The Journal of Private Enterprise 25(1), 2009, 105-123

Can't Buy Me Growth: On Foreign Aid and Economic Change

Art Carden*
Rhodes College

Abstract
Evidence suggests that foreign aid does not promote economic growth. Institutions that promote entrepreneurship do promote growth. Understanding where these institutions come from is paramount to success. This essay analyzes and summarizes theory and evidence regarding the relationship between aid and economic growth.

JEL Codes: O1, O2, O4
Keywords: Economic growth; Foreign aid; Institutions; Property rights

I don't care too much for money, for money can't buy me love.
The Beatles, "Can't Buy Me Love"

"Can Foreign Aid Buy Growth?"
William Easterly, *Journal of Economic Perspectives* (2003)

I. Introduction

Does persistent poverty in the developing world express inadequate moral fiber or political will on the part of developed countries, or is it caused by something deeper? It has been contended that poverty is a moral or political failing on the part of donor countries: poor countries are poor because rich countries do not care, or they are poor because rich countries lack the political willpower to mobilize resources on the poor's behalf. In one view, poverty in the developing world exists and persists because of insufficient aid efforts on the part of rich, industrialized countries; thus, the solution to economic development is to bring unrighteous would-be donors to repentance and to make foreign aid more politically salable. In the other view, the problem runs much deeper than a simple lack of

* This paper received third prize in the 2007 Garvey Fellowship Essay Contest sponsored by the Independent Institute. Participants at the 2008 Association of Private Enterprise Education meetings provided useful comments.

assets and technology. This paper contributes to a debate on foreign aid and economic growth summarized by Jeffrey Sachs (2005) and William Easterly (2005a). Institutions providing incentives for entrepreneurs to accumulate assets and advance technology are at the heart of long-run growth.

Easterly (2005a) asks, "can foreign aid buy growth?" Evidence suggests that foreign aid *as such* has not, cannot, and will not solve the problem of global poverty (Easterly, 2002, 2005a). At the same time, alternative prescriptions aimed at reducing corruption, improving governance, and improving the institutional environment have not proven to be panaceas, either (Sachs, 2005). The billion-plus people who live in poverty or extreme poverty in the world today have been poorly served by modern development theory, policy, and practice, and the failure of trillions of dollars of aid payments over the last several decades to produce measurable results suggests that perhaps we should re-examine the theoretical and empirical foundations of development policy (Sachs, 2005, pp.18-19).[1]

In the words of Jeffrey Sachs, "(e)conomic development works. It can be successful. It tends to build on itself. But it must get started" (Sachs, 2005, p.73). Can countries take off into "sustained economic growth," à la W.W. Rostow, or is development a more complicated process constrained in many ways by political incentives and non-economic factors? In other words, can we create "high mass consumption" in the developing world by providing enough foreign aid to fill the "financing gap" between what a country can save and what a country "needs" for suitable capital investment?[2]

II. Poverty and Prosperity

To bring the question into high relief, consider several cases. The United States, a country with abundant natural resources, prospers. Russia, with abundant natural resources, struggles. Most oil-exporting countries are rife with corruption and poverty. Meanwhile, Hong Kong, Singapore, and Taiwan, countries with few natural resources (if any), prosper. And they have done so for the most part by allowing the invisible hand of the market to work.

[1] Sachs (2005, pp.18-19) puts the number of "extreme poor" in the world at approximately one billion people, while the number of "poor" is approximately 1.5 billion.

[2] For a survey of economic growth models and of the "financing gap" theory in particular, see Easterly (2003).

Developing institutions that harness the power of the market is the key. Differences in the performance of regions with strong markets versus regions with weak markets persist: Sachs reports that economic growth proceeded at a pace of 1.7 percent per year in the United States but at only 0.7 percent in Africa between 1820 and 1998 (Sachs, 2005, p.30).[3] This is particularly remarkable in part because it suggests the continuation of what Lant Pritchett (1997) calls "Divergence, Big Time:" in 1820, the United States was already a rich country. The difference is also highlighted by the relatively recent divergence of per-capita incomes in developed countries as compared to developing countries in the last millennium, as illustrated by Figure 1. Whereas today's developed and developing countries were on relatively equal footing at the end of the first millennium AD, the "developed world" GDP per capita was almost twice that of "developing world" GDP per capita in the early nineteenth century.

