PRS {poverty reduction *strategy*} is a more detailed, operational document, and should be attached to a Medium Term Expenditure *Framework* (MTEF). (emphasis added)

It is perhaps understandable that aid officials would turn to complicated plans, strategies, and frameworks in order to try to meet 54 Millennium Development Goals by 2015. (Wait, some will object that there are only 8 MDGs. Apparently embarrassed at just how baroque the MDG exercise is, the designers of the MDGs have grouped the 54 goals (called “indicators”) into 18 groups of “targets”, which are in turn aggregated into the 8 MDGs.) Sachs and the UN Millennium Project offer a package on how to achieve the 54 goals that makes 10 key recommendations (which are actually 36 recommendations when you count all the bullet points), “a bold, needs-based, goal-oriented investment framework over 10 years,” 17 Quick Wins to be done immediately, 7 “main investment and policy clusters,” and 10 problems to be solved in the international aid system. For 2015, they propose 449 separate interventions to meet the 54 MDGs in a 451 page main report with 3,300 pages of technical annexes. Jeffrey Sachs recommends that the UN Secretary-General personally run the Plan, coordinating the actions of thousands of officials in six UN agencies, the UN country teams, the World Bank, and the International Monetary Fund.<sup>2</sup>

For their part, the IMF and World Bank are fervent advocates of free markets for prosperity, not statist strategizing – but some unlucky countries are so poor that they face the requirement to

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<sup>2</sup> See Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time*, Penguin Press: New York, 2005, p. 285 and the UN Millennium Project, *Investing in Development*, January 2005.

do statist strategizing anyway. This is in the form of what is called a Poverty Reduction Strategy Paper (PRSP). The preparation of the PRSP requires planning that would overwhelm the most sophisticated government bureaucracy anywhere, much less the under-skilled and under-paid government workers in the poorest countries:

The sector ministries prepare medium-term strategic plans that set out the sector's key objectives, together with their associated outcomes, outputs, and expenditure forecasts (within the limits agreed upon by the Cabinet). These plans should consider the costs of both ongoing and new programs. Ideally, spending should be presented by program and spending category with financing needs for salaries, operations and maintenance, and investment clearly distinguished.<sup>3</sup>

If they have any time left after all this planning (not to mention time left after their meeting with the hundreds of donor missions that arrive every year to check up on the plan), they can also come up with a plan for those same donors, namely:

an external assistance strategy in the context of the PRSP process that explicitly identifies the priority sectors and programs for donor financing... More detailed external assistance strategies can then be developed for key areas through sectoral working groups in which representatives of major donors and line agencies participate... Agreeing on financing priorities for individual donors within the framework of a global external assistance strategy, rather than through bilateral agreements...<sup>4</sup>

At least the PRSP requirement is relaxed for failed states; it is instead limited to such peaceful, politically stable, abundantly-staffed, well-governed poor countries like Cambodia, Democratic Republic of the Congo, and Sierra Leone.<sup>5</sup>

The planning nightmare deepens further when we consider how each separate aid agency actor is offering its own plan, which it can only disguise by claiming that its plan is necessary for achieving the overall MDG plan. So we get such mixed-species curiosities as the World Bank's 2003 *Comprehensive Development Framework Progress Report*, whose main title is *Getting Serious About Meeting the Millennium Development Goals*. The Comprehensive Development Framework (CDF) of the World Bank (conceived by former President James Wolfensohn in 1999) still needs to be integrated into the MDG plan although it has since been superseded by the IMF and World Bank's Poverty Reduction Strategy Paper (PRSP) plan. Not to be left out of the planning race, even such unrelated organizations as the World Trade Organization offer an "Integrated Framework for Least Developed Countries (IF)" which of course will connect to everybody else's plans. The IF should "incorporate prioritized Action Plan (Action Matrix) into the country's national development plans such as PRSP."<sup>6</sup> The World Bank's admirable report on excessive red tape for private business in poor countries, called *Doing Business*,<sup>7</sup> has yet to turn its attention to the Gordian knot of CDF/ PRSP/ IF/ MTEF/ MDG planning.

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<sup>3</sup> Poverty Reduction Strategy Paper Sourcebook, Jeni Klugman, editor, World Bank: Washington DC, 2002.

<sup>4</sup> Ibid.

<sup>5</sup> <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/EXTPRS/0,,contentMDK:20240478~pagePK:210058~piPK:210062~theSitePK:384201,00.html>

<sup>6</sup> [http://www.wto.org/english/tratop\\_e/devel\\_e/teccop\\_e/if\\_e.htm](http://www.wto.org/english/tratop_e/devel_e/teccop_e/if_e.htm)

<sup>7</sup> World Bank (2005), *Doing Business in 2006: Creating Jobs*, Washington DC.

Who is motivated to effectively implement all of these plans? Who will be held accountable if the plans fail? Apparently, nobody. The Secretary General of the UN issued a progress report on the MDG plan for the UN World Summit on the MDGs in September 2005. Along with some successes in regions where foreign aid has little role (India, People's Republic of China (PRC), and East Asia), the report recited a litany of failure.<sup>8</sup>

"in sub-Saharan Africa, which already had the highest poverty rate in the world, the situation deteriorated further and millions more fell into deep poverty." (p. 6)

"The decline in hunger is slowing" (p. 7)

"Almost half of all deaths among children under age 5 occur in sub-Saharan Africa, where progress has slowed owing to weak health systems, conflicts and AIDS." (p. 19)

"A safe, effective and relatively inexpensive vaccine has been available for over 40 years. Still, measles strikes 30 million children a year, killing 540,000 in 2002 and leaving many others blind or deaf. Global coverage of measles immunization has risen slowly, but is lagging in Oceania, sub-Saharan Africa and Southern Asia, where about a third of all children are still unprotected." (p. 20)

"there was no change in sub-Saharan Africa, where maternal mortality is highest." (p. 23)

"Forests are disappearing fastest in the poorest regions" (p. 30)

"The growth in the number of slum-dwellers is outpacing urban improvement" (p. 35)

The UN Secretary-General's report documents that the MDG plan is failing. Yet it never occurs to the UN to take responsibility for failure of the plan the UN conceived, sponsored, and publicized. Instead, our attention is directed again to the question of "aid needs":

"If all new commitments are honoured, aid is expected to exceed \$100 billion by 2010. Still, this falls short of the amounts widely considered necessary to achieve the MDGs."

The IMF and World Bank's reports on the MDGs obey the same logic of failure without responsibility. We are first told of failure: "For the poorest countries many of the goals seem far out of reach" and then told of the need to expand aid: "Many of the poorest countries will need additional assistance and must look to the rich countries to provide it."<sup>9</sup>

In other words, the aid community should increase further the scale of the plans that are currently failing. The reason for pointing out failure is not to hold anyone accountable, but to document the continuing "aid needs," i.e. to give a rationale for further expansion of aid. The UN and the World Bank reports do not explain why the poor have a need for more of the same thing that previously failed to address the needs of the poor.

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<sup>8</sup> I am grateful to William Duggan of Columbia, who has his own articulate take on the paradox of UN highlighting failure while disavowing any responsibility, for calling this report to my attention.

<sup>9</sup> <http://ddp-ext.worldbank.org/ext/GMIS/gdmis.do?siteId=2&menuId=LNAV01HOME1>

Of course, the failure to meet goals could occur not just because of the poor effectiveness of the UN, the World Bank, and other international organizations in delivering services to the poor, but also because the goals were too optimistic or depend on factors beyond the control of the UN and the World Bank (this excuse is less applicable for something so measurable and doable as measles vaccination). Far from absolving the aid community, however, this only raises the question of why so much energy is devoted to a campaign (the MDGs) that does not create any positive incentives for any actors because it is over-promising on things that the actors cannot control. The World Bank itself cautions poor countries against setting targets in the PRSPs that are too optimistic for exactly this reason:

Most often {the PRSP targets} are overambitious; they are technically and fiscally unattainable, which defeats their role as effective incentives to action.<sup>10</sup>

While the same PRSP Sourcebook of the World Bank also warns:

it must be possible to disentangle the effects of poor performance by the implementing actors from the effects of external shocks.<sup>11</sup>

While international organizations hold the poor country governments to this standard, the international organizations that design the Millennium Development Goals are apparently themselves exempt from these same sensible rules.

