# Comment on "Rethinking Aid," by Jan Willem Gunning, and "Beyond Rosenstein-Rodan: The Modern Theory of Coordination Problems in Development," by Karla Hoff

*Gustav Ranis*

These two professional and provocative articles are well off the beaten track of the development literature. Though I would have hoped for more breadth in dealing with changes in development theory and policy, both articles make interesting points.

## Gunning's Article

Jan Willem Gunning's article addresses a main theme and a few side issues. The main theme is that Gunning accepts the conclusion of Burnside and Dollar (1997): that good policies are needed before aid can be effective. The question then is, how do donors and countries achieve good policies? Gunning maintains that it is not through ex ante conditionality, which has failed, but through ex post conditionality, or selectivity.

But why does ex ante conditionality not work? Gunning, Burnside, and Dollar seem to have been convinced by the reviews of the World Bank's internal evaluation units, as well as management surveys and academic assessments, that structural adjustment loans have a dismal record. Gunning cites four possible outcomes of conditionality and aid packages:

- Policy changes are not adopted.
- Policy changes are adopted but later reversed.
- Policy changes are adopted but would have been adopted anyway.
- Policy changes are adopted and stay in place.

According to Gunning, only the fourth outcome can be considered a success—and such cases have been few and far between.

### *A Few Problems*

I have two problems with this assessment. The first is minor. Gunning considers the third outcome a failure because policy changes are not driven by conditionality. But

Gustav Ranis is professor of economics and director of the Center for International and Area Studies at Yale University.

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if a policy change is adopted—even if it would have been without a negotiated package—aid may still be crucial to buffer the possible pain arising from the change. Indeed, achieving success through policy dialogue, accompanied by "self-conditionality" (see below), seems ideal.

The second problem is more serious: I believe this premature burial of ex ante conditionality is fundamentally mistaken. First, I cannot resist pointing out that policy-based nonproject lending was not invented by the Bank but sometimes successfully deployed by the U.S. Agency for International Development in the 1960s in places like Chile, the Republic of Korea, Pakistan, and Taiwan (China), when the Bank still favored a "projects only" approach. But the larger point is that the frequent failure of structural adjustment conditionality has more to do with how it has been carried out than with its intrinsic merit. Its rejection reminds me of when people are unwilling to order a certain dish just because they have been to a bad restaurant.

The problem with ex ante conditionality as it is currently handled is that it lacks credibility. At the risk of caricaturing the process, ex ante conditionality packages have come to resemble a ritual dance where both parties are familiar with the music and practice well-rehearsed steps. With all the conditions in place and implied threats in case of noncompliance, both parties agree that the funds need to flow quickly—for the recipient because they are needed and for the donor because they are the main source of leverage and, moreover, are an indicator of banking "success."

This approach to ex ante conditionality is hampered by:

- Inadequate nuancing of what needs to be done in a particular country, what few things can be done, in what sequence, and what risks should be insured against, over what time.
- The fact that it is still too centralized—for example, the Volcker Commission found that World Bank staff spent only 10 percent of their time in direct contact with least developed countries.
- Conditions and installments are usually overcome by the need to lend, a need deeply embedded in the flawed culture of the Bank—and even the International Monetary Fund, which hates to cut country programs. As a result aid may have the opposite effect of what is intended, as Devarajan, Dollar, and Holmgren's (2000) study of structural adjustment in Africa demonstrates. As the pressure for reform is removed, this perverse impact of aid on decisionmaking becomes an extension of the Dutch disease. Others have called it an income effect, distinguishing it from the substitution effect of inducing the desired better policies.
- A lack of sufficient passivity on the part of the international community—which does not let recipient countries offer reform proposals based on domestic consensus and accompanied by self-conditionality agreements (to be differentiated from papered-over "ownership").
- The unwillingness of international financial institutions to refuse to lend for several years if the conditions are not right, or to abandon loans midstream.

