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WHAT THE INDUSTRIAL COUNTRIES CAN DO TO SUPPORT DEVELOPING COUNTRIES' DEVELOPMENT GOALS

by

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This paper was presented for the Vernon W. Ruttan Memorial Lecture on Science and Development Policy and Remembrance Reception, December 3, 2008 in the McNamara Alumni Center at the University of Minnesota, Minneapolis Campus. *Anne O. Krueger is Professor of International Economics in The Paul H. Nitze School of Advanced International Studies at Johns Hopkins University.*

FORWARD

Our dear friend and colleague Vernon Ruttan died on August 18, 2008. In honor of his extraordinary lifetime contributions in Development and Growth Economics we were pleased to host the The Vernon W. Ruttan Memorial Lecture on Science and Development Policy and Remembrance Reception, December 3, 2008 in the McNamara Alumni Center at the University of Minnesota, Minneapolis, MN. We invited his colleagues, friends and family for an afternoon of reflection on Vernon's remarkable contributions to issues of world growth and economic development.

We were delighted and honored to have Professor Anne O. Krueger present a lecture on international development economics, focusing on aspects that were central to Vernon's interests.

Vernon touched the lives of his colleagues, students and family.

VERNON W. RUTTAN (Aug 16, 1924 – Aug 18, 2008)

Vernon was born on a farm in northern Michigan. He received his B.A. from Yale University in 1948 and M.A. and Ph.D. degrees from the University of Chicago in 1952 and 1954. Vern's first academic appointment was at Purdue University in the Department of Agricultural Economics in 1955 where he quickly rose to the rank of professor in 1960. In 1965, Vernon joined the faculty in Agricultural and Applied Economics at the University of Minnesota as Professor and Head of the Department. From 1978 to 1986 Vernon was also Professor in Economics at the University of Minnesota and was named as a Regents professor in 1986.

Among Vernon's substantial contributions to development through authoring well over 200 books, articles and reports, is his book with Yujiro Hayami, Agricultural Development: An International Perspective, published by Johns Hopkins University Press, 1971 and 1985. This book is a basic reference in the field of agricultural development and has been translated into four other languages. Vernon made impressive contributions to assuring world food supplies. His ideas on induced innovation, science and technology policy, and development aid and institutions helped shape public and private investments and policies that have contributed to the tremendous achievements in food security during the past half century.

All who knew Vernon personally or professionally were touched by his incisive insights, his tenor chuckle and his true interest in others. He was generous of his time with students and colleagues. He was always the first to encourage and the first to congratulate. We will miss him deeply as a friend, a scholar, a colleague and a true gentleman.

Vernon is survived by his wife Marilyn, son Christopher, daughters Lia, Alison and Lore, and five grandchildren.

What the Industrial Countries Can Do to Support Developing Countries' Development Goals

It is an honor, but a sad one, to give the Ruttan memorial lecture. Vern was such a vital and engaged person that it is hard to imagine a world without him. He had many sides as a friend and as a colleague. In both capacities, he was enthusiastic, committed, dedicated, self-effacing, and generous with his time. As a colleague, he was a wonderful and stimulating interlocutor, well-informed and widely read, a source of new and important ideas, and unusually willing to engage on the other person's ground, rather than his own. He was an agricultural economist, a development economist, an analyst of technical change and of the impact of the military on development prospects, and much more. His passing is a personal and professional loss for me and for his many friends, professionals and policy makers throughout the world. We need his insights and wisdom in the current situation more than ever.

It is not possible to present a memorial lecture covering all of Vern's interests. But given the centrality of development concerns to most of Vern's thinking, and his ongoing relations and academic work with the aid community, it seems appropriate to focus on what our current understanding is of what industrial, or developed, economies (I shall use the terms interchangeably) can do to support the development efforts of poor countries. Recent criticisms of foreign aid have been widely heard. Whether it is aid fatigue or aid disillusionment, it seems fitting to examine what aid can do, and what else industrial countries can do to support development. Moreover, given the political concern – both selfish in terms of world stability and humanitarian – and the commitments of developed countries through the Millennium Development Goals (MDGs) to foster accelerated improvements in living standards in low income countries, it is important to understand the most promising and effective approaches to support development policy in light of the lessons that have been learned over more than 50 years of concern with development and foreign aid.

To that end, I start by summarizing (very briefly) the essential lessons that have been learned about development – the roles that the rest of the world can play in supporting the process,

and the limits to what the rest of the world can do. The place to start is with early thinking about development policy and about the role of rich countries in supporting it. I then move to the way that thinking influenced early policy in developed countries with respect to foreign aid and support for development objectives.