The international organizations also seem oblivious to the problem of multiple goals and multiple agents for the incentive structure facing aid agencies. Having multiple goals (54 in this case) is equivalent to having multiple principals. It is well known in principal-agent theory that having multiple principals weakens overall incentives for the agent to deliver to any one principal. Indeed the optimal strategy for each principal is to try to penalize the agent for effort towards other goals in favor of effort towards the principal's own goal. In the aggregate, all the principals' incentives cancel each other out and the agent is left with little or no incentive. An agent with multiple tasks gets credit for doing some tasks, so he is not as motivated to complete any one task as an agent would be whose sole responsibility was that one task. To put this in everyday intuitive terms, a worker with multiple bosses can tell each one that he is too busy to work on their task because he is working on the other bosses' tasks (I speak from personal experience as such a worker).

Having multiple agents creates the obvious problems of collective action and free riders. If everyone is to blame if something goes wrong, then nobody is to blame.

Operating in the Bolivian mountains are the International Monetary Fund, the World Bank, the Interamerican Development Bank, USAID, the US Drug Enforcement Administration, the British Department for International Development (DFID), just about every other rich country's aid agency, multiple NGOs, and Bono. None of the agencies is responsible for a particular outcome. They jointly affect what happens to economic development in Bolivia. When something goes wrong in Bolivia, like the economic and political crisis in 1999-2005, after years of effort by these agencies, which one is to blame? We don't know, so no one agency is accountable. This weakens the incentive of agencies to deliver results.

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<sup>10</sup> Luc Christiaensen, Christopher Scott, and Quentin Wodon, Chapter 4: Development Targets and Costs, in Poverty Reduction Strategy Paper Sourcebook, Jeni Klugman, editor, World Bank: Washington DC, 2002.

<sup>11</sup> Ibid.



Introductory economics explains why cultivators with individual property rights (individual responsibility) get much better results than collective farms (collective responsibility). The Chinese economic miracle started with the realization of this principle in the Chinese countryside.

Jeffrey Sachs scorns these principles:

Although introductory economics textbooks preach individualism ... our safety and prosperity depend at least as much on collective decisions to fight disease, promote good science and widespread education, provide critical infrastructure, and act in unison to help the poorest of the poor. (p.3, *The End of Poverty*)

Of course, there are public goods, like those mentioned by Professor Sachs, in which collective action problems must be solved. Rich societies do this through democratic accountability of individual politicians and bureaucrats to the voters. Voters want roads, so they vote for politicians who set up specialized Road Ministries who are responsible for providing good roads. Rich country bureaucracy does not have collective responsibility of the Health, Foreign Affairs, Treasury, Defense, Pensions, and Sports Ministries for good roads. Rather, each one of these ministries is accountable for specialized tasks in its own area to the politicians, who are in turn accountable to the voters. That is why I can usually get a pothole in a road outside my house fixed with one phone call to a public official. Alas, the foreign aid system has neither democracy, nor accountability to the poor beneficiaries, nor specialized responsibility.

The IMF and World Bank have many well-trained economists aware of introductory economics textbooks, yet they still produce documents with statements by their respective leaders like

“How to generate momentum? This report sets out an agenda spanning the responsibilities of all key actors.”<sup>12</sup>

Instead of promoting individual agency accountability for specific tasks, the aid community engages in such fantasies of collective responsibility as the following.

The Paris High Level Forum on Harmonization, Alignment, and Results brought together developing countries, bilateral donors, global funds, UN agencies, civil society, and international financial institutions to assess progress and chart the way forward, including through monitoring of agreed indicators of progress.<sup>13</sup>

With such fatal defects, why are planners so popular? Why is the Millennium Development Goals exercise so widely embraced? The political economy of aid in the rich countries tends to reward grand gestures and utopian promises rather than piecemeal efforts to gradually improve the well-being and opportunities of the poor. The former attracts Bono, Angelina Jolie, and Tony Blair; the latter attracts only hard-working front-line aid workers who toil in the field mostly unnoticed by the rich country public and media. In other words, rich country politics rewards those who make the largest promises, particularly in a situation where there will be only be weak monitoring years later of whether the promises were kept (and even then the collective responsibility system will protect any one actor from being singled out to blame for failure.)

More prosaically, the MDGs are perhaps appealing to many aid agencies as they offer some hope for answering a question beloved by aid agencies: how to assess the need for aid.

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<sup>12</sup> IMF and World Bank, *Global Monitoring Report 2005*, Washington DC, p. xi.

<sup>13</sup> *Ibid.*, p. 235

Unfortunately, the models that allow one to calculate costs from goals are themselves vestiges of the long-since-discredited planning mentality that dominated the early days of development economics, as I will explore in the next section.

However, even if it were possible to estimate costs from goals, it only begs the question of how the goals were determined. Millennium Development Goal #1 is to cut in half the proportion of people living in extreme poverty (as well as halving the proportion of hungry people, with six indicators altogether, so as usual Goal #1 is actually six goals). Why half? Why not cut by two-thirds or three-quarters? Why does Jeffrey Sachs plan to achieve the end of poverty only by 2025, rather than 2020, or 2015? Even if we ignored the already fatal modeling problem, the only hope for pinning down “aid needs” is to pin down goals.

The PRSP Sourcebook that guides the IMF and World Bank PRSPs gives some crucial insight into what is going on with the Millennium Development Goals. The World Bank authors say:

Mobilizing resources is without doubt a primary function of targets set by the international donor community such as the International Development Goals.<sup>14</sup>

There is something to admire in the World Bank so brazenly stating that the whole thing was circular all along. The increased aid is required to reach the Goals. The Goals are required to increase aid. Although this circularity destroys any last shred of hope to determine at what number the “aid needs” reach closure, mathematical indeterminacy is nothing compared to the public relations genius of the whole exercise.

#### Caution: Searchers at Work

Just to give some anecdotal examples of how Searchers could deliver better results than the MDG charade, consider first how a Searcher contributed to a reduction in infant mortality in India. Diarrhea is a deadly disease that is a major contributor to infant mortality. A baby suffering from diarrhea and the dehydration it induces suffers from rapid heart beat, sunken eye-sockets, sunken indentations on the skull, and reduced nutrient supply to tissues and vital organs. If the baby survives, the diarrhea contributes to her malnutrition – the child will be stunted and abnormally thin. Commonly, the baby suffering from diarrhea-induced dehydration goes into shock and dies. Preparing food with unwashed hands spreads the bacteria and viruses that cause diarrhea.

C.K. Prahalad, a University of Michigan Business School professor, wrote in 2005 a fascinating book, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits* (2005). He shows how private firms can sometimes find it in their own interest to help solve some of the problems of the poor traditionally addressed by aid agencies. The Searchers in a free market do much better than aid agencies in solving specific problems of the poor, although having a profit incentive to do so is not the typical case. Still Prahalad’s book is a good reminder of what we know from free markets – self-interested behavior can do good things for others.

Prahalad gives the example of Hindustan Lever Limited (HLL), a subsidiary of the giant multinational Unilever. HLL sold a very simple product, soap, which it realized could find a larger market if they were tied to preventing diarrheal diseases for the poor. Hand-washing with soap is critical to prevent the spread of the viruses and bacteria that cause diarrhea. HLL realized that if it

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<sup>14</sup> Luc Christiaensen, Christopher Scott, and Quentin Wodon, Chapter 4: Development Targets and Costs, in *Poverty Reduction Strategy Paper Sourcebook*, Jeni Klugman, editor, World Bank: Washington DC, 2002.

could promote increased awareness among the poor of the benefits of anti-bacterial soap, products where it dominated the Indian market, it could significantly increase sales.

Getting people to use soap is not as easy as it sounds. Poor people are not well informed about the science of disease transmission. Most poor people only washed their hands if they were visibly dirty, not when their hands were covered with invisible germs after using the latrine or changing a baby's diaper. Invisible germs on hands were the main transmission mechanism for diarrhea. HLL had to actually change behavior.

To realize this market potential, HLL had to find ways of gaining the poor's trust in its health-promoting product. Working with government, aid agencies, and NGOs, it started educational programs. HLL started a program called Lifebuoy Swasthya Chetna, or Lifebuoy Glowing Health, which sent out two-person teams to present to schoolchildren how they could avoid stomach, eye, and wound infections by washing with Lifebuoy soap, and enlisted the village doctors to speak to the children's parents about how hand-washing with soap can prevent diarrhea and other health complications. Swasthya Chetna formed health clubs in the village.

Sales of HLL's antibiotic soap did indeed increase, and on its way to profits it also succeeded in convincing villagers to use a product that protected them against disease.