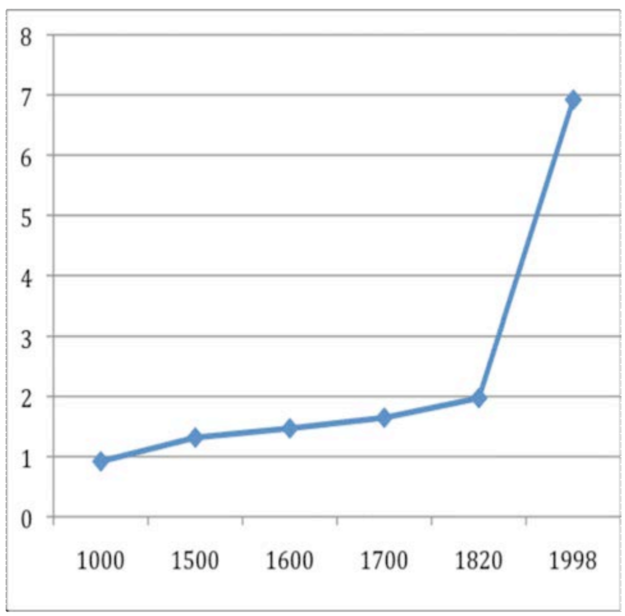

Figure 1. Ratio of Per-Capita GDP in the Developed and Developing World, AD 1000-1998. Source: North (2005, p.91), Table 7.1. Calculated from data in Maddison (2001, p.46). "Developed" includes Western Europe, European offshoots, and Japan. "Developing" includes Latin America, Africa, Eastern Europe, the former USSR, and Asia (excl. Japan).

---

[3] Sachs is reporting data collected by Angus Maddison (2001, 2003).

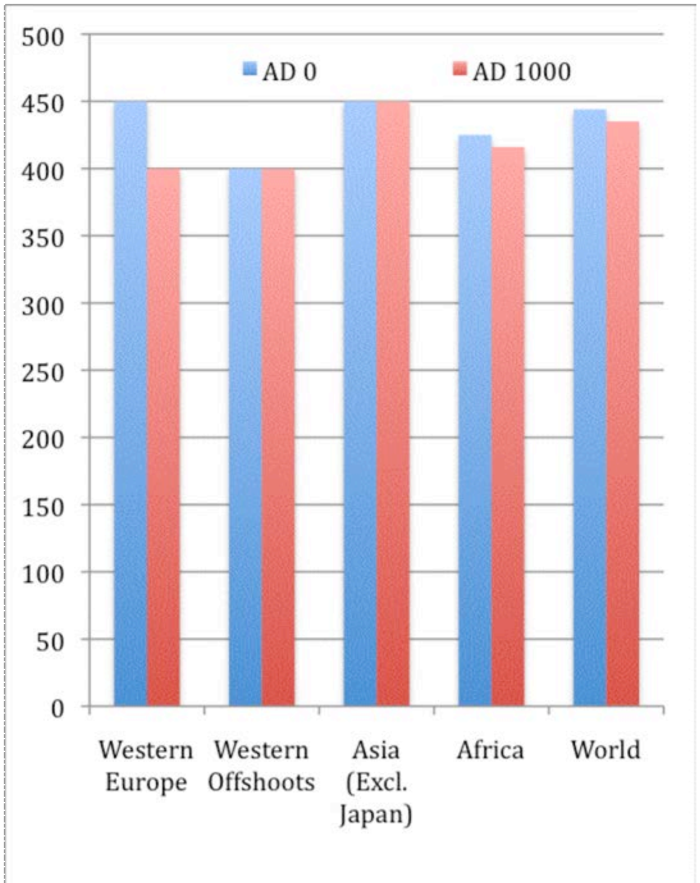

Figure 2: Per-Capita GDP, AD 0-AD 1000. Source: Maddison (2001, p.28). 1990 International Dollars.

Sharper divergence is evident in the last two centuries as developed countries are now almost seven times richer than developing countries.

Per capita GDP (PCGDP) was relatively equal and appears to have changed very little in the thousand years between the birth of Christ and 1000 AD for selected regions (see Figure 2). Indeed, relative stagnation persisted until approximately 1500, after which there were small increases in PCGDP in Africa and Asia but massive increases in Western Europe and her overseas extensions (Figure 3). The differential performance of the developed and developing economies runs counter to conventional models of economic convergence, whereby poor countries catch up to rich countries. As