Next comes a review of the various qualifications to these initial views – qualifications in which Vern played a significant role, and which led to a reassessment of the role of foreign aid in the development process. As I shall discuss, some of those qualifications enabled focus on the importance of industrial countries' other international economic policies, especially the role of trade and trade policy.

Lessons from development experience, both in successful and less successful developing countries, have also contributed to our understanding of the development process and the contributions (positive and negative) that the outside world can make to it. Among the key issues, one in particular must be addressed: the role of foreign aid in the modern world when private capital flows dwarf official flows to developing countries.

I will then come finally to some of the modern-day concerns about development – institutional and governance issues, the role of politics, and so on – on which modern critiques of foreign aid have largely been based, and assess where we stand today in supporting poor countries' development efforts.

Before getting into that agenda, however, two issues must be clarified. A first concerns the difference between development assistance and humanitarian assistance. The second relates to the measures of success in development, and the reasons why growth may be used, at least as a first approximation, as a proxy for rising standards of living and well being in developing countries.

Turning to the first issue, few question the role that financing for and/or direct shipments of food, medical supplies, and other necessities can make in times of humanitarian crises. These efforts are designed to offset insofar as possible the human misery that arises because of drought, crop failure, tsunamis, wars, and other disasters. The aid is intended to help tide people over until recovery takes place so that normal economic activity can resume. While humanitarian aid is

intended to raise living standards from the deplorable levels they would otherwise be, it is not intended to increase productive capacity significantly above what it was pre-crisis. (To be sure, difficult issues sometimes arise in classification – for example, when is provision of seed to enable farmers to plant or replant for the next crop humanitarian and when is it designed to raise living standards?).

By contrast, development assistance – as it is generally known – or foreign aid, is provided with the intent that it will enable a more rapid increase in real output in the recipient country than could otherwise take place. Thus, humanitarian assistance is generally designed to cushion downward pressure on consumption among the poor, while development assistance is intended to enable people to become more productive and hence provide higher living standards even after development aid flows cease. For purposes of this lecture, I focus on development assistance. Much of what is relevant for development assistance is either less so or irrelevant for humanitarian assistance, and the conclusions drawn later on do not necessarily apply to humanitarian assistance.

The second preliminary has to do with the objectives of foreign aid, or development assistance. Clearly, in very poor countries, the objective is to enable higher and rising levels of well-being, especially for the poorer members of society. Aid has sometimes been criticized for aiming at economic growth, rather than “targeting” the poor and focusing more on redistribution. However, while the correlation is not perfect, it is generally true that when rates of economic growth are higher, the living standards of the poor increase more rapidly. No country has been able to sustain higher living standards for the poor without economic growth for any meaningful period of time. The reasons are several. First and foremost, in countries with very low average per capita incomes, there is little that can be achieved by redistribution alone, even ignoring the likelihood that strong redistributive efforts would result in lower total output and average income. Paraphrasing Amartya Sen, you cannot accomplish much by redistributing misery.

Second, and perhaps even more persuasive, countries whose real GDP has grown more rapidly have generally experienced higher rates of poverty reduction than countries achieving slower growth. Higher per capita incomes in developing countries have almost always been associated with

improvements in major dimensions of well being. Life expectancy, for example, has risen dramatically in almost the entire developing world (with the tragic exception of some sub-Saharan African countries where HIV/AIDS has more than offset any improvements that would otherwise have raised life expectancies). In India, for example, life expectancy at birth is estimated to have been about 30 years in 1950, and is now estimated to be well over 60 years. In South Korea, it is estimated to have increased from 35 years in the late 1950s to 78 years of age now – the same as in the advanced economies.

Other measures of well-being have similarly improved, and the rate of improvement has been highly (but not perfectly) correlated with rising real per capita incomes. Nutritional standards (closely related to life expectancy) and educational attainments (including literacy rates as well as years of schooling) are among the most notable.

That said, it is also true that, within a set of policies intended to achieve more rapid economic growth, some policies that are aimed at reducing the immediate impact of poverty can facilitate more rapid increases in the well-being of the poor. Targeted assistance with delivery of foodgrains, health, and basic necessities to the poor can make a significant difference both to the misery inflicted by poverty in the short run and to growth prospects in the longer run. Children whose nutritional status is improved have better health status and are more likely to attend school (and have fewer absences when attending). While lack of time precludes further discussion of this issue, one of the important lessons learned about development policy in general (including development assistance) is the wastefulness of untargeted subsidies and the effectiveness of well-targeted policies in improving conditions and prospects for the poor.