Searchers in India have taken on an even greater challenge that has foiled most efforts at solution – prevention of AIDS. Prostitutes in the red light district of Calcutta, India, Sonagachi, form a world unto themselves. Social norms about female sexual behavior in India are such that prostitution carries even a larger stigma in India than elsewhere. Cut off from the wider world, prostitutes have their own subculture, with an elite of madams and pimps. As in any subculture, its members strive for status. Prostitutes who aspire to greater status attain it most commonly by attracting long-term clients.

Many well-intentioned bureaucrats and planners have tried to help the prostitutes, "rescuing" them, and taking them to shelters to be trained in another profession like tailoring. However, sex work pays a lot better than tailoring, and former prostitutes face harassment and discrimination in the outside world. Hence, most "rescued" women returned to prostitution. The advent of the AIDS epidemic in India and the well-known role of prostitutes in spreading AIDS caused increased concern about these failures.

Dr. Smarajit Jana, head of the All India Institute for Hygiene and Public Health, had another idea in 1992. He and his team would learn the sub-culture of the prostitutes and work with it to fight AIDS. They formed a mutually respectful relationship with the madams and pimps, prostitutes, and clients. They noted the class system within Sonagachi. By trial and error, with feedback from the prostitutes, Dr. Jana and his team hit upon a strategy for fighting AIDS. The strategy was awfully simple in retrospect: they trained a group of twelve prostitutes to educate their fellow workers about the dangers of AIDS and the need to use condoms. The peer educators wore green medical coats when they were engaged in their public health work, and they attained greater status in Sonagachi. Condom use in Sonagachi increased dramatically. By 1999, HIV incidence in Sonagachi was only 6 percent, compared to 50 percent in other red-light-districts in India.

The project had other, unexpected consequences. The increased confidence of the peer educators and the media attention to the success of prevention efforts led the community to aspire to greater things. The prostitutes formed a union to campaign for legalization of prostitutions, a reduction in police harassment, and to organize festivals and health fairs. Dr. Jana's approach based on feedback from the intended beneficiaries succeeded when so many other AIDS prevention programs failed.

Next door in Bangladesh, another Searcher is contributing to the MDG of reducing maternal mortality. Death of mothers during childbirth is virtually unknown in rich countries, but is tragically common in poor countries. Instead of the new life with childbirth that many of us in rich countries count as the most supreme moment in a lifetime, a grieving family in a poor country must confront the death of the wife and mother (and often of the newborn baby as well). The woman herself dies in agony due to such causes as the seizures and severe agitation of eclampsia. Eclampsia (and other causes of death in childbirth) can be prevented with prenatal care that recognizes the warning signs and gets the woman to the hospital once she displays symptoms. Providing such prenatal care is a major challenge in poor countries.

Feroza Yasmin Shahida is a 19-year-old Bangladeshi girl. From a poor peasant family, she got a scholarship from a program run by USAID and the World Bank to finish secondary school. Now she is a paramedic on a bicycle responsible for 515 families in the countryside around Savar, Bangladesh. She is the only health worker these 515 families have. She earns \$25 a month working for Gonoshasthaya Kendra (GK), the People's Health Center.

GK is the brainchild of Dr. Zafrullah Chowdhury (affectionately called Dr. Zaf), a Bangladeshi doctor who returned from Britain after Bangladesh won its independence in 1971. He trained teenage girls to treat common ailments, deliver prenatal and postnatal care to pregnant women, and refer any emergencies to the hospital that Dr. Zaf built. Foreign donors and the Bangladeshi government gave Dr. Zaf money, but he also charged his poor patients modest fees to expand services further. He found that even the poor are willing to pay for good service. Charging the poor modest fees for health care – a notion that outrages globalization activists – is a way to increase accountability for delivering health services. If the villagers don't get good service after they sacrificed to pay for it, they loudly complain. Dr. Zaf says "If a woman dies, the worker has to face the village. Accountability is here." GK has been successful in lowering deaths in childbirth, infant mortality, and also the number of children women choose to have. Maternal mortality in the area covered by GK is a fourth of the national average.

If Feroza continues to be one of Dr. Zaf's best paramedics, she will be promoted to supervisor, with a raise to \$100 a month and a scooter instead of a bicycle. Dr. Zaf had searched for and found a piecemeal way to improve the lot of the Bangladeshi poor.

Another Searcher in Bangladesh was Mohammed Yunus, the founder of the Grameen Bank and the main inventor of the microcredit schemes to credit to poor people, didn't start off with the goal of giving poor people credit. As Columbia University Business School Professor Bill Duggan tells the story in a great book about people who find things that work, *Napoleon's Glimpse*, Yunus started off with the conviction that the Green Revolution and irrigation was the answer to poverty in Bangladesh. His doctoral dissertation at Vanderbilt University was titled "Optimal Allocation of Multi-Purpose Reservoir Water: A Dynamic Programming Model." His first attempt to help the poor was to sponsor tube wells for irrigation during the dry season so farmers could grow two crops a year. He gave the farmers a loan out of his own money to finance the scheme. The farmers reaped a good harvest. Ironically, for the founder of the idea that the poor can be a good credit risk, the farmers didn't fully repay him and he lost money. But Yunus persisted, the city boy visiting as many rural villages as possible to try to understand how to help. He encountered a woman making a bamboo stool named Sufiya Begum. She made a pitiful two cents on every stool, mainly because a moneylender charged her a very high interest rate (around 120 percent per year) to advance her the bamboo. He realized that very small loans to very poor people could make a big difference in their lives. Contrary to conventional wisdom at the time, he realized that the poor had a huge untapped demand for credit. He experimented, and found that microcredit borrowers would repay the loan in order to get access to future loans and also because of peer pressure from other microcredit borrowers. His first loan was to Sufiya Begum, who started a successful peddling

business with the money instead of making more bamboo stools. There was a huge demand for such loans, and Grameen Bank became the legend that it is today, with imitators from all over the world.

Microcredit is not the panacea for poverty reduction that some made it out to be after Yunus' discovery. Some disillusionment with microcredit has already come in response to these blown-up expectations. Microcredit didn't solve everything; it just solved one particular problem – the poor's lack of access to credit except at usurious rates from moneylenders – under one particular set of circumstances.

Bottom-up searchers can emerge in unlikely places. In the tiny village of Xiaogang, Anhui province – the heart of PRC's rice-growing region – twenty families held a secret meeting in 1978. The villagers were desperate because they were starving. As Stanford economist John McMillan tells the story, the commune system which the Communists had in place all over PRC was leading to a breakdown in food production. Under this system, everybody was collectively responsible for tilling the land, and everybody had a share in the land's output. Under this system, you got your rice share whether you worked hard or not, and as a result people hardly worked. The villagers of Xiaogang reached an agreement – they would divide up the land and farm it individually, with each person keeping the output of his own land. They kept their agreement a secret out of fear of the Communist authorities. Rice production in Xiaogang shot up. The results were too spectacular to stay secret for long. Neighboring villages wanted to know how Xiaogang had increased their rice production so much. Other villages also put into place individual farming.

Before long, the Communist authorities got wind of the spontaneous outbreak of property rights in the countryside. The news arrived at a propitious moment, when reformers in the Party were seeking to get rid of the doctrinaire Maoists. Confronted with the evidence that food production increased dramatically with individual farming, the provincial Communist Party officials gave their blessing, and reported the developments to authorities in Beijing. By 1982, a Communist Party conference ratified what had already happened in the countryside, approving individual farming. By 1984, there were no communes left.<sup>15</sup> This was just one pebble that started the landslide of the Chinese economic miracle.

### **III. The Ghosts of Models Past**

If Rip Van Winkle were an aid policymaker, he could have gone to sleep in 1955 and woken up in 2005 without too much discomfort. The same models that were used in the 1950s to justify foreign aid are used today in 2005 to justify foreign aid, unfortunately distracting attention from the real problems of creating incentives to make aid effective. There are four models, all of them now discredited in the literature, that underlie the Planning approach to foreign aid:

1. The “financing gap” or “two-gap” model of aid, investment, and growth
2. The “poverty trap” model of underdevelopment
3. The government to government aid model
4. The expenditure to outcomes model in health and education

I turn to these four models in turn.

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<sup>15</sup> John McMillan, *Reinventing the Bazaar: A Natural History of Markets*, Norton: New York, 2002, pp. 94-95.