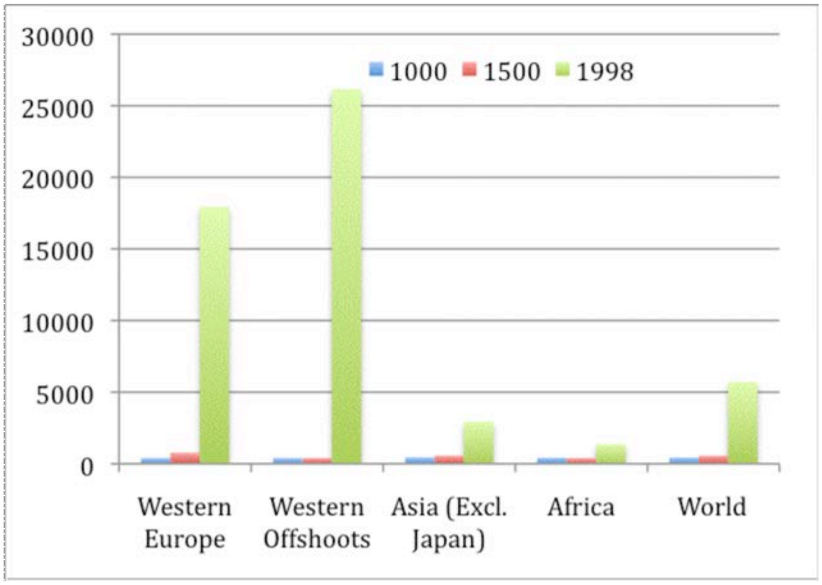

Figure 3. Per-Capita GDP, AD 1000-1998. Source: Maddison (2001, p.264). 1990 International Dollars.

Easterly (2006) argues, this is a result not of a "poverty trap" but of low levels of economic freedom.[4]

While market forces may be universal, formal markets are not.[5] Unknown is where, exactly, markets come from, how they evolve, and how they come to be "corrupted by the political process" (Ensminger, 1996, p.1). In short, our understanding of how markets evolve is tentative at best, and this ultimately constrains our understanding of economic change and development. An economy will be successful if it allows (and even encourages) risk-taking entrepreneurship. Furthermore, a structure of institutions resulting in reliable measures of profits and losses will provide the necessary guides by which entrepreneurs can determine whether they are or are not serving consumers.

By contrast, "(a)nytime the main profit opportunity in the economy is to get around government rules, not much good is going

---

[4] Pritchett (1997), cited in Easterly (2005b). As we will see, though, controlling for average economic freedom in a cross-section of countries supports the conventional convergence theory, in that poor countries grow faster than rich ones (Easterly, 2006).

[5] This characterization is taken from conversations with John VC Nye.

to happen in the real economy" (Easterly, 2002, p.221).[6] This is the case in many developing countries. The highest returns in many of these countries do not come from trade, investment, or production, but from activities aimed at circumventing onerous government regulations or from diverting resources out of private markets and into the hands of those who have been able to best curry favor with a country's rulers. Long-run development requires that people have incentives to produce something of value. No such incentive appears to exist in many poverty-stricken areas.

The formation of a market economy may be a complicated and difficult process. Ensminger reports that among the Orma society in Kenya, traditional social structures were disrupted by exposure to markets. In particular, the extent of the "moral economy" was reduced, and the degree of reverence that the young had for their elders decreased. Authority also came to be centralized in the hands of the state. All of these complications accompanied privatization of formerly "public" property as well as exposure to formal markets (Ensminger, 1996, p.2). Furthermore, it is important to note that the state's comparative advantage in violence means that private property institutions may not be credible.[7]

Economic development is an institutional rather than an infrastructural or technological problem. People respond to incentives, and the institutions defining those incentives have fundamental implications. In the case of "(t)he advocates of nation building," people are regarded as "bricks rather than human beings, bricks to be manipulated at will for the purposes of the rulers" (Bauer, 1988, p.222). Failure to recognize that people respond to incentives has led to many of the policy disasters of the last several decades (Easterly, 2002).

III. Institutions and Economic Freedom[8]

Empirical research on the causes of global poverty has focused in recent years on the role of institutions. Daron Acemoglu, Simon

---

[6] Easterly made this statement in the context of Jamaican currency regulation. De Soto (2000) attributes widespread poverty in part to a lack of formal property titles, which either pushes economic activity "underground" or diverts resources to wasteful rent-seeking.

[7] For more on this point, see North (1981) and Nye (1997).

[8] Easterly (2003, 2005a, 2005b, 2006) and Sachs (2005) discuss in detail the theoretical and empirical research on economic growth.

Johnson, and James A. Robinson (2001) use variation in historical patterns of settler mortality to identify the causal effect of the institutions of private property, while John W. McArthur and Jeffrey D. Sachs (2001) have criticized their findings on the grounds that the historical disease environment is correlated with the current disease environment and, therefore, an inappropriate instrument for institutions. More recently, Feyrer and Sacerdote (2006) have found that wind vectors, which are a plausible source of exogenous variability in island settlement, provide a "natural experiment" for exposure to European institutions. They find strong evidence that exposure to European institutions is causally correlated with higher economic development.

Economic freedom appears to be especially important.[9] Gwartney et al. (2006) report that lower economic freedom is correlated with higher poverty: countries with the lowest levels of economic freedom (which include primarily countries in Africa, Latin America, and Eastern Europe) tend to have the lowest levels of per-capita income. Average per-capita income for countries in the top quartile of the Fraser Institute's index of economic freedom is $24,402, while average per capita income for countries in the bottom quartile is $2,998. Perhaps the most striking (and distressing) characteristic of economically unfree countries is that their "unfree" status handicaps their economic development. The average annual growth rate in per capita income for countries in the top quartile of the Fraser index is 2.1 percent, while the average annual "growth" rate in per capita income for countries in the bottom quartile is -0.2 percent. The rich are getting richer, and the poor are getting poorer; however, this appears to be related in part to the fact that "the poor" are handicapped by institutions restricting economic freedom.[10]

What does this tell us about the relationship between foreign aid and economic growth? William Easterly reports tentative empirical results suggesting that foreign aid does not have a positive impact on

---

[9] This discussion is drawn from Gwartney et al. (2006).

