

# THE EVOLUTION OF THE DEVELOPMENT DOCTRINE AND THE ROLE OF FOREIGN AID, 1950–2000

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## **Introduction**

The economic and social development of the third world, as such, was clearly not a policy objective of the colonial rulers before the Second World War. Such an objective would have been inconsistent with the underlying division of labour and trading patterns within and among colonial blocks. It was not until the end of the colonial system in the late forties and fifties, and the subsequent creation of independent states, that the revolution of rising expectations could start. Thus, the end of Second World War marked the beginning of a new regime for the less developed countries involving the evolution from symbiotic to inward-looking growth and from a dependent to a somewhat more independent relation *vis-à-vis* the ex-colonial powers. It also marked the beginning of serious interest among scholars and policymakers in studying and understanding better the development process as a basis for designing appropriate development policies and strategies. In a broad sense a conceptual development doctrine had to be built which policymakers in the newly independent countries could use as a

guideline to the formulation of economic policies.

The selection and adoption of a development strategy - i.e. a set of more or less interrelated and consistent policies - depend upon three building blocks: (1) the prevailing development objectives which, in turn, are derived from the prevailing view and definition of the development process, (2) the conceptual state of the art regarding the existing body of development theories, hypotheses and models and (3) the underlying data system available to diagnose the existing situation and measure performance. Figure 1.1 illustrates the interrelationships and interdependence which exist among (i) development theories and models, (ii) objectives, (iii) data systems and the measurement of performance and (iv) development policies and strategies, respectively. These four different elements are identified in four corresponding boxes in Figure 1.1. At any point in time or for any given period these four sets of elements (or boxes) are interrelated. Thus, it can be seen from Figure 1.1 that the current state of the art, which is represented in the southwest box embracing developments theories, hypotheses and models, affects and is, in turn, affected by the prevailing development objectives - hence, the two arrows in opposite directions linking these two boxes. Likewise, data systems emanate from the existing body of theories and models and are used to test prevailing development hypotheses and to derive new ones. Finally, the choice of development policies and strategies is jointly determined and influenced by the other three elements - objectives, theories and data, as the three corresponding arrows indicate.<sup>1</sup>

[Figure 1.1 about here]

In turn, the role and function of foreign aid is influenced by and has to be evaluated in the light of the contemporaneous state of the art in each of these four areas. Clearly a deeper and better understanding of the process of development, based on the cumulative experiences of countries following different strategies over time, and empirical inferences derived from these experiences, helps illuminate how foreign aid can best contribute to development.

At the same time it is evident - and is well documented in other chapters of this book - that the socio-economic development of the aid-recipient countries is only one of the objectives of the donor countries. Political and commercial objectives play an important role in the allocation of foreign aid in the programmes of many donor countries. While recognising the role that non-developmental goals play in the allocation of aid, it would be overly cynical to dismiss altogether the developmental benefits of aid - whether they resulted directly from developmental motivation by donors or indirectly, as a side-effect of politically motivated resource transfers. Furthermore, a significant part of aid is distributed through multilateral channels and is therefore less susceptible to being influenced by strictly political considerations.

Hence, in this opening chapter we explore how the concept of foreign aid as a contributing factor to the development of the third world evolved historically within the broader framework of development theory and strategy over the course of the last five

decades. The analytical framework presented above and outlined in Figure 1.1 is applied to describe the state of the art that prevailed in each of the last five decades and, in particular, how the conception of the role of foreign aid changed as a function of the development paradigm in vogue entering a given decade.

The application of the above framework to the situation that actually existed in each of the last five decades helps to highlight in a systematic fashion the changing conception of the development process. Such an attempt is undertaken next by contrasting the prevailing situation in the fifties, sixties, seventies, eighties and nineties, respectively. The choice of the decade as a relevant time period is of course arbitrary and so is, to some extent, an exact determination of what should be inserted in the five boxes in Figure 1.1 for each of the five decades under consideration.<sup>2</sup>

Figures 1.2-6 attempt to identify for each decade the major elements which properly belong in the five interrelated boxes. In a certain sense it can be argued that the interrelationships among objectives, theories and models, data systems and hypotheses and strategies constitute the prevailing development doctrine for a given time period. A brief sequential discussion of the prevailing doctrine in each of the last five decades provides a useful way of capturing the evolution that development theories and strategies have undergone and of the changing role of aid. A final section sums up and concludes.