However, while targeted assistance to the poor can make a difference, growth rates still matter enormously. For that reason, I shall focus on rates of economic growth as a measure of success with development (and of foreign aid in supporting development), and only occasionally point to targeted assistance when it is necessary for the argument.

Let me turn, then, to early thinking about development and development assistance. It will be recalled that the field known as “development” really came into being only after the Second

World War. As former colonies achieved independence and the world examined differences between the rich and the poor, the differences were so sharp that many focused on a single causative explanation: rich countries were rich because they had a great deal of capital per worker, thus generating high productivity of labor, while poor countries were poor because there was little capital, and hence low productivity.

The argument seemed to make sense. After all, poor people could not be expected to save much, or so it seemed, and if they did not save they would not be enabling the investments that would improve productivity. Hence, early thinking focused almost exclusively on the “shortage” of capital in developing countries.

Moreover, at that time, it was widely and largely correctly assumed that private foreign capital flows would be relatively small except perhaps for short-term financing of international trade and some investments in minerals and perhaps a few other natural resources.

Seen in that light, foreign aid could play a very useful role in enabling an increase in the rate of investment over and above that could be sustained by domestic savings. Investment can only exceed savings in a given country if the country can obtain additional resources from the rest of the world. Foreign aid was seen as the mechanism by which low-income countries could obtain those resources and raise their investment rates and hence, it seemed to follow, to grow more rapidly.

The reasoning was certainly not entirely wrong. India’s savings rate was estimated to be around 6 percent in the early l950s, and no country can achieve rapid growth with investment at that level. South Korea in fact had a negative domestic savings rate (and the third lowest per capita income in Asia) in the late 1950s. In those circumstances, the additional resources provided through foreign aid appeared to, and in many cases did, permit higher investment rates, which in turn were assumed to enable more rapid growth.

However, while resources for investment matter, an important lesson has been that the efficiency of investments is also important, and depends on many things, but especially on the incentives with which decision-makers – public and private -- are confronted. Many countries raised their savings rates in the first several decades of development efforts by more than had been

anticipated, with only lackluster increases in growth rates. In India, for example, it was anticipated that a savings rate over 20 percent would enable growth of about 6 percent annually. The savings target was overachieved, but until the 1980s, the productivity of investment was falling so that the growth rate remained fairly constant at about 3.8 percent annually. The story was similar in many other countries.

But there was a second aspect to early development thinking. Not only was it believed that more physical capital per man would enable development, but it was almost universally believed that industrialization was the key to development. In the early postwar years, casual observation indicated that developing countries (or underdeveloped, as they were then called) had 70-80 percent of their populations residing in rural areas and dependent on agriculture for their livelihoods. Exports generally consisted predominantly of primary commodities, usually agricultural but sometimes mineral. To a first approximation, it seemed that developed countries were ones with much manufacturing and a comparative advantage in exporting manufactures, while developing countries were those with predominantly primary commodity, agricultural based, economic activity and exports. It was believed that, without policy intervention, developing countries would ever be agricultural, low income, and low productivity producers and exporters of primary commodities.

The policies then adopted in virtually all developing countries were designed to foster industrialization. For a variety of reasons, the chosen method was to build high walls of protection against imports to encourage the development of manufacturing industries, sometimes in the public sector and sometimes in the private sector. The strategy was termed “import substitution”, and over time more and more goods were stricken from lists of eligible imports as domestic production was undertaken.

Further, most developing countries adopted development plans that strained domestic resources, while simultaneously adopting fixed nominal exchange rates. The expansionary budgets generated inflation, which in turn led to increasingly overvalued exchange rates. Because of that, incentives for exporting were falling, while the demand for imports of capital goods, and intermediate goods to support newly established manufacturing enterprises was increasing rapidly. The

authorities were reluctant to undertake devaluation, believing that raising the price of capital goods would discourage investment. In fact, the constraint on investment was in large part foreign exchange availability, as the failure of exports to grow as rapidly as the demand for imports resulted increasingly in “foreign exchange shortage” and led to the imposition or intensification of quantitative restrictions on imports.

That sequence had many consequences which cannot be pursued here. But one consequence was crucially important for its effects on the impact of foreign aid: because foreign exchange was seen as scarce, foreign aid increased the supply of foreign exchange, thus somewhat reducing the pressure of excess demand. “Two-gap” models of foreign aid were developed, pioneered in large part by Hollis Chenery, in which aid filled both a “savings gap” and a “foreign exchange gap” and was thus doubly potent in supporting accelerated growth. “Program aid” was chosen over “project aid” because it was believed that the increased savings and foreign exchange resources provided by aid were supporting development.