[10] Gwartney et al. (2006). Economic freedom appears to be growing around the world: 98 of the countries with economic freedom scores in both 1980 and 2004 are more free now, while only four countries appear to have become less free, according to the data reported by Gwartney et al. They attribute this increase to "reductions in marginal income-tax rates," "improvements in monetary policy," and "global trade liberalization."

economic growth (Easterly, 2006, p.35).[11] "A quirk in the aid system such that small countries receive large shares of their income as aid, unrelated to their economic performance or needs" allows Easterly to control for the possible (even likely) endogeneity of foreign aid by instrumenting for aid as a percentage of gross national income with the log of 1980 population. In a regression in which per-capita income growth from 1960 to 2002 is taken to be a function of foreign aid as a percentage of gross national income from 1960-2001 and per-capita income in 1960, the coefficient on the aid measure is statistically insignificant; moreover, it is negative.

Easterly re-estimates the model using countries' average levels of economic freedom from 1970-2002; this results in several interesting findings.[12] First, evidence fails to support the "poverty trap" thesis. Controlling for both economic freedom and foreign aid, the coefficient on initial income is negative, which suggests that poor countries *do* grow faster than rich ones, all other things being equal.[13] Second, the evidence suggests that average economic freedom leads to higher economic growth, all else equal. Finally, controlling for economic freedom triples the magnitude of the foreign aid coefficient and suggests that foreign aid has a statistically significant, negative effect on economic growth.[14]

Even if foreign aid were perfectly effective, it is unclear that the recommended aid will produce the desired results. Timothy Besley and Robin Burgess report that much progress can be made with internal reform as opposed to foreign aid (Besley and Burgess, 2003).

---

[11] The following discussion summarizes Easterly's findings. Easterly notes that "(i)nstrumenting for two right-hand-side variables at once leads to more complicated problems of identification and weak instruments," suggesting that we "treat this exercise as illustrative rather than definitive."

[12] Easterly instruments for economic freedom using distance from the equator and four measures of the origin of the country's legal system: British, French, Spanish, and Socialist. It is to be noted that the sample size shrinks considerably in this case, from 94 countries to 65 countries. Nonetheless, as Easterly points out, this simple exercise suggests that there may not be a relationship between foreign aid and economic growth.

[13] This is consistent with the literature on convergence originating in part with Barro and Sala-i-Martin (1992).

[14] Easterly is "hesitant to stress this result too strongly, as the previous literature has found a zero effect of aid on growth, not negative," but "(a)t the very least…this illustrative exercise is consistent with the previous literature that aid does not have a *positive* effect on growth" (emphasis in original).

The United Nations recommends that wealthy countries devote 0.7 percent of GDP to aid; if this were done by the G7 countries, it would yield $142 billion in foreign aid dollars annually. By comparison, however, achieving a transfer of $1 per day to everyone in the world currently living would require annual outlays of $443 billion, and debt cancellation would require annual outlays of $1 billion. Even if potential donors could marshal the political willpower to devote 0.7 percent of GDP to foreign aid and even if this aid were uncorrupted by the political process, it appears that Besley and Burgess are correct in their contention that "domestic reforms are going to have to do the lion's share of the work" (Besley and Burgess, 2003, p.19).[15]

Markets are most effective because they eliminate errors and reward successes.[16] Where attempts at rational economic calculation in the absence of private property rights will be entirely arbitrary, entrepreneurs acting in formal markets with clearly-defined property rights will direct resources to where they are most highly valued. No such incentive exists in bureaucratic systems; indeed, actors in markets with poorly-defined property rights and extensive state intervention are often incentivized *against* policies that promote economic growth. As Easterly argues, "(p)lanners don't have a search-and-feedback mentality; rather, they implement a preconceived notion of what will work and keep implementing it whether it is working or not."[17]

Easterly argues that those with what he calls a "planner" mentality are often disposed to think in terms of what is appropriate and what will work *ex ante*. But we can never have the kind of certainty required for the planner approach to be feasible; indeed, *ex post* certainty regarding the impact of any policy or action is impossible, but where property rights are secure the person engaging

---

[15] The G7 includes the United States, Canada, the United Kingdom, Germany, France, Italy, and Japan.

[16] This characterization is originally from F.A. Hayek. See Easterly, (2005b) and North, (2005). Heyne, Boettke, and Prychitko (2002) define "the market" as "a system of competing bids and offers."