### **The development doctrine during the fifties**

Economic growth became the main policy objective in the newly independent less developed countries. It was widely believed that through economic growth and modernisation *per se*, dualism and associated income and social inequalities which reflected it, would be eliminated. Other economic and social objectives were thought to be complementary to - if not resulting from - GNP growth. Clearly, the adoption of GNP growth as both the objective and yardstick of development was directly related to the conceptual state of the art in the fifties. The major theoretical contributions which guided the development community during that decade were conceived within a one-sector, aggregate framework and emphasised the role of investment in modern activities. The development economists' tool kit in the fifties contained such theories and concepts as the 'big push' (Rosenstein-Rodan 1943), 'balanced growth' (Nurkse 1953), 'take-off into sustained growth' (Rostow 1956) and 'critical minimum effort thesis' (Leibenstein 1957) (see Figure 1.2).

[Figure 1.2 about here]

What all of these concepts have in common, in addition to an aggregate framework, is equating growth with development and viewing growth in less developed countries as essentially a discontinuous process requiring a large and discrete injection of investment. The 'big push' theory emphasised the importance of economies of scale in overhead facilities and basic industries. The 'take-off' principle was based on the simple Harrod--Domar identity that in order for the growth rate of income to be higher than that of the population (so that per capita income growth is positive) a minimum threshold of

the investment to GNP ratio is required given the prevailing capital--output ratio. In turn, the 'critical minimum effect thesis' called for a large discrete addition to investment to trigger a cumulative process within which the induced income-growth forces dominate induced income-depressing forces. Finally, Nurkse's 'balanced growth' concept stressed the external economies inherent on the demand side in a mutually reinforcing and simultaneous expansion of a whole set of complementary production activities which combine together to increase the size of the market. It does appear, in retrospect that the emphasis on large-scale investment in the fifties was strongly influenced by the relatively successful development model and performance of the Soviet Union between 1928 and 1940.

The same emphasis on the crucial role of investment as a prime mover of growth is found in the literature on investment criteria in the fifties. The key contributions were (i) the 'social marginal production' criterion (Khan 1951 and Chenery 1953), (ii) the 'marginal per capita investment quotient' criterion (Galenson and Leibenstein 1955) and (iii) the 'marginal growth contribution' criterion (Eckstein 1957).

It became fashionable to use as an analytical framework one-sector models of the Harrod--Domar type which, because of their completely aggregated and simple production functions, with only investment as an element, emphasised at least implicitly investment in infrastructure and industry. The one-sector, one-input nature of these models precluded any estimation of the sectoral production effects of alternative investment allocations and of different combinations of factors since it was implicitly

assumed that factors could only be combined in fixed proportions with investment. In a one-sector world GNP is maximised by pushing the investment-ratio (share of investment in GNP) as high as is consistent with balance-of-payments equilibrium. In the absence of either theoretical constructs or empirical information on the determinants of agricultural output, the tendency was to equate the modern sector with high productivity of investment and thus, direct the bulk of investment to the modern sector and to the formation of social overhead capital - usually benefiting the former.

The reliance on aggregate models was not only predetermined by the previously discussed conceptual state of the art but also by the available data system which, in the fifties, consisted almost exclusively of national income accounts. Disaggregated information in the form of input--output tables appeared in the developing countries only in the sixties.

The prevailing development strategy in the fifties follows directly and logically from the previously discussed theoretical concepts. Industrialisation was conceived as the engine of growth which would pull the rest of the economy along behind it. The industrial sector was assigned the dynamic role in contrast to the agricultural which was, typically, looked at as a passive sector to be 'squeezed' and discriminated against. More specifically, it was felt that industry, as a leading sector, would offer alternative employment opportunities to the agricultural population, would provide a growing demand for foodstuffs and raw materials, and would begin to supply industrial inputs to agriculture. The industrial sector was equated with high productivity of investment - in

contrast with agriculture - and, therefore, the bulk of investment was directed to industrial activities and social overhead projects.<sup>3</sup> To a large extent the necessary capital resources to fuel industrial growth had to be extracted from traditional agriculture.