But while those models provided a rationale for foreign aid in the context of the import substitution development strategy chosen, difficulties with that strategy began to appear. Successive foreign exchange shortages became increasingly severe, resulting in “stop-go” growth patterns; each “go” was shorter and weaker than the last and “stops” were longer. In most countries, agricultural production grew slowly at best, with consequent failures of rural real incomes to grow and growing gaps between urban and rural living standards.

In addition, by the early 1960s, an alternative “outer-oriented” trade and development strategy was adopted in a few economies. Initially, South Korea and Taiwan were the most notable. And their success with the strategy was breathtaking.

Whereas the “two-gap” models had posited that growth could never exceed 6 percent or so, these countries attained rates of growth of 10, 12, and even 13 percent for periods of several years, if not decades. Moreover, they did so through policies that provided incentive for all exports, but which resulted in particularly high rates of increase in manufacturing output and exports.

Among the many consequences, concerns arose – correctly – that foreign aid was not achieving, or at least not sufficiently achieving, the intended objectives. There were several obvious reasons for this: program aid was supporting policies that were not conducive to rapid economic growth; as import substitution policies persisted over time, the inefficiencies associated with a highly restrictive trade regime increased and productivity growth slowed; and provision of foreign aid enabled countries to maintain unrealistic exchange rates and unproductively high walls of protection for longer periods of time, thus discouraging exports. To the extent that foreign aid deterred domestic production and productive efficiency, it was not as productive as had been anticipated.

Lessons were learned about appropriate development strategy and about aid. For development strategy, perhaps the most important lesson, still valid today, was the importance of an open trade regime for providing the appropriate incentives for domestic producers to achieve rapid growth. A second was the importance of economic policy in general for affecting the rate of economic growth: foreign aid was significantly less productive in contexts where policies were providing incentives for behavior that was inconsistent with economic efficiency and growth. Thirdly, because of these and other insights, it had to be recognized that a unicausal theory – such as that physical capital shortage was the reason for poverty – was inadequate. Development was a far more complex process.

The importance of open trade policies requires emphasis because, as I shall stress later, one of the most significant contributions industrial countries can make to the prospects for rapid growth in developing countries is to insure a growing open multilateral trading system. With a healthy growth of the international trading system, new entrants to the international economy can achieve more rapid growth than is feasible with a less buoyant international economy.

The importance for developing countries of open, or outer-oriented trade policies, lies largely in the incentives that are provided for domestic producers. When tariff barriers and other restrictions on imports are significant, domestic producers find themselves in a sheltered domestic market, usually with few competitors and significant monopoly positions. As such, incentives are to seek political influence for import licenses, for preventing new entrants, and otherwise protecting one's territory.

The result is generally low productivity growth, and poor quality of many domestic products in a captive domestic market. When producers instead are aware that their fortunes depend on their ability to compete internationally, their behavior changes significantly (and producers adept at obtaining political factors but not at efficient production become less important). No developing country has sustained a high rate of economic growth over a longish period of time without opening up its economy to the international market. In the case of Korea, the economy was transformed over a period of more than 3 decades from l960 as the rate of growth averaged well over 8 percent (6 percent per capita), export growth averaged around 40 percent annually, and the structure and productivity of the economy was transformed. More recently, China's dramatic growth has been spurred in significant part by its opening to the rest of the world. But many other countries – Thailand, Malaysia, Turkey and, Chile, to name just a few – have experienced vastly improved economic performance with opening to trade.

It is of course true that opening to trade by itself is not a panacea – there must be investment, supporting infrastructure, and much more. But opening to trade, and an environment in which such opening permits success is a critical ingredient.

While the importance of an open trade policy was one of the early lessons, there were many others. Among the first was recognition of the importance of human capital, as pioneered by T. W. Schultz. Equally, the role of agriculture, and the importance of increasing agricultural productivity, came to be appreciated, including of course Vern's seminal work on the role of agricultural research and development, and extension, as well as the importance of the choice of appropriate techniques – land saving or labor saving – in development in countries with very different land-man endowments in his work with Yojiro Hayami.

While there were many other lessons, only one more needs mention here. That is, the role of governments and private sectors respectively in development. As I mentioned, most developing countries' governments sought to spur industrial production. To achieve this, they not only provided strong incentives (albeit for monopoly power, as well as for production) for new private domestic producers, but they usually regulated many aspects of private economic activity <u>and</u> established

state owned enterprises (SOEs) to undertake manufacturing activities which in industrial countries had traditionally been carried out by private firms. These regulations of private economic activity, and state ownership of SOEs, led to incentives that often led to behavior inconsistent with increasing economic efficiency. SOE managers were generally political appointees, and were often rewarded for providing employment to relatives of politicians regardless of qualifications or, indeed, whether there was a job needing to be done. Decisions as to plant location, types of goods to be produced, conditions of employment, and other aspects of normal private economic activity were often taken either because of existing laws and regulations or because of the necessity of pleasing particular political groups. By the 1990s it was clear in most countries that the intended purposes of the regulation and ownership were not being served.