[17] The characterization of "competing bids and offers" is from Heyne et al. (2003). The argument that socialist calculation is impossible without private property rights originates in Mises (1920 [1990]). The quote from Easterly is from Easterly (2006).

in a particular action is close enough to his or her decisions to know whether they have created value or not.[18]

Through the political system, inappropriate institutions feed upon themselves until they create a morass that is almost impossible to escape. Rent-seeking coalitions will have it in their best interests to push for institutional changes that lead, ultimately, to the creation of a system that is increasingly chaotic and disordered. Institutions evolve to take on a life of their own: through a series of small, perhaps imperceptible changes at many margins, what may begin as a relatively simple, ordered system may turn very quickly into a chaotic mess.[19]

Consider, for example, a country's tax and regulatory environment. The system may begin in a state of relative harmony, with a simple, low flat tax to provide basic public services and an array of relatively simple regulations aimed at reducing fraud. Chaos begins immediately as various coalitions push for special favors and transfers through the tax code. Firms in a "strategic industry" may win tax breaks for certain activities. Additional regulations may be called for in order to thwart the onset of competition. Homeowners may win a tax deduction. Taxes may be raised, perhaps on "the rich," to compensate for the lost revenue from the tax deduction. Some goods are prohibited by tariffs. And so on. Eventually, what began as a relatively simple system degenerates into chaos.

The great success of the entrepreneurial system, of the market economy, is that it admits failure. Providing entrepreneurs with the flexibility they need to exploit profitable opportunities will be an important aspect of a growth-promoting institutional environment. By the same logic, a structure of institutions that allows firms to fail is also essential to economic growth. It provides reliable signals to eliminate ideas and production plans leading to wasted resources. Moreover, history, especially recent history, does not suggest that planners will have much success picking winners.

IV. Modeling Social Change

Sachs argues that there are four fundamental causes of economic growth: saving, trade, technology, and resources (Sachs, 2005, pp.52-56). Similarly, Joel Mokyr (1990) follows William Parker in describing

---

[18] For more on this point, see Block et al. (2006).

[19] For more on this point, see Olson (1983).

four types of economic growth: "Solovian growth," which occurs by increasing the stock of capital assets (physical and human capital); "Schumpeterian growth," which occurs via technological change; growth attributable to scale economies from increased population; and "Smithian growth," which is growth that occurs by moving closer to the production possibilities frontier via increased trade. Whether people have incentives to create value or expropriate it will determine whether a country is rich or poor, and the evolution of institutions that provide these incentives has produced several important strands of theoretical and empirical literature.

Models of social evolution discussed by Douglass C. North and Oliver Williamson provide some context for a positive analysis of how institutions evolve over time. In his 2005 book, Douglass C. North pushes back the frontiers of his inquiry into the role of institutions in economic performance by shifting his focus to the role of beliefs and "perceived reality" in shaping institutional change.[20] Our perceptions of "reality" – of the nexus of cause-and-effect relationships that govern the physical and social environment – will influence the types of beliefs that we form. "Beliefs" are propositions to which we assign truth values; these include both positive beliefs about cause-and-effect relationships as well as normative beliefs about justice, virtue, and other considerations. These beliefs inform the kinds of institutions that emerge, the constraints governing institutional evolution, and the organizations that form in response to the institutions. Very generally, organizations enact *policies*, *policies* create *outcomes*, and these outcomes alter our perceptions of reality. Over time, institutional, economic, and social change will be slow, incremental, and in many respects, fundamentally unpredictable.

The nexus between beliefs, institutions, organizations, and policies can be illustrated by considering the evolution of the guild system in pre-modern Europe. The rise of guilds (and of the regulatory state) can be explained by two problems. First, particularly for skilled labor, guilds and regulation may arise as a response to information problems. Guild membership certifies quality. Second, guilds may also be a vehicle for wasteful rent-seeking. As in most cases, guilds did "a little bit of both." While guild members had a

---

[20] For more on this, see North (2005). This discussion draws from Carden (2006). Alston and Ferrie (1999) propose a similar model to explain how institutional change affected economic outcomes in the Southern United States.

direct economic interest in the fruits of rent-seeking or information market completion, they were also enabled by a more general view that it was the duty of the consumer to provide the worker with a suitable standard of living. The idea that a conscientious, skilled laborer was "worthy of his wages" for his own sake facilitated the rise of the guild system and, in the twentieth century, lended credence to the 19th and 20th century labor movements in the United States and Europe.[21]

As Easterly points out, many failures of development policy have their roots in a general failure to recognize that people respond to incentives; indeed, the message of "old growth" economics was that "long-run growth would be at the rate of technological progress no matter what the incentives are" (Easterly, 2002, p.146). The channels through which growth occurs, as described by Sachs and Mokyr, outline the proximate causes of the wealth of nations; however, one is unlikely to see saving, trade, technological development, or resource exploitation in the absence of the right incentives. Specifically, in the absence of incentives that reward risk-taking and that specify clear residual claimants to the income accruing to assets, potential trades and investments will not be made, and people will be poorer for it.