## 1. The Ghost of Financing Gap

One of the most widely cited papers estimating the costs of meeting the Millennium Development Goals is by Devarajan, Miller, and Swanson (2002), all World Bank researchers.<sup>16</sup> One has to feel some sympathy for the contortions these well-regarded authors had to go through to arrive at an estimate, which they pretty much say they do not believe themselves. The central exercise in the paper is to use the “financing gap” or “two-gap” model of aid, investment, and growth to estimate aid requirements.

According to this model, economic growth is proportional to investment, which in turn is financed by domestic saving plus foreign aid. To reduce poverty rates by half (Goal #1 of the MDGs), you calculate a “required growth rate.” This in turn determines a “required investment rate.” If domestic savings is not adequate to finance “required investment,” then there is a “financing gap” – the difference between required investment and available savings. The role of aid is to fill the financing gap. (Another variation on this model was the “two-gap model,” which had a foreign exchange gap in addition to the investment-saving gap. However, at this point the less time we waste on exposition of these gaps, the better.) The model thus predicted that investment would increase one for one with aid and that an increase in investment would have a predictable, stable, immediate effect on growth. Thus aid seemed to be a panacea for creating economic development. The development economics literature had discarded these simplistic predictions after the 1960s and 1970s in the face of evidence to the contrary.<sup>17</sup>

In case there is any doubt that this is exactly the model the authors are using, they say,

To estimate the additional ODA {overseas development assistance} needed to reduce poverty rates to half of the 1990 levels, we begin with a simple, “two-gap” growth model in which growth depends upon the level of investment and the efficiency with which investment is turned into output.

In a footnote, the authors note that the gap model suffers from some defects, namely being outdated and wrong:

“The workhorse development model of the 1960s and 1970s, the two-gap model has been criticized as being inappropriate for projections (Easterly [1999]) and for analyzing policies (Devarajan et al. [1997]) and poverty (Devarajan et al. [2000]).”<sup>18</sup>

In other words, the authors themselves give no reason to believe in the model (including their own previous research). Still the estimates made in this paper on the basis of this lack of conviction became the benchmark for much of the discussion about the “aid needs” for the MDGs. Coincidentally, the calculation was that aid should approximately double, the same increase that World Bank President James Wolfensohn had called for publicly before the paper was written (simultaneously embraced by Tony Blair, Gordon Brown, Bono, and other dignitaries).

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<sup>16</sup> Shantayanan Devarajan, Margaret J. Miller, Eric V. Swanson, Goals for Development: History, Prospects, and Costs, World Bank Policy Research Working Paper 2819, April 2002.

<sup>17</sup> See discussion in W. Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, MIT Press: Cambridge MA, 2001, chapter 2.

<sup>18</sup> The references are Devarajan, Shantayanan, et. al. 1997. “Simple General Equilibrium Modeling.” In J. Francois and K. Reinert, eds., *Applied Methods For Trade Policy Analysis : A Handbook*. New York: Cambridge University Press; Devarajan, Shantayanan and Delfin Go. 2000. “A Macroeconomic Framework for Poverty Reduction Strategies.” Washington, D.C.: World Bank (processed); Easterly, William. 1999. “The Ghost of Financing Gap: Testing the Growth Model Used in the International Financial Institutions.” *Journal of Development Economics* 60(2): 23-38.

## 2. The Poverty Trap<sup>19</sup>

The second model assumes that the poorest countries are in a *Poverty Trap*, from which they cannot emerge without an aid-financed *Big Push*, involving investments and actions to address all constraints to development, after which they will have a *Takeoff* into self-sustained growth and aid will no longer be needed. This was exactly the story that gave birth to Foreign Aid in the 1950s; it is exactly the story that the advocates of a massive aid increase are giving today.<sup>20</sup>

According to Jeffrey Sachs and the UN Millennium Project (for example), the Big Push of massive aid increases is supposed to get poor countries out of a “poverty trap,” which automatically prevents very poor countries from growing. As Jeffrey Sachs explains it in his 2005 book “The End of Poverty” (pp. 56-57):

When people are ... utterly destitute, they need their entire income, or more, just to survive. There is no margin of income above survival that can be invested for the future. This is the main reason why the poorest of the poor are most prone to becoming trapped with low or negative economic growth rates. They are too poor to save for the future and thereby accumulate the capital that could pull them out of their current misery.

Sachs also argues the poverty trap stems from increasing returns to capital:

An economy with twice the capital stock per person means an economy with roads that work the year round, rather than roads that are washed out each rainy season; electrical power that is reliable twenty-four hours each day, rather than electric power that is sporadic and unpredictable; workers who are healthy and at their jobs, rather than workers who are chronically absent with disease. The likelihood is that doubling the human and physical capital stock will actually *more* than double the income level, at least at very low levels of capital per person. ( p. 250)

Under these circumstances, Sachs argues, “foreign aid ... would enable the economy to break out of the poverty trap and begin growing on its own.” (p. 250)

We can check this story out. We have data on per capita income from 1950 to 2001 for 137 countries from a statistical compilation done by the economist Angus Maddison (I exclude Communist economies and Persian Gulf oil producers as special cases). We rank countries according to their per capita income in 1950. Did the poorest countries in 1950 remain stuck in poverty over the next half century? Well, no. The poorest fifth of countries in 1950 increased their income over the next five decades by a factor of 2.25 times. The other four-fifths of countries increased their incomes by a factor of 2.47 times. The difference in growth rates between the two groups is not statistically distinguishable from random fluctuation. We can statistically reject that the growth rate of the poorest countries as a group was zero. Examining all periods, only the 1985-2001 period fits the “poverty trap” story; I will return to this period shortly.

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<sup>19</sup> This section is based on W. Easterly, “Reliving the 50s: Poverty Traps, the Big Push, and the Takeoff in Economic Development,” NYU Development Research Institute Working Paper, 2005

<sup>20</sup> The classic references are Paul Rosenstein-Rodan, Sir Arthur Lewis, and Walt Rostow.

### Testing the Poverty Trap for Long Periods

Per capita growth per year for:	1950-2001	1950-75	1975-2001	1980-2001	1985-2001
Poorest fifth at beginning of period indicated	1.6%	1.9%	0.8%	0.5%*	0.2%*
All others	1.7%	2.5%**	1.1%	0.9%	1.3%**
Reject stable income for poorest fifth	Yes	Yes	Yes	Yes	Yes
Fail to reject unstable income for poorest fifth	Yes	Yes	Yes	Yes	Yes

\*Poorest fifth not statistically distinguishable from zero

\*\*All others's growth statistically distinguishable from poorest fifth

Sample: 137 countries. Statistical tests exclude 12 transition economies and Gulf oil states

There are further statistical tests we can do to assess the poverty trap hypothesis. If the poverty trap hypothesis holds, then the poorest countries should have stagnant income at a very low level. Income will fluctuate randomly around this level, but will always tend to return to it. There are two ways we can test whether low income countries have stationary income. We can assume stationarity and see whether the data reject that assumption, or we can assume nonstationarity and see whether the data fail to reject nonstationarity. When we do a test for the stagnation of income over the subsequent half century for the poorest fifth of countries in 1950, we decisively reject the hypothesis of stationarity. When we assume nonstationarity – such as positive growth – the data provide no evidence against that assumption.

Perhaps it was aid that enabled poor countries to break out of stagnant income? When I break the sample in half into those poor countries that had above average foreign aid and below average foreign aid, I find identical results 1950-2001 in both halves as with the above tests of stationarity. Over 1950-2001, countries with below average aid had the same growth rate as countries with above average foreign aid. Poor countries without aid had no trouble having positive growth.<sup>21</sup>

To be sure, there were individual poor countries that failed to grow among the poorest countries. Chad had zero growth from 1950 to 2001. Zaire/Democratic Republic of the Congo actually had negative per capita growth over this period. Aid still has a role to help those unlucky enough to be born into a stagnant economy.

The stagnant economies were offset by such success stories as Botswana, which was the fourth poorest in 1950, but increased its income by a factor of 13 by 2001. Lesotho was the fifth poorest in 1950, but increased its income by a factor of 5 over the half-century. Other subsequent success stories who were among the poorest in 1950 are PRC and India.

Let us keep looking for confirmation of the two main predictions of the poverty trap story: (1) that growth of the poorest countries is lower than other countries, and (2) per capita growth of the poorest countries is zero or negative. The poorest did have lower growth in an earlier period, 1950-75, than the others. However, this was not a poverty trap, as average growth of the poorest during 1950-75 was still a very healthy 1.9 percent per year (roughly the same as the long-run growth rate of the American economy, for example).