Thus, by the 1990s, something akin to the "Washington consensus" – so labeled by John Williamson – had emerged. All of the factors mentioned above were deemed to be important for development. Reasonably open trade policy was essential; attention to health and education was important; getting incentives that were conducive to productivity increases and appropriate allocation of resources was also crucial. In addition, there was increasing disillusionment with the activist role of governments in directly owning and operating state-owned enterprises (SOEs) in manufacturing. Governments had failed to carry out some of the important functions which can only be done by the public sector (such as agricultural research and development and extension, and provision of infrastructure and education), while simultaneously undertaking activities in which they demonstrated a strong comparative disadvantage (such as operating tourist hotels, steel mills, and other manufacturing activities). In many (but not all) developing countries, reforms began to be undertaken to privatize, remove costly regulations, move toward a more outer oriented trade regime, and otherwise redress earlier problems.

However, as seems to be the case with development economics every decade or so, focus shifted yet again. In significant part, this was a response to the observation that some countries that had undertaken "Washington consensus" reforms had failed to experience significant increases in

growth rates. But, in part, it was simply a continuation of our ongoing learning process about development.

To try to do justice to these insights would take me far afield. But, for purposes of asking what industrial countries can do to support accelerated growth in developing countries, they must at least be mentioned. Three interrelated concerns are part of the development paradigm in the first decade of the new millennium. They are: governance, institutional strength, and corruption. Governance is virtually self-explanatory: what is needed are processes and understandings as to how decisions are to be made and how transparent both the processes and the decisions are. Governance can be poor either because there are overlapping authorities, each hindering the others from taking responsibility and being accountable, or because the relevant authorities are so weak that either decisions are not made or they are not carried out. An important aspect is the transparency of the decision-making process, desirable both because affected citizens can provide feedback to the authorities as to the effectiveness of particular measures and because decision-makers themselves are likely to be more constrained when they know that their actions are known to all in their constituencies.

Institutional strength, another area on which Vern focused, is important to insure the legitimacy and predictability of laws, government regulations and other actions. When the tax collectors are generally honest because there is an incorruptible chief collector, there can be little assurance as to what will happen once that chief inspector moves on. Moreover, when institutions are weak, private sector decision makers will generally be confronted with considerable uncertainty as to the future of existing regulations. Even if the customs authorities are exceptionally lenient and waiving customs duties, there can be no assurance that this will persist under the next director of customs in the absence of a relatively strong and independent customs authority. In the absence of that assurance, few will be likely to invest or base other important decisions on the current absence of customs collection.

Even in early development assistance, there was a considerable technical assistance component. Some of it was in areas such as agricultural research and extension, already mentioned, and was important in improving agricultural productivity. The most dramatic success, of course, was

the green revolution, but there was much more. But in addition to that sort of technical assistance, another important component has been in providing support for improving institutions associated with governance. Support for improving tax collecting capabilities (through such devices as establishing large taxpayer units, computerizing parts of the system and linking it to other sources of information), for monitoring and improving control of government expenditures, for streamlining customs procedures), for improving land registries and commercial codes, and for a host of other necessary governmental functions has proved to be important, if largely invisible and underappreciated, work. I shall return to this in discussing what industrial countries can continue to do to support development efforts.

Finally, there is the closely-related issue of corruption. In recent years, anecdotal and other evidence has mounted that the pervasiveness and magnitude of corruption is considerably greater than had earlier been thought. One particularly shocking estimate has it that only between 10 and 30 per cent of finances allocated to road construction in one Indian state actually reach a road construction project. In many countries, expediters' fees of 15-25 percent are common. Corruption not only diverts public resources away from productive uses but can create sufficient uncertainty as to act as a major deterrent to private sector activity. Weak institutions and poor governance contribute significantly to it.

Currently, much research in the development area is examining these three "new" topics, both with an eye to finding cases and estimating the costs of poor governance, weak institutions and corruption and to drawing lessons from instances where lasting changes were brought about. There is much still to be learned. Fortunately, it does not appear to be the case that all institutions must be simultaneously strengthened, that governance must be reformed overnight, nor that any corruption renders public expenditures impotent.