- The same donors' unwillingness or inability to adjust assistance in line with the risks, pain, and rewards of policy change and the need to ward off vested interests, including inside the government.
- The lack of attention paid to international institutions' potential role as knowledge banks, as emphasized by Gunning—allowing recipient countries to draw on them as they build domestic consensus on viable reforms. The provision of outside knowledge, as imperfect as it may always be, should be separate from the provision of dollars. Instead of denigrating the specialized agencies of the United Nations, they should be strengthened and accorded their proper role in the provision of know-how—when and if asked.
- *Inadequate attention to the possible regionalization of ex ante conditionality.* By this I mean increasing the involvement of regional development banks, which are closer to the local scene, and inducing neighboring countries (such as those in West Africa) to organize subregional self-conditionality following the post–World War II Marshall Plan in Europe.

Aid selectivity is Gunning's favored instrument. He sees policies as exogenous, so donors can reward "good" countries ex post. This notion troubles me for several reasons. Most important, learning occurs in repeated games, and policies inevitably become endogenous—so ex post becomes ex ante over time. Gunning seems to be aware of this, but overlooks it in his argument.

A second problem with selectivity is that it does not answer the question of what happens to poor people in badly performing countries. Donors cannot reach the poor through nongovernmental organizations or parachute drops if governments are opposed or not interested. So, donors need to do what they can even in less than ideal circumstances.

Third, apparently only Ghana, Mali, and Uganda would qualify for aid under Gunning's strictures. But Uganda's recovery has been quite recent. Was its marked change in policies really exogenous? And could it have been achieved without the ex ante provision of external resources?

Incidentally, I have no conceptual problem with an evaluation system based on outcomes rather than policy inputs, as suggested by Gunning. Indeed, I can see some advantage given that neither donors nor recipients ever grasp the complete truth. But we still must judge whether to reward countries when they have had some exogenous good luck, relative to others who tried to reform but were caught in an equally exogenous drought or terms of trade deterioration.

## A Few Detours

Gunning also takes a few detours that are somewhat off the track of his main argument. For example, he unveils the special case where aid effectiveness depends not only on the quality of policies but also on structural vulnerability. I am puzzled: if adding such vulnerability variables as terms of trade fluctuations means that the aid and policy interaction variable is no longer significant, why the also? Are vulnerability and good policies really independent variables?

A second question concerns the claim that if there is a terms of trade decline, savings will be used to smooth consumption. If the permanent income hypothesis has not met empirical tests in industrial countries, it seems even less likely to apply to poor farmers in Sub-Saharan Africa. But perhaps the biggest puzzle is why, if Burnside and Dollar (1997) are right in the general case, Gunning finds it necessary to introduce this special case at all.

Later in the article Gunning discusses the high cost of taxation as a substitute for aid. I agree, though again I do not see a clear connection to his main theme, which focuses on policy change, not alternative sources of straightforward resource flows. Gunning advocates using unconditional aid for tax cuts or for transfer payments to favored elites. But what is the threshold where these elites exceed a critical share of the population? Moreover, I am not convinced that poor people are necessarily helped by across-the-board tax relief. They usually do not pay direct taxes; what they need is increased spending, especially on health and education.

Gunning presents another apparent obiter dictum. It is no surprise that Alesina and Dollar (1998) find that aid allocations are linked to former colonial ties. Donors—bilaterally or through their influence over multilateral agencies—often have objectives quite aside from achieving development goals. Regression analysis performed at the U.S. Agency for International Development in the 1960s found proximity to the communist bloc to be the most significant explanatory variable. In fact, country allocations are often determined by such political factors, while choices within countries are more likely to be guided by development goals.

A final comment on this stimulating and thought-provoking article: it is understandably somewhat Afrocentric. Would Gunning have expressed the same preference for ex post conditionality in South Asia or the Andean countries of Latin America?