There is no evidence of lower growth for the poorest countries for recent periods, like 1975-2001 or 1980-2001. Their growth was disappointing – much worse than in the previous period

<sup>21</sup> More systematically, a large literature on aid and growth fails to find a robust causal link from aid to growth or to investment. See Rajan and Subramanian (2005) for a survey of where this literature stands now, and for their own tests of the aid and growth relationships.



– but so was growth in middle income countries. The poorest fifth of countries at the beginning of those periods had growth performance over the subsequent period that was statistically indistinguishable from the other four-fifths of countries. Only when the starting point is put in 1985 does there finally appear evidence that the poorest did worse.

The evidence that Jeffrey Sachs adduces for the poverty trap in his book *The End of Poverty* is from this later period. So over 1985 to the present, it is true that the poorest fifth of countries have significantly lower per capita growth than other countries, about 1.1 percentage points lower over. Even for this period, we reject the hypothesis that all of the poorest countries had stable per capita income for 1985 to the present.

The numbers in the table don't seem to add up. The poorest countries did not have lower growth in the whole period 1950-2001, but they had slightly lower growth in 1950-75 and much lower growth in more recent periods. The solution to the conundrum is that the identities of the poorest countries at the start of each period show keeps changing. It doesn't help the poverty trap story that 11 out of the 28 poorest countries in 1985 had NOT been in the poorest fifth back in 1950. They had gotten into poverty by declining from above, rather than being stuck in it from below, while others escaped. If the identity of who is in the poverty trap keeps changing, it must not be much of a trap.

To make things worse, the poorest countries were getting more in foreign aid as a percent of their income in the last decade, compared to the previous decades (as we saw for Africa above). Foreign aid is supposed to be helping the poor countries escape from the poverty trap; hence the poorest countries in the recent decade should have been LESS likely to be stuck in poverty than the previous decades with lower foreign aid. (I can also separately test whether aid raises economic growth, which I will do next.) All told, there is not very strong evidence of a poverty trap snapping shut on the poorest countries.

Other scholars have also failed to find any evidence for a “poverty trap.”<sup>22</sup> Aart Kraay and Claudio Raddatz in a January 2005 paper studied the saving rate and found that that saving *does* not behave the way the poverty trap requires at low income. The reasons countries stay poor must lie elsewhere.

### 3. The Government to Government Aid Model

What about the period of lower growth and stagnation in poor countries in 1985-2001 shown above? The UN Millennium Project and Jeffrey Sachs argue that it is the poverty trap rather than bad government that explains poor growth of low income countries and the failure to make progress towards the Millennium Development Goals (MDGs). Sachs says “the claim that Africa’s corruption is the basic source of the problem {the poverty trap} does not withstand practical experience or serious scrutiny.”<sup>23</sup> Likewise the Millennium Project says “Many reasonably well governed countries are too poor to make the investments to climb the first steps of the ladder.”<sup>24</sup>

The search for the elusive “well governed low income countries” casts a broad net. The Millennium Project report lists 63 poor countries that are “potentially well governed,” and thus

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<sup>22</sup> Aart Kraay and Claudio Raddatz, *Poverty Traps, Aid, and Growth*, World Bank mimeo, January 2005 and Bryan Graham and Jonathan Temple, 2004. “Rich Nations, Poor Nations: How much can multiple equilibria explain?,” mimeo, Harvard University, 2004

<sup>23</sup> Jeffrey D. Sachs, *The End of Poverty: Economic Possibilities for Our Time*, The Penguin Press: New York, 2005, p. 191

<sup>24</sup> UN Millennium Project Report, *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals: Main Report*, p. 34.

potentially eligible for a massive increase in foreign aid. The list includes 5 out of the 7 countries singled out by Transparency International in October 2004 as the most corrupt in the world: Azerbaijan, Bangladesh, Chad, Nigeria, and Paraguay. The list of “potentially well governed” countries also includes fifteen governments that Freedom House classifies as “not free.” Such dictators as Paul Biya of Cameroon, Hun Sen of Cambodia, and Ilham Aliyev of Azerbaijan are on the list. President Aliyev of Azerbaijan scored a double as most autocratic and most corrupt since he was “elected” to succeed his autocratic father in 2003.<sup>25</sup>

Although convinced that bad government was not the problem, the UN report did rule out aid to the four most awful rulers in the world. The report identifies these 4 governments -- Belarus, Myanmar, North Korea, and Zimbabwe -- as beyond the pale. This is a pretty small number for bad governments of the world. Even a dictator like Saparmurat Niyazov of Turkmenistan, who so terrorizes his country that he renames the months of the year after himself and his late mother, can't get into the UN bad despots club.

Why does it matter whether it is bad government or a technological poverty trap? The case for planning is even weaker if planners must deal with the complexities of bad government. Jeffrey Sachs worries in *The End of Poverty*: “If the poor are poor because ... their governments are corrupt, how could global cooperation help?”<sup>26</sup> Unfortunately, whether poor country governments are corrupt must be determined by evidence, not by hopes for global cooperation.

The UN seems desperately to want to deny the existence of bad government because it threatens another cherished model of traditional aid delivery: the government to government aid model. In this view, the altruistic rich country government (either directly or through multilateral organizations) gives money to an altruistic poor country government, who implements aid projects to benefit the poor in the poor country.

Let us test bad government against the poverty trap as a story for poor economic growth. The earliest rating we have on corruption is from 1984, from the International Country Risk Guide. We have a rating on democracy for the same year from a research project at the University of Maryland called Polity IV. Let's take countries that have the worst ratings on both corruption and democracy, and call these countries “bad governments.” While poor countries did worse, it's also true that the 24 countries with bad governments in 1984 had significantly lower growth 1985 to the present: 1.3 percentage points slower than the rest. There is some overlap between these two stories, as poor countries are much more likely to have bad government. So which is it, bad government or the poverty trap? When we control for both initial poverty and bad government, it is bad government that explains the slower growth. We cannot statistically discern any effect of initial poverty on subsequent growth once we control for bad government. This is still true if we limit the definition of bad government to corruption alone. The recent stagnation of the poorest countries appears to have more to do with awful government than with a poverty trap, contrary to the Sachs hypothesis.

Actually if the UN Millennium Project report about escaping the well-governed poverty trap had looked in its own country studies, it would have found interesting clues to this result, such as the following vignette on Cambodian school-teachers: “many supplement their income by soliciting bribes from students, including the sale of examination questions and answers....the end result is a high dropout rate.”<sup>27</sup>

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<sup>25</sup> <http://www.underreported.com/modules.php?op=modload&name=News&file=article&sid=1241>

<sup>26</sup> Sachs 2005, p. 226

<sup>27</sup> UN Millennium Project Report, Millennium Development Goals Needs Assessment, January 2005, p. 119

The international aid Planners have remained stuck on the government to government aid model even though decades of evidence have accumulated against it. Another camp of Planners has a variant on the UN model of overlooking bad government. This other camp (associated with the US government, World Bank, and IMF) says poor country governments are bad and the West should get tough with the bad governments – force them to change in return for aid. This contrasts with the UN/ Sachs camps that says poor country governments are not so bad and they should be free to determine their own development strategies. However, this artificially restricts the debate. It may be true that poor country governments are bad, and it may be just as true that Western attempts to change them have been fruitless.

We see here that bad government has a lot to do with low growth of poor countries that were allegedly in “poverty traps.” In the introduction, we saw some evidence that bad government has a lot to do with them being poor in the first place.

Along with these formal data, we have plenty of anecdotes of what a poor job the state does in poor countries in enforcing contracts or protecting property and persons. In one poor neighborhood in Thailand, the police were so ineffective that parents reported keeping children out of school to guard against break-ins.<sup>28</sup> Police in Mtamba, Malawi gave crime victims the unwelcome assignment of catching the thief or murderer and delivering them to the police station.<sup>29</sup> The police, far from enforcing property rights, often seize property themselves to extort bribes. The police seized the tea shop of Ali Ahmad in Patna, India and detained him. He bribed the policeman 920 rupees to get his shop back, which his wife borrowed at a high interest rate from a neighbor. The police and criminals collaborate in blackmail, harassment, and extortion from shop owners and vegetable sellers in Patna.<sup>30</sup>

The world’s 25 most undemocratic government rulers (out of 199 countries the World Bank rated on democracy) got a sum of \$9 billion in foreign aid in 2002. Similarly, the world’s 25 most corrupt countries got \$9.4 billion in foreign aid in 2002. The top 15 recipients of foreign aid in 2002, who each got a more than a billion dollars each, have a median ranking in the worst fourth of all governments everywhere in 2002 (ranked by democracy, corruption, etc.). It would be good to get aid from the rich of rich countries to the poor of poor countries, but what we see happening is that aid shifts money from being spent by the best governments in the world to being spent by the worst. What are the chances that these billions are going to reach poor people?