Development has also been cast as a problem of transportation costs and excess labor. In other words, poor countries are poor because they lack the infrastructure necessary to grow and because their capital/labor ratio is too low. On one hand, decrepit physical infrastructure reduces the reliability of power generation, makes for relatively high transportation costs, and provides inadequate water and sewer services. On the other, a society may not have enough machines and "building factories would soak up this (excess) labor without causing a decline in rural production" (Easterly, 2002, p.30).[22]

This reduces problems of economic development to a set of very simple problems. First, external aid can fill the "financing gap" that causes the relatively low ratio of capital to labor (Easterly, 2002, p.30). Second, external aid can fix the infrastructure problems hindering development and can thus create the context for economic development. This stands in contrast, however, to the thesis of

---

[21] The evolution of the guild system in Europe is discussed by Landes (1998, pp.242-245).

[22] Here Easterly is interpreting the research of Nobel Laureate Sir Arthur Lewis.

Ludwig von Mises, who showed that rational economic calculation cannot happen without prices, which are in turn a function of local conditions (Mises, 1920 [1990]).

Oliver Williamson offers an analytical framework in which economic decision-making (first-order economizing) is constrained by governance (second-order economizing) and in which governance is constrained by the institutional environment (third-order economizing). This is, in turn, constrained by the cultural environment. The incremental, evolutionary framework ultimately produces culture and beliefs, with culture being the "transmission from one generation to the next, via teaching and imitation, of knowledge, values, and other factors that influence behavior." Culture transmits the lenses the through which we interpret reality and which help us develop mental models of the world around us. Institutions, then, arise from the interaction of "shoulds" constituting a society's beliefs and transmitted by culture.[23]

Institutions are, of course, only effective insofar as they are enforced. Thus, governance and credible commitment interact with formal and informal institutions to inform entrepreneurial expectations. In considering investment decisions, entrepreneurs consider the variance of anticipated income streams and of anticipated policy responses. Governance alters the marginal cost and marginal benefit of investment activities, and while markets will converge on "correct" marginal conditions (in that, in the limit, any action will be undertaken until marginal benefit equals marginal cost), these may produce outcomes inferior to what would obtain under different institutional constraints. Market forces lead us to equilibrium, but the characteristics of that equilibrium will be determined by the institutional environment and the governance structure.

Robert Higgs has analyzed the duration of the Great Depression using a similar framework in which he attributes part of the Depression's duration to "regime uncertainty" that manifested itself in a large-scale reduction in private investment (in some years, the reduction was so great that, allowing for depreciation, the economy experienced net private disinvestment). Higgs (1997, p.568) quotes Alston, Eggertsson, and North (1996, p.4): "In an economy where

---

[23] Williamson (1999, pp.9-11). The definition of "culture" is from Boyd and Richerson (1985, p.2), as quoted in North (1990, p.37).

entrepreneurship is decentralized, economic actors will hold back on long-term investments unless the state makes credible commitments to honor its contracts and respect individual ownership rights." Higgs goes on to state that "…the security of private property rights rests not so much on the letter of the law as on the character of the government that enforces, or threatens, presumptive rights." A sentence earlier, Higgs argues that "(m)any intermediate threats can arise from various sorts of regulation, for instance, of securities markets, labor markets, and product markets" (Higgs, 1997, p.568).

Outside the firm, transaction costs stem in part from incomplete markets and from state-created barriers to entry. Generally, there is an entrepreneurial imperative to fill holes in incomplete markets either through certification (in the case of incomplete markets for information) or through the creation of an actual market in which buying and selling can occur. Barriers created by the state may include licensing requirements or, in more corrupt countries, restrictions on firm size or a dizzying array of institutional arrangements, which might then require bribery and corruption if production is to take place.

Institutions reduce uncertainty "precisely because they are widely shared and have some degree of permanence" (Ensminger, 1996, p.6). Institutional change, then, may increase short-run uncertainty precisely because the new institutions may not be "widely shared" and may instead have some degree of transience. At each successive stage of "the game," so to speak, incremental institutional change will produce a new set of information on the basis of which members of a society will act. This new information will create a new set of relative prices. These new relative prices will constitute the new incentives that produce further institutional change. Whether governments are able to conduct "surgical strike" interventions is, at least, ambiguous: any intervention will alter relative prices to the disadvantage of another group and, therefore, lead to new rounds of rent-seeking and intervention.[24]

The institutional framework has important implications for foreign aid and its relationship to economic growth. Even if aid can cover the "financing gap" and lead to sustained economic growth, the transfer of aid from rich to poor will be complicated by the political incentives inherent in large cash transfers from rich to poor.

---

[24] For more on this, see Mises (1944 [1983]).