## Hoff's Article

Karla Hoff's article revisits Rosenstein-Rodan with the help of modern theory. Overall, it is a fascinating, erudite article—the author is clearly a superior theorist and craftsperson. Still, I have a few concerns. For one thing, the article is geared toward looking for underdevelopment traps and downplays the analysis of a system's ability to escape from them. In this sense Rosenstein-Rodan, who discussed a possible escape through balanced growth—if not necessarily stimulated by market forces—was much more optimistic than Hoff. I agree that private rationality does not necessarily lead to social rationality, but neither are the two necessarily in conflict.

Turning to a more detailed assessment of Hoff's contribution, which has a distinctly Stiglitzian flavor, she argues convincingly against the inevitability of a neoclassical good equilibrium, and I agree. But neither is a bad equilibrium inevitable. Hoff presents a formidable list of possible coordination failures leading to traps:

- Markets are not perfect, and information asymmetries exist.
- Search costs are high.

- Even research and development can be subject to the prisoner's dilemma and a consequent race to the bottom.
- Returns to rents may exceed returns to productive activity—probably due to heavily intervened markets.
- Institutional change does not necessarily lead to more perfect markets.
- Even more heretically, market forces do not necessarily lead to a better equilibrium, given the high cost of enforcing property rights.
- An unequal distribution of wealth can lead to biases and distortions in factor markets.
- There may be a mismatch between investment in training and the requirements of a new technology.
- There may be predatory behavior on the part of government or a lack of social capital in civil society.

Unlike many of my colleagues, I do not have to be convinced that development is not an equilibrium enterprise. Even Kenneth Arrow readily acknowledges that the neoclassical good equilibrium, especially in a development context, is at best reached only over time. But Hoff promises to examine ways to counter coordination failures and harness spillovers with the help of policy reforms to enhance the chance for good equilibria. She refers to pitfalls and opportunities, but I found little reference to opportunities. Hoff seems to be trapped by the task of locating and explicating the meaning of a variety of traps.

In particular, I was surprised that Hoff did not refer to the new growth theory of Romer (1990) and Lucas (1988), which emphasizes the possibility of positive spillovers and externalities. While I am not impressed with the lack of empirical content in that theory, it does emphasize growth as an evolutionary process and focuses on opportunities. Admittedly, economic systems may be diverging instead of converging, but it is possible to achieve a good equilibrium and development success without convergence. Indeed, convergence makes unrealistic assumptions about all countries following the same production function and being subject to the same institutional constraints and knowledge frontier. That may hold only for typological neighbors, such as members of the European Union or states of the United States. Still, the theory should not be ignored.

Turning to Hoff's econometric test of rural China, I found somewhat doubtful the assumption of little factor mobility in response to different geographic opportunities, given the movement of workers to coastal areas and cities—especially now that migration prohibitions have been lifted. While I agree that county wealth affects household wealth through private income and public spending patterns, living standards and growth rate differences are more a function of different agricultural productivity and distance from ports, not wealth per capita (see Jalon and Ravallion 1998). Indeed, the richer Jalon and Ravallion model abandons county and household wealth and comes close to offering rather conventional multivariate analysis to explain consumption growth.

The basic question should presumably be what combination of markets and the state best reduces the risk of coordination failure—not what special assumptions are needed to generate a trap. Deep interventions, not fully defined, are claimed to have permanent, irreversible effects, presumably leading to bad equilibria. Shallow interventions, not defined, presumably can be reversed and lead to positive opportunities. But this is not explored.

In conclusion, I accept that the behavior of other agents affects my welfare. But I am not convinced why this should most likely lead to a bad rather than a good equilibrium, counter to what new growth theory tells us. Hoff is clearly a capable professional. I just hope that in the future she does not take her "dismal science" union card as seriously as she has in this article.