There has been some progress over time. Ten years ago, the aid donors, World Bank, and IMF seldom discussed corruption or dictatorship. Since then, Donor Talk Radio has been full of chatter about “good governance.” Unfortunately, rhetoric has outpaced action. Donors have still not figured out what to do to make good governance happen, or how to be selective to whom they give their money.

More systematically, Alberto Alesina of Harvard and Beatrice Weder of the University of Mainz have found no evidence that aid donors give less aid to corrupt countries; in fact, in some of their statistical analyses donors gave more aid.<sup>31</sup> Have things changed over the past few years? In 1996, there was no association between how much aid per capita a developing country received and its rating on the World Bank measure of corruption (controlling for other determinants of aid per capita, like per capita income and population size). Six years later in 2002, after oceans of ink on

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<sup>28</sup> World Bank, *Voices of the Poor*, Volume 1, p. 181

<sup>29</sup> World Bank, *Voices of the Poor*, Volume 3, p. 71

<sup>30</sup> *Voices of the Poor*, Volume II, Chapter 8.

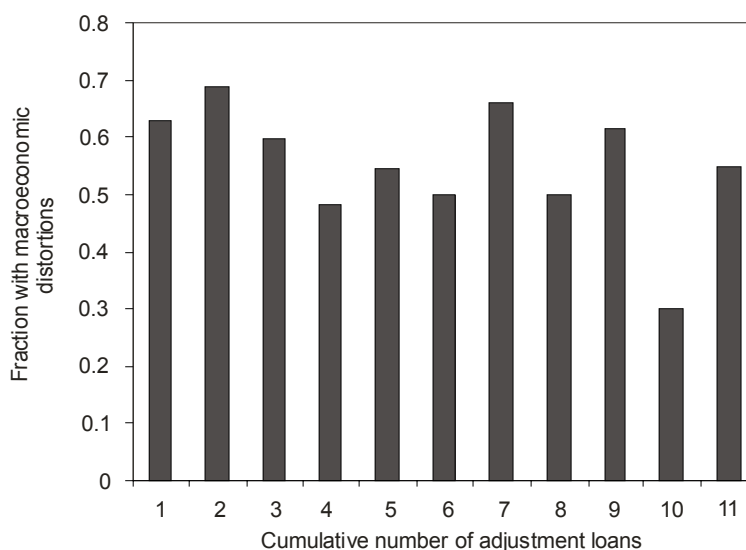
<sup>31</sup> Alberto Alesina and Beatrice Weder, “Do Corrupt Governments Receive Less Foreign Aid?” *American Economic Review*, September 2002, 92: 1126-37

corruption, there was still no association between aid given to a country and how corrupt it was.<sup>32</sup> Similarly, there was no association between aid given to a country and how democratic it was, either in 1996 or 2002, controlling for per capita income and population size.

The IMF/World Bank view is that aid should always work through government but conditions on aid should try to change government behavior. Apparently, this is not working as far as punishing countries that are corrupt or tyrannical. The other major attempt of the World Bank and IMF to change behavior was the structural adjustment loan. “Structural adjustment,” meant reforms to straighten out finances and promote free markets. The key number is what happens to the budget deficit. Remarkably, budget deficits do not improve from one adjustment loan to the next over 1980-1999.<sup>33</sup>

Next let’s broaden the definition of bad government policy to include a variety of indicators: (1) whether the inflation rate was above 40 percent, (2) whether the dollar is trading on the black market for foreign exchange at a more than 40 percent premium over the official rate, (3) whether the official exchange rate is more than 40 percent out of line with the competitive rate that facilitates exports, (and (4) whether interest rates are controlled to be more than 5 percent below the rate of inflation. If any of these conditions are met, economic policy is classified as bad. These are exactly the kind of bad economic policies targeted by the IMF and World Bank. That is, the IMF and World Bank give “structural adjustment loans” on the condition that all of these problems are corrected. Yet the fraction of structural adjustment loan recipients that was violating one or more of these conditions did not go down from one structural adjustment loan to the next (figure 2).

Figure 2: Fraction of Countries with Macroeconomic Distortions by Cumulative Number of Adjustment Loans



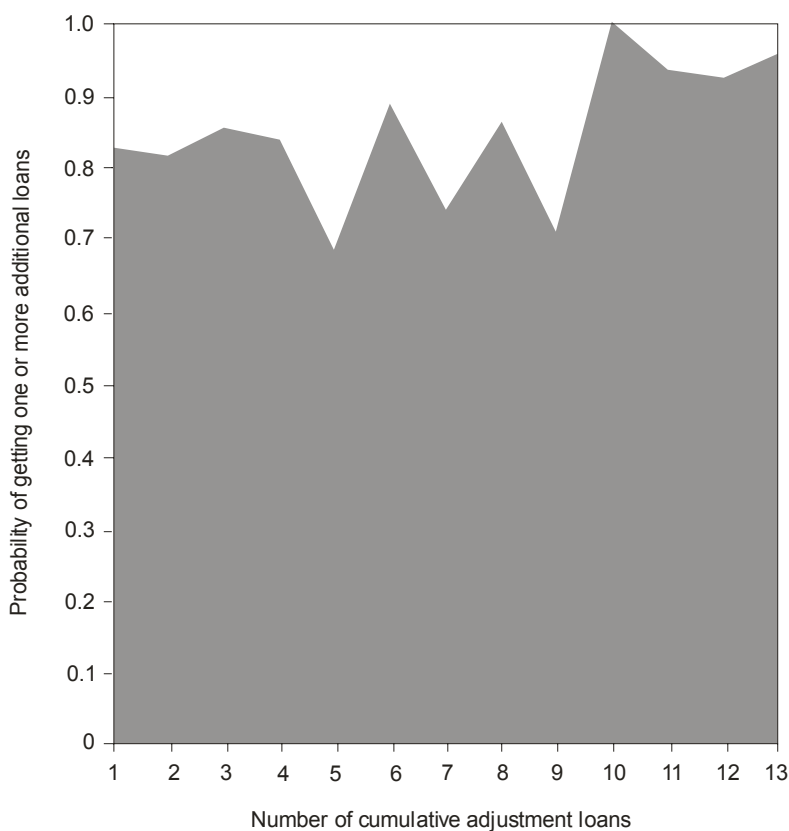
What explains this surprise? One possible explanation is the Bank’s and IMF’s tendency to wipe the slate clean with each new loan, especially if new officials are in power in the recipient

<sup>32</sup> The regression ran the log of aid per capita on log of population, log of per capita income, and the Kaufmann-Kraay indicator of corruption, all for the year cited. The sample (including all countries that received positive aid inflows) was kept the same in between 1996 and 2002. The source for all data is the World Bank’s World Development Indicators.

<sup>33</sup> William Easterly, What did structural adjustment adjust? The association of policies and growth with repeated IMF and World Bank adjustment loans, *Journal of Development Economics*, 2005.

country. Even though an adjustment loan is supposed to be a short-term or medium-term bailout, the countries often don't seem to stay bailed out. Other countries fail to fulfill the conditions on old loans, and yet get new loans anyway. Countries like Ecuador and Pakistan went for over two decades receiving one IMF loan after another, even though they never completed any previous IMF program (meaning they didn't fulfill the conditions to get a second or later installment of a loan commitment).<sup>34</sup> Countries have a remarkably high repetition rate for structural adjustment loans, which does not go down no matter how many structural adjustment loans a country has already gotten (figure 3).

Figure 3: Repetition Rates of Adjustment Lending after Given Number of Loans, 1980-99



The IMF in particular has a capricious relationship with its clients. First, the IMF is tough on cutting budget deficits and causes riots. Then a new government comes in and again runs a high deficit, which the IMF then tries to bring down again (the deficit, not the government). The record of structural adjustment brought the worst of all worlds – the government could blame poor outcomes on the IMF and World Bank forcing it to do things it didn't want to do, even though the governments in the long run often didn't fulfill the conditions anyway.

The IMF and World Bank are increasingly aware that it looks bad to boss around poor country governments, and increasingly they deny that they do so. At the same time, IMF and World Bank want to put conditions on aid and loans to ensure that the government uses the money well. The Planners tie themselves up in rhetorical knots as they try to resolve the un-resolvable contradiction between the two. The World Bank described in 2001 the Poverty Reduction Strategy

<sup>34</sup> Both countries recently completed IMF programs successfully for the first time.