Under this 'industrialisation-first strategy' the discrimination in favour of industry and against agriculture took a number of forms. First, in a large number of countries, the internal terms-of-trade were turned against agriculture through a variety of price policies which maintained food prices at an artificially low level in comparison with industrial prices. One purpose of these price policies - in addition to extracting resources from agriculture - was to provide cheap fuel to the urban workers and thereby tilt the income distribution in their favour. Other discriminatory measures used were a minimal allocation of public resources (for both capital and current expenditures) to agriculture and a lack of encouragement given to the promotion of rural institutions and rural off-farm activities. In some of the larger developing countries, such as India and Pakistan, the availability of food aid on very easy terms - mainly under U.S. Public Law 480 - was an additional element which helped maintain low relative agricultural prices.<sup>4</sup>

A major means of fostering industrialisation, at the outset of the development process, was through import substitution - particularly of consumer goods and consumer durables. With very few exceptions the whole gamut of import substitution policies, ranging from restrictive licensing systems, high protective tariffs and multiple exchange rates to various fiscal devices, sprang up and spread rapidly in developing countries. This inward-looking approach to industrial growth led to the fostering of a number of



highly inefficient industries.

It should not be inferred that the emphasis on investing in the urban modern sector in import-substituting production activities and physical infrastructure was undesirable from all standpoints. This process did help start industrial development and contributed to the growth of the modern sector. It may even, in some cases, have provided temporary relief to the balance-of-payments constraint. However, by discriminating against exports - actual and potential - the long-run effects of import substitution on the balance-of-payments may well turn out to have been negative.

#### *Role of foreign aid*

The main economic rationale of foreign aid in the fifties was to provide the necessary capital resource transfer to allow developing countries to achieve a high enough savings rate to propel them into self-sustained growth. The role of aid was seen principally as a source of capital to trigger economic growth through higher investment. Households in poor countries - hovering around the subsistence level - were seen to face the almost impossible task of raising their savings rates to a level sufficient to generate sustained growth rates. As Ruttan (1996) pointed out, in most cases developing areas lacked the physical and human capital to attract private investment so that there did not appear to be any alternative to foreign aid as a source of capital.

Two other interrelated factors made aid attractive as an instrument of growth: first, the

faith that governments could plan successfully at the macro level as evidenced by the large number of five-year plans formulated during this period and, second, the simplicity of the Harrod--Domar model to calculate the amount of foreign aid required to achieve a target growth rate. In retrospect it was this totally aggregate planning framework and the focus on industrialisation-first that led to the neglect of the agricultural sector.

In any case, whatever the development rationale of aid in the fifties, it was clearly already subservient to security objectives in the aid programmes of the U.S. and probably Western Europe. U.S. aid was intended as a weapon to address the security threat of spreading communism (Ruttan 1996: 70).

### **The development doctrine during the sixties**

Figure 1.3 captures the major elements of the development doctrine prevailing in the sixties. On the conceptual front the decade of the sixties was dominated by an analytical framework based on economic dualism. Whereas the development doctrine of the fifties implicitly recognised the existence of the backward part of the economy complementing the modern sector, it lacked the dualistic framework to explain the reciprocal roles of the two sectors in the development process. The naive two-sector models *à la* Lewis (1954) continued to assign to subsistence agriculture an essentially passive role as a potential source of 'unlimited labour' and 'agricultural surplus' for the modern sector. It assumed that farmers could be released from subsistence agriculture in large numbers without a consequent reduction in agricultural output while simultaneously carrying

their own bundles of food (i.e. capital) on their backs or at least having access to it.

[Figure 1.3 about here]

As the dual-economy models became more sophisticated, the interdependence between the functions that the modern industrial and backward agricultural sectors must perform during the growth process was increasingly recognised (Fei and Ranis 1964). The backward sector had to release resources for the industrial sector, which in turn had to be capable of absorbing them. However, neither the release of resources nor the absorption of resources, by and of themselves, were sufficient for economic development to take place. Recognition of this active interdependence was a large step forward from the naive industrialisation-first prescription because the above conceptual framework no longer identified either sector as leading or lagging.