But, in large part because regulations and policies once in place create sizeable interest groups benefiting from them, dismantling the apparatus of regulation and control has been challenging in many countries. Even after significant reforms, there are many productivity-inhibiting measures in place in many countries. To be sure, industrial countries also have efficiency-inhibiting

laws and regulations, but in general they are less extreme relative to the economic strength of the country.

To give an example, consider some of the items listed by the World Bank in its most recent Doing Business, which provides data on a number of parameters of the business environment in over 170 countries. Consider Egypt, a country in which there has been significant economic reform (and more successful economic performance over the past few years.

Despite undertaking many reforms in the first decade of the new millennium, Egypt is ranked 128th among the 180 countries assessed. To obtain a construction permit takes months. It costs two and a half years salary to fire a worker. Registering property takes over 6months. Getting credit is difficult because legal rights are weak. A business must pay 36 different taxes, estimated to require 711 man hours per year, with a tax rate of 48 percent. It takes 1,010 days to get a court judgment for enforcing a contract and costs about 25 percent of the claim. 4 years are needed to close a business and the recovery rate is 16 cents on the dollar. If Egypt is 128th out of l80, there are some countries that have an even more difficult business environment, but even some of those rated below 100 are not regarded as business-friendly. For developed countries, procedures are many fewer, there are few delays, court processes and awards are much faster, and so on.

While we have been learning more about development, several factors have changed in the circumstances surrounding development and foreign aid efforts. On one hand, major differences among developing countries emerged and expanded over the 1980s and l990s. Some, such as South Korea and Singapore, virtually became developed countries. Others were growing rapidly, and were deemed to have excellent prospects for further development. But some remained relatively slow-growing or even stagnant during this period. In many sub-Saharan African countries, for example, per capita incomes actually fell during the l980s and l990s; some even had lower per capita incomes than they had had at independence.

A second change in the terrain occurred for the more successful developing countries. For them, private international capital flows, which had been small relative to official (aid) flows in the earlier years, became larger in absolute value and also as a percentage of total capital flows,

especially for the “emerging markets” as those countries whose development was proceeding at a reasonably rapid pace came to be called. This raised and raises questions as to the role of foreign aid in circumstances in which private capital might well provide additional resources for poor countries.

So, current understanding of the development process is much more nuanced and complex than was the case a half a century ago. Issues that are highly pertinent to some emerging markets (such as appropriate development and regulation of the financial sector) are not as central in some of the still least developed countries.

To evaluate what industrial countries can do to support development today, therefore, it is necessary to consider, first, those things that can enable all developing countries to be more successful. Then I shall turn to issues important for the emerging markets, and finally to those relevant to the least developed countries. Finally, I shall turn briefly to the organization of support for development, both in individual industrial countries and in international organizations.

Starting with actions that benefit all countries, an open multilateral trading system is clearly at the top of the agenda. In the 1950s and 1960s, almost all developing countries grew at rates well above those they had experienced in earlier decades and centuries. Those with policy regimes more conducive to economic growth grew much more rapidly, to be sure, than those with policies that were inner-oriented and heavily interventionist. But all countries grew more rapidly when the international economy was expanding rapidly, and experienced slowdowns in growth in periods such as the mid 1970s and early 1980s. While South Korea would undoubtedly have experienced above-average growth after reversing some of the most egregious growth-retarding policies of the 1950s, that country could not have achieved the spectacular growth rate actually realized had the international economy been stagnant.

An open and growing international economy provides an environment in which countries committed to economic growth can achieve more rapid growth than would be possible in a stagnant environment. And, since there is always opposition to dismantling trade barriers, greater success

reduces opposition more rapidly and thus makes the policy shift more likely to be politically sustainable.

I am not speaking here about high commodity prices, although they have helped many developing countries (including some of the least developed countries) in recent years. Rather, it is the growth of international markets for all sorts of goods and services that permits greater success for individual reforming economies. At the present juncture, concerns about the financial crisis and its impact on the real economy seem to be leading to protectionist pressures, and the Doha Round of trade negotiations has stalled. Despite the pledges by the leaders of the G-20 that there would be a standstill on protectionist measures, we hear of new ones and new proposals each day. The Mercosur countries (Argentina, Brazil, Paraguay and Uruguay) have jointly announced that they will raise tariffs on January 9, despite their leaders' pledges not to do so. Russia and India have already raised tariffs on selected goods. In the United States, subsidized lending to the auto industry is under discussion, and leading to consideration of similar measures in Europe, Canada and elsewhere.