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# Comment on "Rethinking Aid," by Jan Willem Gunning, and "Beyond Rosenstein-Rodan: The Modern Theory of Coordination Problems in Development," by Karla Hoff

*Charles C. Soludo*

Especially for the 48 least developed countries, few topics are more important than those raised by Jan Willem Gunning and Karla Hoff. Despite more than 50 years of development economics and official development assistance—along with 20 years of special attention to Sub-Saharan Africa—the track record is an embarrassment. Since the early 1970s only diamond-rich Botswana has moved out of the group of least developed countries, this despite the fact that official development assistance to these countries has averaged 19 percent of GDP a year.

In fact, during this period more countries became least developed countries than graduated from the class. The average person in these countries was richer in 1979 than in 1999. Severe poverty continues to deepen. And the debt burden from earlier aid circumscribes prospects for sustainable development as well as the effectiveness of current and future aid. For these countries it is as if the insights from development economics and the role of development finance have been incomplete or entirely wrong. Thus the entire approach to development must be reconsidered, and Hoff and Gunning should be congratulated for the job they have done dealing with voluminous, difficult subjects.

But while Hoff and Gunning generally do a good job of addressing underdevelopment traps, their analyses suffer from two defects. First, the analyses center on the nation-state—so there is no recognition of the implications of globalization. The nation-state is grossly inadequate for understanding why underdevelopment traps have become localized in certain regions and why aid is often ineffective. Second, the authors' policy conclusions are somewhat simplistic and couched in an extremist either-or framework. As a result they overlook complementarities in the causes of and solutions to underdevelopment traps and ineffective aid.

## Gunning's Article

I have several concerns about Gunning's article. First, its title advertises more than the article delivers. Rather than addressing the larger issue of aid, it focuses on the

Charles C. Soludo is professor of economics at the University of Nigeria.

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functions of aid. It reviews the recent debate on the role of aid in providing finance, changing policies, transmitting knowledge, and providing insurance against shocks. Needless to say, some of the conclusions are controversial.

But Gunning omits several important issues in the debate on the delivery and effectiveness of aid. Among these are basic issues about the domain of aid—that is, the amounts to be delivered by communities, the central government, and regional or global actors. (Put another way, this is the debate on national and regional or international public goods.) Gunning also misses an important debate on donor coordination (see Kanbur, Sandler, and Morrison 1999). In addition, the article skates around the question of what aid should finance beyond tax relief and a knowledge bank. Finally, the relationship between debt and current and future aid effectiveness is overlooked. In countries where debt payments exceed government spending on health and education, or where debt rescheduling eats up more than half the time of senior civil servants, it is hard to evaluate aid without addressing these issues.

Second, Gunning argues that ex ante conditionality does not work, and should be replaced by ex post conditionality, or selectivity. But this prescription is based on the shaky premise of an exogenous policy regime. In most of the least developed countries, policy choices—and more important, the sustainability of reforms—are not determined by exogenous political will. Policies are circumscribed by a number of other issues, including debt, expected aid, and exogenous economic shocks. While aid cannot buy sustained reform from unwilling governments, willing governments of least developed countries cannot sustain reform without aid. It is a chicken and egg problem.

For example, frequent reversals of trade liberalization have little to do with political will for reform and much more to do with the macroeconomic incompatibility of liberalization. None of Africa's least developed countries has been able to sustain trade liberalization without ex ante aid or promises of aid to smooth the fiscal and balance of payments problems that liberalization entails. So, if donors are looking for a proven track record with trade liberalization before delivering aid, they are unlikely to find one in Africa. Ultimately, aid would continue to be a gamble—with an ex ante commitment being the relevant variable. Furthermore, ex ante conditionality has not failed in all cases, and the swing to selectivity is a naive response to an imperfect delivery process.

In my view selectivity is donors' response to declining aid. The argument seems to be that if there is not enough aid to go around, why not just give it to countries that can make the best use of it? But selectivity does not solve the problem of declining aid. If all the least developed countries were to implement the policies required by selectivity, current aid would be too thin to be effective.