Paper (PRSP) as a means to resolve the contradiction: “the PRSP ... was a crucial step towards greater national ownership of development programs which is essential for increased effectiveness of external assistance.”<sup>35</sup> The IMF agreed: “The broadest and most fundamental changes to the work of the IMF arise from the fact that the targets and policies embodied in {IMF}-supported programs will emerge directly from the country's own poverty reduction strategy.”<sup>36</sup> (The “country” here means the government, as it almost always does in foreign aid.)

Cornell political scientist Nicolas Van de Walle describes the PRSP process as one of “ventriloquism” by the IMF and World Bank.<sup>37</sup> The IMF and World Bank have allegedly given up on telling governments what to do. So the IMF and World Bank want the governments to tell them what the governments will do in order to get a loan. Of course, the IMF and World Bank will approve only acceptable actions in return for infusions of cash. So the poor country governments, instead of being told what to do, are now trying to guess what the international agencies will approve them doing. The PRSP plans are similar to the long lists of conditions that the IMF and the World Bank impose on the poor countries. If the government doesn't guess the right answer the first time, the IMF and World Bank prepare a “Joint Staff Assessment” of each PRSP.

Neither pretending that bad governments are really good governments, nor forcing bad governments to be good, has worked well. Nevertheless, the Planners remain stuck on the government to government aid model, confirming once again the prediction that planners keep doing the same thing over again even if it fails.

#### 4. Expenditures to Outcomes in Social Sectors

Returning to the Devarajan et al. (2002) paper, they also report an attempt to derive aid needs for the MDGs based on the costs of inputs to the health and education outcomes covered by the MDGs. Of course, it is one thing to estimate the cost of providing a health service as being say \$1 per drug dose, and a completely different thing to assume that an additional \$1 of foreign aid will result in a drug dose being given to a sick patient. Much as they did with the “gap model,” Devarajan et al. themselves explain that they see no reason to believe their own calculations: “empirical evidence from developing countries suggests only a weak link between public spending on education and school enrollments, or between health expenditures and mortality or disease.”<sup>38</sup>

The authors cited, Deon Filmer, Jeffrey Hammer, and Lant Pritchett (also World Bank researchers) point out such stories as the results of a survey at government health centers in the Mutasa district of Tanzania. In the survey, new mothers reported what they least liked about their birthing experiences assisted by government nurses. The poor mothers-to-be were “ridiculed by nurses for not having baby clothes (22 percent)...and nurses hit mothers during delivery (13 percent).”<sup>39</sup> Because of the insistence on working through governments, aid funds get lost in patronage-swollen national health bureaucracies (not to mention international health

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<sup>35</sup> (World Bank 2001, IDA-13)

<sup>36</sup> (IMF 2001)

<sup>37</sup> p. 67, Nicolas van de Walle, *Overcoming Stagnation in Aid-Dependent Countries*, Center for Global Development: Washington DC, 2005.

<sup>38</sup> Devarajan et al.(2002). The research they cite is Filmer, Deon. 1999. “A Note on Public Spending and Health and Education Outcomes.” Washington, D.C.: World Bank (processed); Filmer, Deon, Jeffrey S. Hammer, and Lant H. Pritchett. 2000. “Weak Links in the Chain: A Diagnosis of Health Policy in Poor Countries.” *World Bank Research Observer* 15(2): 199-224.

<sup>39</sup> Filmer Hammer, and Pritchett 2000. Bureaucracies in rich countries where clients don't have much voice could be equally oppressive, like Customs or Immigration in the US. The US government during the Clinton Administration tried to make various agencies more client-friendly. According to an anecdote by John Nellis, the response of Customs officials to this initiative was “we don't have clients; we have suspects.”

bureaucracies). In countries where corruption is as endemic as any other disease, health officials often sell aid-financed drugs on the black market. Studies in Guinea, Cameroon, Uganda, and Tanzania estimated that 30 to 70 percent of government drugs disappeared before reaching the patients. In one low-income country, a crusading journalist accused the Ministry of Health of misappropriating \$50 million in aid funds. The Ministry issued a rebuttal: the journalist had irresponsibly implied the \$50 million went AWOL in a single year, whereas they had actually misappropriated the \$50 million over a three-year period.

Another egregious case that donors tried to remedy is Pakistan, which has poor health and education even compared to other poor countries. Compared to other countries at its level of income, Pakistan has 36 percent lower births attended by trained personnel. It has 11 percentage points higher babies born with low birth weight, 42 percent lower health spending per capita, 1.6 percent of GDP less in public health spending, 27 excess infant deaths per thousand, 19 excess child deaths per thousand, and 23 percentage points less share of population with access to sanitation. Relative to other countries at its level of income, Pakistan has 20 percentage points fewer of its elementary school age children enrolled in primary school. This gap is explained entirely by the 40 percentage points fewer of elementary school age girls who attend primary school. The 14 percentage point shortfall in secondary enrollment compared to other countries at its income level is explained mainly by a 20 percentage point shortfall for females. Twenty-four percentage points more of Pakistan's population is illiterate than is normal for a country of its income level, reflecting excess illiteracy of 32 percentage points for females and 16 percentage points for males.

The World Bank in 1993 tried to repair this social train wreck by supporting a “Social Action Program” in Pakistan, which aimed to “improve the coverage and quality of basic social services.” An independent analyst, Nancy Birdsall of the Center for Global Development, later concluded that aside from a few modest successes,

The period during which the SAP was implemented witnessed stagnation, marginal improvement, or – in some cases – even a decline in social indicators. For example, aggregate education enrollment rates stagnated during the 1990s, with enrollments for boys and children from public schools registering a modest decline.<sup>40</sup>

Bank staff recognized the first phase of the project, SAP I, as a failure. Therefore, Bank management approved a second phase, SAP II. Deep into the project, in 2000, a Bank review concurred “improvements in service delivery are either not happening, or occurring at a very slow pace.” After nearly a decade of failure, the SAP was finally abandoned in June 2002.

Dr. Birdsall asks “Why did a sound idea turn into a practical disaster?” She said that “implementation failures were rampant – manifested in non-merit recruitment of staff, absenteeism of teachers and doctors, and frequent transfers of essential staff... politicians used staff recruitment, construction contracts, and site selection for schools and clinics to enrich their kith and kin.” A Pakistani economist gave the deeper reason for failure in 2003: “[T]he poor face markets, state institutions and local structures of power that discriminate against [them]. . . [They are] unable to access public entitlements like ... goods and services.” Foreign aid could not deal with the deep roots of bad government in Pakistan, such as a powerful agrarian elite and sharp ethnic divisions.

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<sup>40</sup> Nancy Birdsall, Adeel Malik and Milan Vaishnav, *Poverty and the Social Sectors: The World Bank in Pakistan 1990-2003*, Prepared for the World Bank's Operations Evaluation Department, September 2004.

Such examples, as well as systematic cross-country evidence that social expenditure does not equal social outcomes, have little effect on aid Planners. Jeffrey Sachs suffers from the same fallacy of aid service costing implying aid service delivery in the Millennium Project's *Investing in Development* (2005), *The End of Poverty* (2005) and in the earlier *Report of the Commission on Macroeconomics and Health* (2001).<sup>41</sup> Each of these exercises has elaborate costing exercises based on unit costs of multitudinous inputs, but each fails to address the issue of who will be motivated to deliver these inputs to the poor in such a way that they produce better outcomes. Devarajan et al. (2002) cite the Commission on Macroeconomics and Health's estimates as support for the estimates in their paper, estimates based on the same flawed methodology that their paper itself disqualifies on evidentiary grounds.

#### IV. Conclusions

That foreign aid by itself could accomplish the Millennium Development Goals was always a delusion. Most of the hope for reduced poverty and human suffering comes from the self-reliant efforts of the poor themselves in free markets. While the aid community planners were dithering about whether to increase foreign aid by a few tens of billions for all poor countries, the citizens of just two large poor countries – India and PRC – were generating an increase in income for themselves of \$715 billion every year.

Aid can still do much good for the poor, but only when individual aid agents have the incentive to deliver tangible services for which they can be held accountable. The bad incentives created by top down planning, collective responsibility, and multiple goals can be replaced by individual accountability for aid agents, based upon independent evaluation of aid outcomes, which will motivate a search for what works in the field under the varied circumstances of each time and place.