Failure to complete the Doha round of multilateral tariff reductions would significantly dampen the growth prospects of all countries in the world, but would have the largest negative impact on those poor countries where reforms of trade regimes are in prospect. Increases in protection in the international economy would be even more negative in its impact: in the l930s, the "beggar thy neighbor" policies of the industrial countries intensified the Great Depression and failed to achieve intended objective in the protecting countries. For both the short term prospects for the international economy as a whole, as well as the prospects for developing countries, it is critical that increased protectionist pressures be avoided. Completion of the Doha Round would be highly beneficial for the longer term outlook, but would also provide reassurance that the world will not turn protectionist at this juncture.

Many developing countries have insisted upon the importance of the dismantling of agricultural protection in developed countries as a necessary condition for their acquiescence in completion of the Doha Round. To be sure, dismantling that protection is in the interests of the

industrial countries as a whole, as well as in the interests of the international economy. But relative to achieving a higher growth rate for international trade overall, the degree of reduction in agricultural protection, desirable as it is, is secondary. It is to be hoped that the forthcoming Geneva Ministerial this month will insure progress in this direction.

Going beyond trade issues, the question remains as to what foreign aid can do. For the emerging markets, the conclusion must be that there is not much. To be sure, they benefit from the existence of the international financial institutions, the World Bank and the International Monetary Fund, and the technical assistance and support those institutions offer. The IMF's role as a provider of liquidity in cases of sudden stops in financial markets is obviously still important, as exemplified by the current list of new recipients of financing. If measures are taken which reduce the volatility of the international financial system without significantly reducing its capacity to allocate investible resources where their returns are highest, that, too, would provide a service for all developing countries.

For emerging markets, however, private capital flows have been, and will continue to be the major source of external finance, and the role earlier played by foreign aid has been superseded. To a considerable extent, that is a sign of the progress made over the past half century.

For low income countries, however, the situation is quite different. Despite the obvious shortcomings of past aid efforts, as discussed by Easterly, among other, there is much that foreign aid can do, and many of the failures of the past have provided lessons for future aid effectiveness. A first lesson, however, is that aid will not do much unless the policy environment within the recipient country is appropriate. Most low income countries are not, and probably should not be, candidates for significant private capital inflows. In part, this is because further policy reform (hopefully supported by technical assistance and resources from the international community) is needed before growth rates can accelerate to the point where private capital inflows will be attractive to foreign providers. In part, it is because some of the capital needs of low income countries are for the finance of infrastructure projects where the payoff may be well outside the maturity dates for commercial financing.

In these circumstances, foreign aid can provide support not only in the form of resources, but often in the form of technical assistance harnessing available resources to their most productive uses. Achieving control of government budgets on the expenditure side is one of the many challenges facing least developed countries. Technical assistance with insuring appropriate and timely reporting and installing the necessary controls so that over-budget and off-budget expenditures do not occur is more productive than is generally appreciated. One of the lessons of development that has become increasingly evident over the past decade is the harm that high inflation, itself the outcome of larger than planned fiscal deficits, has inflicted upon many economies. Even among the least developed economies in sub-Saharan Africa, those countries where fiscal discipline enabled single-digit inflation rates experienced increases of growth rates of several percentage points, even when microeconomic policies detrimental to growth had not yet been altered. Moving further with technical assistance to support development of the financial sector, starting with the banking system, but moving beyond to deepen equity and other financial markets, can make an important contribution to growth prospects.

In these, and many other areas, the importance of developing appropriate institutional structures and governance, and designing corruption-resistant structure, is much more appreciated than was the case in earlier decades. While there is not and cannot be a formula for installing long-lasting institutions or eliminating corruption, significant progress has been made in finding ways to install and strengthen institutions, and reducing the scope of corruption. There is much still to be learned about these issues.

But the area in which foreign aid could <u>potentially</u> be most valuable for the low-income countries is in supporting economic policy reform. Despite progress made to date, most low-income countries still have far too much regulation and control over private economic activity, and too many state-owned enterprises, while simultaneously provision of public goods – roads, schools, public health clinics, ports and so on – is either inefficient and costly or simply unavailable. Barriers to private business, as I illustrated with the case of Egypt, are a significant drag on productivity.

Resistance to reform is strong, on the part of SOE employees, politicians who stand to lose a source of patronage, and many who believe that public ownership is good. Reforms, once undertaken, seem to have more immediate costs than benefits, and it generally requires a period of a year or more before the benefits begin to be felt. Foreign aid can support reform efforts by enabling budgets to be somewhat larger during the transition period, by focusing additional expenditures on groups that would otherwise be adversely affected, and by financing other spending that can help ease the transition.