A third issue involves the signaling role of aid. Gunning argues that donors could use selectivity to signal that aid is tied to success. But such signaling does not mesh with country incentives, because success results in higher debt payments. Furthermore, the argument for using aid to lock in policies in recipient countries presumes certainty on what constitutes the best policy options. Because donor preferences are subject to fads and fashions, efforts to lock in "good" policies run the risk of maladjusting the least developed countries—as the past 20 years have shown. Gunning acknowledges this uncertainty on what works best. Put differently, the signaling role of aid would not be all that different from ex ante conditionality because *it would signal which* behaviors are rewarded.

My last comment on Gunning pertains to his argument that aid be used for tax relief. True, there is a strong argument for using aid to provide temporary tax relief at early stages of growth. But it cannot be generalized. Aid and taxation should be seen as complements, not substitutes. Domestic resource mobilization does not always imply higher tax rates. It could involve higher compliance ratios—or lower rates with a broadened base. For example, lower tariffs could reduce the incentive for smuggling, raising government revenue. Resource mobilization also depends on initial conditions. In a country where tax revenue accounts for 5–10 percent of GDP, it is possible to raise revenue without distorting production.

## Hoff's Article

Hoff summarizes the evolution of modern theories of development, especially the broader understanding of sources of spillovers. She emphasizes developments in institutional economics, path dependence, and views on externalities and public goods. These models show that multiple equilibria can occur—some of them desirable and some of them underdevelopment traps—and that the market may fail to deliver a good equilibrium. Thus coordination failures are important.

Hoff evaluates new insights on the nature of the traps, which in the 1950s necessitated official development assistance, and concludes that the new view dictates not more resources but less resources and deeper interventions (requiring more skills). This conclusion requires further elaboration: it is not clear from the article what less resources would entail. More precisely, couching the issue in terms of either resources or legal changes and the like (deep intervention) can send the wrong message. From the analysis, both are required: they are complements, not substitutes. Hoff acknowledges this complementarity in several places. For example, she argues that development requires complementary changes in the behavior of agents that not even the market can coordinate.

Hoff goes on to recommend temporary legal reforms, policies that change beliefs, and changes in the distribution of wealth, which may contribute to coordinated changes to shift an economy to a better equilibrium. But the effectiveness of such efforts may be circumscribed by the same factors that Hoff refutes as being fundamental to development—free markets and international trade, the transfer of capital, and the emergence of an entrepreneurial class. Denying the importance of these variables does more to obfuscate than clarify the issues. For example, such a position ignores the causal two-way links between beliefs, culture, and the production structure on one hand, and the alteration of the production structure and the variables described as not being fundamental to development on the other. Frankly, the tragedy of the development discourse of the past 50 years is that every little addition has been dramatized as the ultimate insight instead of part of the accumulated body of knowledge. Complementarity is the key word that many analysts fail to internalize.

My second point is that Hoff takes a narrow view of underdevelopment traps, largely confining her analysis to nation-states. If globalization is taken into account, and traps are analyzed within the context of the global village, both the breadth and depth of the traps would change. The analysis of multiple equilibria would apply as much to a nation-state, a region of a country, or the world. Policy responses—shallow or deep interventions, or combinations of skills and resources—would differ depending on the framework of analysis. If Rosenstein-Rodan framed his analysis in the context of a closed economy, Hoff's is to a large extent guilty of a similar framework.

An open economy framework is crucial for understanding traps and their remedies because of the asymmetries of globalization. Globalization enables productive resources to move freely while populations are confined to certain locations. Given the poorer initial conditions of certain locations and path dependence, destitution seems to be localized. Moreover, the cost of breaking out of a vicious circle seems to be getting higher by the day. For example, countries that fall short of the capital required for self-sustaining growth are, given path dependence, condemned to low-level equilibrium. As a result investments quickly move from poorer to richer countries. Thus the Biblical injunction is fulfilled that "to he who has, more shall be given and to he who has not, even the little he has shall be taken away and given to he who has more."