Easterly points out that "(t)he stress on aid disbursements is understandable given the peculiar nature of the aid mechanism" and summarizes this point directly:

> The governments of the poor countries, through which the aid is directed, often have little incentive to raise the productive potential of the poor, especially when doing so might engender political activism that threatens the current political elite. The aid agencies themselves in this difficult environment do not have much incentive to achieve results, since the results are mostly unobservable. One can hardly monitor growth itself for a given country for a given year, since growth in any given year or even over a few years reflects too many other factors besides aid. In these circumstances, it is understandable the aid agencies prefer to emphasize an observable indicator of effort – namely, aid disbursements.[25]

Another complication in the foreign aid debate is "tied aid," which is "restricted to the procurement of goods and services from the donor country" (OECD, 2001, p.1). Approximately half of the $8 billion in bilateral aid disbursed to "least developed countries" in 2000 was tied (OECD, 2001, p.1). While the OECD reports that there may be a macroeconomic justification for this policy in that tied aid restores balance-of-payments equilibrium by offsetting an outflow with an inflow, "such tying of aid implies a subsidy to enterprises in donor countries" and imposes burdens on aid recipients by increasing prices by 15-30 percent (OECD, 2001, p.1).

Since aid is a transfer from domestic taxpayers to foreigners, tying it to the purchase of donor-country goods and services may make it politically saleable in the donor country. However, transfers with strings attached are distortionary, as they require countries to purchase goods from providers who may not have a comparative advantage in a global marketplace.

Aid may represent a multi-million (or multi-billion) dollar appropriation; this in turn may provide an opportunity for rent-

---

[25] Easterly (2003, pp.34-35). In a sub-subheading in *The Elusive Quest for Growth*, Easterly points out the incentive problems inherent in government aid by noting that "Politicians are People, Too."

seeking, pork-barrel spending, and appeasement of interest groups. The unscrupulous policymaker may be able to kill two birds with one stone. On one hand, he can signal his care, concern, and commitment to international development by supporting foreign aid. On the other hand, he can appease various interest groups by attaching strings to the aid.

So what should we do? Easterly becomes sanguine in proposing a path "out of corruption and its growth-killing effects:" to "set up quality institutions" and to "establish policies that eliminate incentives for corruption" (Easterly, 2002, p.252). This is certainly easier said than done, but it points us in the right direction. All told, we are led in three directions. First, we should seek to improve the entrepreneurial climate in developing countries. Second, we should seek to reduce corruption in donor countries (via the problems associated with tied aid) so as to improve the aid situation. Finally, we should support the establishment of institutions that reward productive activity and punish predation.

V. Conclusion

Our quest to understand "the nature and causes of the wealth of nations" produced, in the two hundred years following Adam Smith, an array of models in which economic growth was a fundamentally technological problem. Countries with insufficient capital can be brought into modern growth through appropriate, targeted investments in infrastructure. Global development could be achieved by visionaries building bridges, literally. However, the relationship between official development assistance and economic development is tenuous at best, and evidence reported by William Easterly strongly indicates that there is at least no positive relationship between aid and growth. Moreover, the "poverty trap" thesis – that people are poor because they are poor (or because they started out poor) – finds little support in the data and, once one controls for economic freedom, it becomes clear that the neoclassical model of convergence holds (Easterly, 2006).

If not aid, then what? There are many directions we could take if we are interested in the plight of the very poor. First, there have been some aid-related development successes; clearing away the transaction costs and corruption that reduce the effectiveness of aid may be an important first step. In addition, institutions that reward entrepreneurship (or at least, enable entrepreneurship) are an important step toward allowing countries to enjoy economic development.

The problem is that these changes are certainly not simple. All institutions and arrangements exist for a reason – not necessarily a teleological reason, but for a reason in that institutions are the outcome, oftentimes the unintended outcome, of a process of incremental change through which people, responding to costs and benefits, alter political, social, and economic structures. The process may be slow, halting, and ugly. To the extent that we wish to understand why some people are very rich and other people are very poor, we would do well to examine at a deeper level how economies have evolved to "get it right," to use North's phrase (North, 2005). Evidence suggests that additional aid is unlikely to create higher growth. Understanding institutional change is of paramount importance: as institutions ultimately determine the structure of a society's incentives (and, therefore, the rate at which an economy grows), we should better understand their causes and their consequences.

References

Acemoglu, Daron, James A. Robinson, and Simon Johnson. 2001. "The Colonial Origins of Comparative Development: An Empirical Investigation." *American Economic Review* 91: 1369–1401.

Alston, Lee J., Douglass C. North, and Thrainn Eggertsson, eds. 1996. *Empirical Studies in Institutional Change*. Cambridge, UK: Cambridge University Press.

Alston, Lee J., and Joseph P. Ferrie. 1999. *Southern Paternalism and the American Welfare State: Economics, Politics, and Institutions in the South, 1865-1965*. Cambridge: Cambridge University Press.