To be sure, even some aid-financed reform programs will flounder – reforms are always uncertain in outcome, partly because of the possibility of political reversal and hence of the unwillingness of decision-makers to act on the new incentive structure in the short run, and partly because there is an element of luck – good or bad harvest, high or low export prices, and so on – in the outcome of most reform programs.

And even beyond an initial period of reforms, aid financing can facilitate the continuation and extension of reforms. No country is ever finished reforming – as economic development progresses even rich countries must address the changing economic circumstances that render earlier policies outmoded. But in poor countries, “first stage” reforms – often entailing trade liberalization, removal of price controls, and similar measures – need to be followed by other, perhaps less headline-grabbing but equally essential measures: moving agricultural commodity prices closer to international ones; charging appropriate user fees for water, power, and other public utilities; integrating and simplifying the tax structure, and so on. Some measures, such as improving the efficiency of ports and railroads, are often delayed for lack of resources and, again, foreign aid can be supportive.

To be sure, there are difficulties with all of these types of aid support. Some have originated from our (still) less than perfect understanding of the development process. But many have resulted from political pressures: heads of government can want aid directed to countries or causes that would not be high on an economist’s list of high-return expenditures. Indeed, some of the aid failures often cited by aid skeptics have been the result of political decisions, where the aid projects or programs that were in effect were there despite opposition of the technocrats, as Vern lamented.

One way of partially insulating aid from political pressures of this type is to increase the resources flowing through the World Bank and regional development banks, reducing the resources coming from individual member governments. When that is not possible, efforts can be made to find other ways to insulate the decision-making process for aid from political pressures, although that is admittedly very difficult.

One last issue requires mention. Except for a few specific issues, I have spoken of foreign aid without specifying the source. Yet many countries have bilateral foreign aid programs, while the international community has programs through the World Bank, the regional development banks, the United Nations Development program, and more.

For reasons already discussed, the substance of foreign aid should be and is being improved in qualitative and quantitative terms. But the aid donors remain as fragmented and incoherent as ever. Reports are frequently heard of countries' capitals, especially in sub-Saharan Africa, where as many as forty or fifty aid missions visit the finance minister and others within a given week. Aid projects that are funded can be complementary, but they are sometimes not. There are consortia that meet to pledge funding for particular countries (and less frequently, for individual projects), but once macroeconomic pledges are made, individual countries often proceed to fund those items that appeal to them without regard to coherence of the overall package.

Some degree of competition among aid agencies is no doubt desirable, if for no other reason than to encourage some experimentation with new approaches and ways of supporting development efforts. But with a large number of bilateral donors, the risk of diverting local officials' attention and talents away from their core functions is very great. Ways to shift more aid-decision making to the international arena, where there is at least a somewhat greater degree of insulation from domestic political pressures, would be desirable. The challenge is there, but ways to accomplish it are yet to be found.

To sum up: Despite the criticisms of foreign aid, there has been learning over the past decades, and it continues. Perhaps even more important, the political imperatives associated with the Millennium Development Goals and humanitarian concerns for living standards in very poor

countries insure that foreign aid will continue, so the problem on which attention should focus is how to make it as effective as possible, which does of course include learning from past mistakes. As already indicated, technical assistance especially for improving governance and institutions and reducing corruption can do much. Resources supporting economic policy reforms can have a very high rate of return. And even financing for infrastructure and other public goods associated with successful development can have high payoffs in very poor countries.

The largest four aid recipients of U.S. aid programs (then the largest source of aid) in the 1950s were Brazil, India, South Korea, and Turkey. All four of those countries are now regarded as being sufficiently successful to be classified at least being as emerging markets, but in the l960s and l970s many observers called into question how effective aid had been in those countries. Aid is, in any event, only one ingredient affecting the outcomes of development efforts. There have only been a few countries and a few periods of time where an aid inflow was more than 2-3 percent of the recipient's GDP. While support of that magnitude can be important, it cannot be determinative of the overall development outcome. It is to be hoped that in another 30 or 40 years, those now least-developed countries will also have reached emerging market status; at that time, it may be possible to look back and determine when and how aid was productive in achieving that outcome.

Let me conclude with the concluding paragraph of Vern Ruttan's 2003 book Social Science Knowledge and Economic Development (P. 268). "Since the l950s our understanding of the development process has made major advances. But we can never fully anticipate the consequences of any assistance activity or of any intervention into complex and interdependent social systems. Our limited knowledge about how to give and use aid to contribute most effectively to development does not, however, protect us from an obligation to assess the consequences of our strategic or development assistance and to advance our capacity to understand the role of external assistance in the development process. This constitutes a major challenge to the social sciences to advance knowledge for the design of sustainable development assistance programs in a world characterized by social and political disorder."