This process explains the increasing divergence between least developed and OECD countries over the past 40 years. And despite the liberalization of current accounts and capital mobility, returns are not equalized. Nor does arbitrage occur to equalize returns: there is still a home bias for capital or even the "ethnicity" of capital. The United Nations Conference on Trade and Development estimates that investment returns are highest in Africa, yet foreign direct and portfolio investments have not flowed to the region. Without conscious efforts to break out of the traps, poor economies might remain mired in perpetual poverty.

## Globalization Tax and Trade as Remedies?

From the above discussion it is evident that low-level equilibrium traps are as much a feature of national economies as of the global system. Getting out of the traps requires good policies. Poor countries need stronger institutions, deeper reforms, and better sequencing. But they also need increased global coordination and a significant big push—given the drains on the system due to poverty, much larger resource transfers are needed. This same insight underscored the development economics of the 1950s. But the main reason past resource transfers failed was that their size and timing were determined more by the whims of the donors than by the development needs of the recipients. In addition, there is little international coordination to make aid work for development and help poor economies move from aid dependence to sustainable growth.

Aid flows are falling. Despite growing needs and better policies in poor countries, aid dropped 23 percent in real terms in the 1990s. Aid is falling because its political and commercial motivations have changed. With the World Trade Organization, there is little incentive to "buy" trade with aid. With the end of the Cold War, there is little incentive to dole out aid for strategic interests. And countries hardly provide charity with aid, except occasional humanitarian responses.

Because low-level equilibrium traps will persist without significant aid injections, the challenge is ensuring increased resource flows and sustaining a move out of poverty. Because the current system based on altruism does not work, a global mandatory transfer mechanism is needed. An example of such a mechanism is the proposal for a globalization tax (Soludo 1999).

The case for a mandatory transfer is intuitive. Multilateral arrangements—the World Trade Organization, the Bretton Woods institutions, the United Nations system—already harmonize policies and institutions, but without a governance structure to ensure mandatory transfers to pull along left-out countries. The current global system is akin to a federal state without free movement of people, and with no mandatory transfers to poorer regions.

This system needs serious rethinking to develop a structure for implementing the transfers. For example, further attention could be given to the suggestion by the U.S. Congressional committee on the Bretton Woods institutions that the World Bank become solely a grantmaking institution and the International Monetary Fund serve as the global lender of last resort (world central bank). A globalization tax, perhaps set as a percentage of countries' GDP or realized as proceeds from a global Tobin tax, could be paid to the World Bank. In turn, grants would be made to the poorest countries based on agreed criteria, including the level of underdevelopment, commitment to reforms, and need for regional and international public goods.

Beyond increased mandatory transfers to poor regions, the multilateral system needs better coordination. Even with increased mandatory transfers, globalization may not lead to good equilibria at the global level. Better coordination requires action at two levels. On the one hand there is a need for increased capacity and capability building—especially to diversify production and build export competence. Here aid can help provide skills and act as a knowledge bank (as emphasized by Gunning).

But different coordination is also required, and entails providing the poorest countries with preferential trade opportunities. Unless small, poor economies have unlimited access to OECD markets it is difficult to see how they can achieve sustainable growth. Since populations will not move freely across borders, trade preferences can be a powerful stimulus for global income distribution. OECD countries provide agricultural subsidies equal to Africa's GDP, and this agricultural output is dumped in Africa. Though Africa is supposed to have a comparative advantage in primary commodities, it cannot sustain a competitive advantage in the face of such dumping. Furthermore, even the little that Africa produces faces enormous obstacles because of nontariff barriers imposed on such goods by OECD countries. Thus, to escape the low-level equilibrium and empower African producers to reap appropriate returns from their labor, unrestricted access to Western markets is crucial.

Without mandatory transfers to the poorest countries and coordination that gives producers in these countries unconditional access to Western markets, it is hard to see how underdevelopment traps can be overcome or future aid made more effective. If these ideas sound too idealistic, so be it: nearly every idea that later became orthodoxy started that way. The problem is not so much the soundness of the idea but whether rich countries have the political will and courage to think and do things differently.

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