A gradual shift of emphasis took place regarding the role of agriculture in development. Rather than considering subsistence agriculture as a passive sector whose resources had to be squeezed in order to fuel the growth of industry and to some extent modern agriculture, it started to become apparent in the second half of the sixties that agriculture could best perform its role as a supplier of resources by being an active and co-equal partner with modern industry. This meant in concrete terms that a gross flow of resources from industry to agriculture may be crucial at an early stage of development to generate an increase in agricultural output and productivity which would facilitate the extraction of a new transfer out of agriculture and into the modern sector. The trouble

with the alternative approach which appears to have characterised the fifties of squeezing agriculture too hard or too early in the development process was described in the following graphic terms: 'The backwards agricultural goose would be starved before it could lay the golden egg.' (Thorbecke 1969: 3).

The 'balanced' versus 'unbalanced' growth issue was much debated during the sixties. In essence, the balanced growth thesis (Nurkse 1953) emphasised the need for the sectoral growth of output to be consistent with the differential growth of demand for different goods as income rises. Unbalanced growth, on the other hand, identified the lack of decisionmaking ability in the private and public sectors as the main bottleneck to development (Hirshman 1958). The prescription for breaking through this bottleneck was to create a sequence of temporary excess capacity of social overhead facilities which, by creating a vacuum and an attractive physical environment, would encourage the buildup of directly productive activities. Alternatively, the process could start by a buildup of directly productive activities ahead of demand, which, in turn, would generate a need for complementary social overhead projects.

The similarities between the balanced and unbalanced growth theses are more important than their apparently different prescriptions. Both approaches emphasised the role of inter-sectoral linkages in the development process. In a certain sense they extended the dual-economy framework to a multi-sectoral one without, however, capturing the essential differences in technology and form of organisation between modern and traditional activities. This was at least partially due to the type of sectoral disaggregation

available in the existing input--output tables of developing countries during the sixties. Except for the various branches of industry, the level of sectoral aggregation tended to be very high, with agricultural and service activities seldom broken down in more than two or three sectors. Consequently, any attempt at distinguishing traditional, labour-intensive activities from modern, capital-intensive activities in either agriculture or in service, could not be performed given the classification criteria underlying input--output tables. This example illustrates the interdependence that exists between the prevailing data systems and the conceptual framework in the actual formulation of development plans and strategies. This is an issue which is returned to subsequently.

Another contribution of the late sixties which was imbedded in inter-sectoral (input--output) analysis is the theory of effective protection, which clarified and permitted the measurements of the static efficiency cost of import substitution when both inputs and outputs are valued at world prices.

Still another important set of contributions that appeared in the sixties relates to the inter-sectoral structure and pattern of economic growth. Two different approaches provided important insights into the changing inter-sectoral structure of production and demand throughout the process of economic development. The first approach, based largely on the work of Kuznets (1966), relied on a careful and painstaking historical analysis of a large number of countries. The second approach was pioneered by Hollis B. Chenery and based on international cross-sectional analysis which was subjected to regression analysis to derive what appeared to be structural phenomena in the process of

growth (Chenery 1960 and Chenery and Taylor 1968).

The models that were designed in the sixties can be divided into three types: (i) two-gap models, (ii) semi-input--output models and (iii) simple general equilibrium models. The first type tried to incorporate into a macroeconomic model the role of foreign aid (Chenery and Strout 1966). The underlying logic of these models is that two independent constraints may limit economic growth. The first constraint on skills and savings, if it were the binding one, is described as the investment-limited growth. Alternatively, when the balance-of-payments constraint is effective, trade limited growth would follow. This is a disequilibrium-type model which assumes that developing countries are characterised by limited structural flexibility - with either the investment--savings gap or the balance-of-payments gap binding at any one point in time.

The other types of models (b and c above) rely on an inter-sectoral input--output framework. The semi-input--output method initiated by Jan Tinbergen distinguishes between international sectors which produce tradable goods and national sectors which produce non-tradable goods (Kuyvenhoven 1978). Hence, the required capacity expansion throughout the growth process can be computed for, at least, the non-tradable sectors. The general equilibrium models which appeared in the sixties were either of a consistency or linear programming type. The main purpose of these models was to throw more light on the inter sectoral linkages and the effects of alternative sectoral investment allocations on economic growth (Fox et al. 1972: ch. 13 and Manne 1974).

