Book reviews


Chapter 1 of Easterly’s book, entitled “To Help the Poor”, vividly demonstrates why growth matters. Infant mortality rates are 50 times higher in the poorest fifth of countries compared with the richest fifth. Millions of children and adults in developing countries suffer from diseases which are inexpensive to prevent or cure. The poorest of the poor face both hunger and oppression. Easterly’s book is an engaging discussion of what has gone wrong with economic development over the last 50 years. This includes a detailed discussion of the role the economics profession has played in this sad history. While the book does include recommendations for improved policy making, in the conclusion Easterly notes, “The problem of making poor countries rich was much more difficult than we thought. It is much easier to describe the problems facing poor countries than it is to come up with workable solutions to their poverty” (p. 291).

In Part II of the book, Easterly provides a systematic analysis of development panaceas that have failed. His discussion begins with an analysis of foreign aid designed to fill the gap between saving and desired investment in the developing economy. This financing gap approach was inspired by the Harrod-Domar growth model in which output is proportional to capital. The financing gap approach has been a failure for two reasons. First, the relationship between investment and output is not stable; when economic incentives are distorted, bad investments are made and the expected growth does not follow. Economic development is more than just capital accumulation. Second, in most countries, the data do not show a positive link between aid and investment.

Easterly uses the computations of Lucas to show that observed differences in the level economic development are not consistent with a transition to the steady state in a Solow growth model. This model implies unrealistically high real interest rates in poor countries such as India. Again, development is not simply a matter of capital accumulation. As Solow concluded long ago, long-
run growth must be driven by technological progress. Easterly argues that differences in the level of technology across countries are due to differences in incentive structures.

Easterly does a fine job of demolishing capital fundamentalism, but in spots he seems almost too enthusiastic in downplaying the role of capital in development. Once the incentives are “right”, investment will be productive and a great deal of technological advance will be embodied in physical capital. Similarly, in Chapter 4, Easterly presents a strong case that increases in the level of education do not automatically result in economic growth. If incentives are distorted, people will accumulate the wrong set of skills, or allocate their skills to rent-seeking activity rather than productive activity. Once again, Easterly is at times too enthusiastic in debunking education as a growth panacea: “One clue as to why education is worth little more than hula hoops to a society that wants to grow comes from what the educated people are doing with their skills” (p. 82). His own discussion on increasing returns (see, e.g., p. 160) indicates he believes that education plays an important role in growth, when people are responding to the right incentives.

In the course of his discussion of capital accumulation and growth, Easterly (p. 59) cites some figures which should be at the fingertips of anyone interested in the globalization debate: The poorest 20% of the world receives 0.7% of foreign direct investment, while the richest 20% receives 79%. An even greater percentage of portfolio capital flows to the rich countries. The belief that capital is pouring out of the rich countries in search of rock bottom wages in the poorest countries is simply wrong. The idea that extreme poverty in the poorest 20% of the world is somehow caused by the multinationals who do invest there is absurd. A more reasonable complaint for protesters against globalization (at least those who purport to care about the poor in developing countries) would be that the U.S. is soaking up so much of the world’s capital!

Easterly (a World Bank economist) has an extensive discussion of adjustment lending by the IMF and World Bank. While there are a few success stories, many countries have received numerous loans without any permanent adjustment taking place. A failure to comply with the conditions of a loan seldom results in a cutoff of future lending. Easterly cites bureaucratic incentives as reasons why loan conditions are not more strictly enforced. These include a possible Samaritan’s dilemma. To the extent that the aid agencies care about the poor in the recipient country, they may not have a credible threat to cut off lending in the event that loan conditions go unmet. But the aid game is repeated, and this should provide international lenders with an incentive to acquire a reputation for enforcing the conditions of loan agreements.

Easterly recommends that aid be tied to past policy performance. Aid should flow to those countries with a proven record of adopting policies
conducive to growth. He also recommends that aid increase with a country’s income. He argues that this avoids a perverse incentive countries may face which is that as they grow, aid levels generally drop. This would be a difficult policy to justify to the public and it seems unnecessary if we follow Easterly’s first bit of advice and tie aid to policy performance. If aid is really taken away when bad policies are followed, the prospect of losing aid gradually through growth should not matter. Also, foreign aid is peanuts compared with the benefits of growth. (Just think about what foreign aid amounts to as a percentage of developed country GDP.) Any government which cares sufficiently about the welfare of its citizens to follow sound economic policies should realize this.

Debt relief is another form of foreign aid and there have been many calls for additional debt relief for highly indebted poor countries. Easterly points out that debt relief has not generally reduced debt burdens as new borrowings take the place of forgiven debt. He concludes that: “Debt relief is futile for countries with unchanged government behavior. The same mismanagement of funds that caused the high debt will prevent the aid sent through debt relief from reaching the truly poor” (p. 136). He argues that debt relief should be a one-time event reserved for governments with a proven record of responsible policymaking.

Easterly provides an extensive discussion of externalities and increasing returns to scale. He clearly believes these are an important part of the growth story. As is well known, externalities and increasing returns to scale can lead to poverty traps. Thus achieving growth may require more than the avoidance of bad policies. For example, if skill complementarities are important, it may be necessary to subsidize skill accumulation to escape an equilibrium in which few individuals find it profitable to acquire skills. Easterly also believes that externalities associated with knowledge creation justify the subsidization of R&D activities.

Easterly devotes an entire chapter to a discussion of luck in economic development. He notes that there is very little correlation between growth from 1960–1975 and growth from 1975–1990. Since policies within a country seem to be much more highly correlated over time than growth, Easterly attributes part of the variance in growth to chance. To the extent that increasing returns to scale are important, chance may play a very important role in a country’s success. A favorable shock may allow a country to escape a poverty trap, while a negative shock could throw a country back into an unfavorable equilibrium. This chapter contains an excellent discussion of mean reversion and an example, using roulette, of how pure randomness can leave some people looking very smart and others looking very dumb.
While luck matters, so does policy and Easterly follows his discussion of chance with a familiar litany of policy failures in developing countries. These include high inflation, a high black market premium on foreign exchange, negative real interest rates, excessively high budget deficits, and a restrictive trade regime. In addition, many developing country governments have failed to provide an adequate infrastructure and health services. Many of these basic activities are estimated to have very high rates of return. Several of the policy failures identified by Easterly have led to opportunities for government corruption, which he identifies as another important barrier to growth. Decentralized corruption is most damaging to growth, since atomistic bribe takers do not take into account the effect of their activities on the aggregate level of economic activity.

Easterly provides an extensive discussion of the effect of polarization on growth. He cites research indicating that greater income inequality leads to slower growth and greater political instability as measured by revolutions and coups. In addition, the most ethnically diverse nations have lower per capita growth, fewer public services and significantly greater risk of civil war and genocide. Ethnic diversity is measured by the probability that two random members of a population speak different languages. Easterly notes that this measure of ethnic diversity is highest in sub-Saharan Africa, a region of the world which has had a very poor growth performance over the last forty years.

This is a stimulating book, whose flaws are relatively minor. The ratio of insight gained to effort expended by the reader is very high. It is accessible to senior undergraduates and would also make good supplementary reading for a graduate development course. It will provide an excellent entrée to a very large literature on growth and development. This book will also be of considerable value to a wide group of economists and other social scientists with an interest in growth and development.

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In reviewing a volume of this sort, which aspires to cover the field of public choice, one has three hopes for the various essays: First, that each be comprehensive and encyclopedic in its coverage. Second, that the essays be clearly written, perhaps even lively. Finally, and perhaps the hardest hurdle