The Planners' approach led to collective responsibility for multiple goals for each agency, one of the worst incentive systems invented since mankind started walking upright. The Planning agenda also led to an unproductive focus on trying to change whole political systems and governments. The status quo -- large international bureaucracies giving aid to large national government bureaucracies -- is not getting money to the poor. Conditions on aid don't work to change government behavior.

When you are in a hole, the top priority is to stop digging. Discard the Planners' patronizing confidence that the Planners know how to solve other peoples' problems better than the people themselves do. Don't try to fix governments or societies. End conditionality. Stop wasting our time with summits and frameworks. Give up on sweeping and naive institutional reform schemes. The aim should be to make individuals better off, not to transform governments or societies.

Once we are willing to aid individuals rather than governments, some conundrums that tie foreign aid up in knots are resolved. Those so unlucky as to have warlords or kleptocrats as leaders will still be eligible for aid. We can end the pathetic spectacle of the IMF, World Bank, and other aid agencies coddling the warlords and kleptocrats. We can end the paternalism and hypocrisy of conditionality. We can end the inherent contradiction between "country ownership" and dictating conditions from Washington.

Aid should not aim directly at the end of poverty. The main hope for ending poverty is the homegrown development based on the dynamism of individuals and firms in free markets. Shorn of

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<sup>41</sup> World Health Organization, *Macroeconomics and Health: Investing in Health for Economic Development*, Report of the Commission on Macroeconomics and Health (Geneva: World Health Organization, 2001).



the sweeping Planners' task of general economic development, aid can achieve much more than it is achieving now to relieve the sufferings of the poor.

Put the focus back where it belongs: get the poorest people in the world such obvious goods as the vaccines, the antibiotics, the food supplements, the improved seeds, the fertilizer, the roads, the boreholes, the water pipes, the textbooks, and the nurses. This is not making the poor dependent on handouts; it is giving the poorest people the health, nutrition, education, and other inputs that raise the payoff to their own efforts to better their lives.

I don't mean to imply that all aid should be for projects. Other areas of aid agencies' possible comparative advantage could include distilling practical knowledge on operating banking systems or stock markets, advice on good macroeconomic management, simplifying business regulations, or making piecemeal reforms that promote a merit-based civil service.

The current aid system is not working partly because the rich countries don't care enough about making aid work for the poor, and are willing to settle for grand utopian Plans that don't work. It is partly because nobody is actually held accountable for making THIS intervention work in THIS place at THIS time. My suggestions here could be ludicrously misguided; they should be subject to skeptical examination and ex-post evaluation just like everything else.

I will plunge recklessly ahead with some suggestions, just because the current system is unacceptable. This book presented some historical lessons that could guide the Searchers.

Fix the incentive system of collective responsibility for multiple goals. Have individual accountability for individual tasks. Let aid agencies specialize in the sectors and countries they are best at helping. Then hold the aid agencies accountable for THEIR results by having truly independent evaluation of their efforts.

Perhaps the aid agencies should each set aside a portion of their budgets (such as the part now wasted on self-evaluation) to contribute to an international independent evaluation group made up of staff trained in the scientific method from the rich and poor countries, who will evaluate random samples of each aid agency's efforts. Evaluation will involve randomized controlled trials where feasible, less pure statistical analysis if not, and will at least be truly independent even when randomized trials and statistical analysis are not feasible. Experiment with different methods to just ask the poor if they are better off. Mobilize the altruistic people in rich countries to put heat on the agencies to make their money actually reach the poor, to get angry when the aid does NOT reach the poor.

With specialization on a small number of tasks and the fear and reward induced by independent evaluation, maybe agents of aid will be willing to keep exploring different means of fixing a problem, like malnutrition, until they get it working. Agents of aid can experiment with different delivery mechanisms: an NGO, private firms, social entrepreneurs who scout out ways to help the poor, maybe even a decently functioning local government agency. Specialization on modest tasks and evaluation for whether you accomplished them will transfer power from Planners to Searchers.

Although I think the existing bilateral or multilateral aid agencies and poor country governments have done a bad job, they might be able to perform better once they are held accountable. Official aid agencies and national government bureaucracies should remain on the list of possible vehicles for delivering development services. Again, all that matters is what works to get help to the poor.

If the main problem with foreign aid is the lack of FEEDBACK from the poor themselves, and ACCOUNTABILITY to those same poor, then why not attack the problem directly? Is aid reaching the poor? Well, let the agents of foreign assistance ask them. Evaluation efforts could include surveys of the poor, just asking the poor whether they got what they most needed and whether they are better off because of an aid intervention, and holding the aid agencies accountable for the results. Hold surveys of the population's well-being both before and after the aid program to compare the results on specific outcomes. More rigorous evaluation could use the randomized controlled trial methods which have been successfully applied in many settings to see which interventions work (Duflo and Kremer 2003).

The main mechanism for feedback and accountability for public services in the West, as described above, is democracy. Could aid agencies find democratic mechanisms for local communities to vote on what services and projects they want? Could independent local watchers make sure the goods actually arrive and deliver what the agencies promised? Myriads of volunteers like local college students could simply monitor a sample of potholes, missing textbooks for schoolchildren, or drugs out of stock in health clinics. They could make the call to the responsible party to repair the pothole, supply the textbooks, or restock the drugs. Publicize the results and thus put pressure on the aid donors and their local partners. Reinikka and Svensson (2005a, 2005b) describe the positive results of a newspaper campaign in Uganda to announce how much local schools should be receiving in direct grants from the government, to reduce diversion of these funds before they reached the schools. The program increased the amount that reached the schools, raising school attendance and student performance.

It is strange that aid agencies talk so much these days about "good governance" in the aid recipient countries without worrying about "good governance" of their own aid projects.

Aid could utilize far more one group of agents who do have an incentive to find things that please the customers: private firms. For example, private firms can provide services that reach the poor, function as watchers, provide funding for poor entrepreneurs, and train aid workers to think like Searchers for customer satisfaction.

A little bit of this is happening already, but not in any systematic way that aid agencies take seriously. Surveys, votes, and watchers are not always reliable, but on average they would be a big step forward from the accountability-free zone that aid agencies now enjoy.

The best aid plan is to have no plan. Just reward aid agencies for doing more of what works, and less of what doesn't work. It is not possible to say how much aid "is needed." However, when the rich country public sees aid delivering the many things that do work to create more opportunities and less suffering for the poor, then public support for more aid will increase accordingly.

Searching can work in foreign aid by following some simple maxims: experiment, evaluate, and learn. The basic principles are much easier to state than to actually make happen. Agents of assistance have to have incentives to search for what works to help the poor. If you want to aid the poor, then:

- (1) Have aid agents individually accountable for individual, feasible areas for action that help poor people lift themselves up.
- (2) Let those agents search for what works, based on past experience in their area.
- (3) Experiment with the results of the search..

- (4) Evaluate, based on feedback from the intended beneficiaries and scientific testing, and learn what works.
- (5) Reward success and penalize failure. Get more money to interventions that are working, take money away from interventions that are not working. Each aid agent should explore and specialize further in the direction of what they prove good at doing.
- (6) Make sure incentives in (5) are strong enough to do more of what works, then repeat steps (4) on. If action fails, make sure incentives in (5) are strong enough to send the agent back to step (1). If the agent keeps failing, get a new one.<sup>42</sup>

It's so obvious, I'm embarrassed to even lay it out. It's worth laying out only because it is the opposite of the present methodology of foreign aid.

Think of the great potential for good, if aid agencies probe, experiment, and learn their way towards effective interventions – such as saving the life of a child with malaria, building a road for a poor farmer to get his crops to market and support his family, or getting food and dietary supplements to people who would otherwise be stunted from malnutrition. Think of the positive feedback loop that can get started as success is rewarded with more resources and expanded further. Think of the increased support for foreign aid if rich people know that an additional dollar of aid is an additional dollar to meet the desperate needs of the poorest people in the world.

Is it time yet to end the impunity of foreign aid, in which aid agents are not held accountable for whether the scarce aid dollars reach the poor? What a tragedy, that aid agencies have spent \$2.3 trillion over the last 5 decades and yet there is still so much preventable human suffering that they failed to prevent. Could the Aid Wall, behind which the poor must put up with Planners while on the other side the rich prosper with Searchers, finally come down? The Planners have had five decades to deliver results in foreign aid and have not done so. It is past time in foreign aid to take power away from Planners and give Searchers a chance.

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<sup>42</sup> This is akin to Duggan 2003, p. 167