Barro, Robert J., and Xavier Sala-i-Martin. 1992. "Convergence." *Journal of Political Economy,* 100(2): 223–251.

Bauer, Lord Peter. 1988. "Black Africa: Free or Oppressed?" In *Freedom, Democracy, and Economic Welfare: Proceedings of an International Symposium*, ed. Michael E. Walter, 213–223. Vancouver: The Fraser Institute.

Besley, Timothy, and Robin Burgess. 2003. "Halving Global Poverty." *Journal of Economic Perspectives,* 17(3): 3–22.

Block, Walter E., Art Carden, and Stephen W. Carson. 2006. "Ex Ante and Ex Post: What Does Rod Stewart Really Know Now?" *Business and Society Review,* 111(4): 427–440.

Boyd, R., and P.J. Richerson. 1985. *Culture and the Evolutionary Process.* Chicago: University of Chicago Press.

Carden, Art. 2006. Institutions and Southern Development: Lynching as a Signal of Insecure Property Rights. PhD diss. Washington University in Saint Louis.

De Soto, Hernando. 2000. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. New York: Basic Books.

Easterly, William. 2002. *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*. Cambridge, MA: MIT Press.

Easterly, William. 2003. "Can Foreign Aid Buy Growth?" *Journal of Economic Perspectives,* 17(3): 23–48.

Easterly, William. 2005a. "Reliving the '50s: the Big Push, Poverty Traps, and Takeoffs in Economic Development." Center for Global Development Working Paper Number 65.

Easterly, William. 2005b. *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good.* New York: Penguin Books.

Easterly, William. 2006. "Freedom Versus Collectivism in Foreign Aid." In *Economic Freedom of the World: 2006 Annual Report*, ed. Gwartney et al., 29–41. Vancouver: Fraser Institute.

Ensminger, Jean. 1996. *Making a Market: The Institutional Transformation of an African Society*. Cambridge: Cambridge University Press.

Feyrer, James, and Bruce Sacerdote. 2006. "Colonialism and Modern Income – Islands as Natural Experiments." http://ssrn.com/abstract=933591.

Heyne, Paul, Peter Boettke, and David Prychitko. 2002. *The Economic Way of Thinking,* 10th Edition. Upper Saddle River, NJ: Prentice-Hall.

Higgs, Robert. 1997. "Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War." *Independent Review,* 1(4): 561–590.

Landes, David. 1998. *The Wealth and Poverty of Nations: Why Some Are So Rich and Others So Poor*. New York: W.W. Norton.

Maddison, Angus. 2001. *The World Economy, Volume 1: A Millennial Perspective*. Organization for Economic Cooperation and Development.

Maddison, Angus. 2003. *The World Economy, Volume 2: Historical Statistics*. Organization for Economic Cooperation and Development.

McArthur, John W., and Jeffrey D. Sachs. 2001. "Institutions and Geography: Comment on Acemoglu, Johnson and Robinson (2000)." National Bureau for Economic Research Working Paper 8114.

Mises, Ludwig von. 1920. "Economic Calculation in the Socialist Commonwealth." Repr., Auburn: Ludwig von Mises Institute, 1990.

Mises, Ludwig von. 1944. *Bureaucracy*. Repr., Grove City, PA: Libertarian Press, 1983.

Mokyr, Joel. 1990. *The Lever of Riches*. Oxford: Oxford University Press.

North, Douglass C. 1981. *Structure and Change in Economic History*. New York: W.W. Norton.

North, Douglass C. 1990. *Institutions, Institutional Change, and Economic Performance*. Cambridge: Cambridge University Press.

North, Douglass C. 2005. *Understanding the Process of Economic Change*. Princeton: Princeton University Press.

Nye, John V.C. 1997. "Thinking about the State: Property Rights, Trade, and Changing Contractual Arrangements in a World with Coercion." In *The Frontiers of the New Institutional Economics*, ed. John V.C. Nye and John Drobak, 121-142. San Diego: Academic Press.

Olson, Mancur. 1983. "The South Will Fall Again: The South as Leader and Laggard in Economic Growth." *Southern Economic Journal,* 49(4): 917–932.

Organization for Economic Cooperation and Development (OECD). 2001. "Untying Aid to the Least Developed Countries." *OECD Observer*, July.

Pritchett, Lant. 1997. "Divergence, Big Time." *Journal of Economic Perspectives,* 11(3): 3–17.

Sachs, Jeffrey. 2005. *The End of Poverty: Economic Possibilities for Our Time*. New York: Penguin.

Sowell, Thomas. 2002. *A Conflict of Visions: Ideological Origins of Political Struggles*. New York: Basic Books.

Williamson, Oliver. 1999. "The New Institutional Economics: Taking Stock/Looking Ahead." *ISNIE Newsletter*, Fall: 9–19.