The conception of economic development in the sixties was still largely centred on GNP growth as the key objective. In particular, the relationship between growth and the balance-of-payments was made clearer. Toward the end of this decade the increasing seriousness of the un- and underemployment problem in the developing world led to a consideration of employment as an objective in its own right next to GNP growth. The most noteworthy change in the conception of development was the concern for understanding better the inter-sectoral structure and physiology of the development process - as the preceding review of the conceptual state of the arts revealed.

The development policies and strategies that prevailed in the sixties flowed directly from the conceptual contributions, development objectives and the data system. These policies fall into a few categories, which are reviewed briefly below. The first set embraces the neoclassical prescription and can be expressed under the heading of 'fine-tuning' and 'appropriate prices'. In a nutshell the 'fine-tuning' instruments embrace the use of an appropriate price system (including commodity, tax and subsidy rates), the removal of market imperfections, and appropriate exchange rate and commercial policies. It was expected that these measures would lead to a more appropriate output-mix between production activities and input-mix, or choice of technique, and thereby generate increased employment.

A second set of policies can be classified as essentially structural, emphasising the importance of inter-sectoral linkages. They include the allocation of investment and current public expenditures among sectors, so as to achieve a process of inter-sectoral

balanced (or, in some instances, unbalanced) growth. More specifically, by the late sixties agriculture was assigned a much more active role in the development process. The provision of a greater level of public resources to that sector - combined with less discriminatory price policies - were expected to result in a growth of output and productivity which would facilitate a net transfer back to the rest of the economy.

### *Role of foreign aid*

The role of foreign aid, in the light of the two-gap models, was considered important in removing either a savings deficiency through an increased flow of foreign savings or a deficit in the current account of the balance-of-payments by providing the necessary foreign exchange. The faith in the capacity of foreign aid to break either one of these constraints appears, in retrospect, to have been somewhat misplaced - not the least because of the large balance-of-payments burden created, over time, by the need to service a cumulative sequence of foreign loans, even at concessionary terms (see Chapter 15). The increasingly binding foreign exchange constraint led to a critical reappraisal of import substitution policies and gradually to the encouragement of a mild form of export promotion, namely through the creation of regional custom areas and common markets. This process of regional integration in the developing world has, so far, been notoriously unsuccessful and may well be moribund by now.

Ruttan (1996: 104) summarised well the two directions in which development thought and foreign aid shifted in the sixties:



First, shortages in domestic savings and foreign exchange earnings were identified as potentially limiting factors on growth. The counterpart in official policy was to extend programme-type lending to fill the foreign exchange gaps in the less developed countries. A second focus of the sixties, influenced by the emergence of the dual-economy literature, was on sectoral development and, in the late sixties, on sector lending for agriculture. As sectoral development processes began to be better understood, the importance of investment in human capital and of policies designed to overcome resource scarcities through technical assistance began to be appreciated.

### **The development doctrine in the seventies**

Figure 1.4 summarises the major development objectives, theories, data sources and policies prevailing in the seventies. By the seventies the seriousness of a number of development problems and issues, combined with the failure of a GNP-oriented development strategy to cope successfully with these problems in a number of developing countries, led to a thorough re-examination of the process of economic and social development. The major development problems that became acute and could no longer be ignored during this decade can be summarised briefly as: (i) the increasing level and awareness of un- and underemployment in a large number of developing countries, (ii) the tendency for income distribution within countries to have become more unequal or, at least, to have remained as unequal as in the immediate post-WWII period, (iii) the maintenance of a very large, and perhaps rising, number of individuals

in a state of poverty, i.e. below some normative minimum income level or standard of living, (iv) the continuing and accelerating rural--urban migration and consequent urban congestion and finally (v) the worsening external position of much of the developing world reflected by increasing balance-of-payments pressures and rapidly mounting foreign indebtedness and debt servicing burdens. Largely as a consequence of these closely interrelated problems a more equal income distribution, particularly in terms of a reduction in absolute poverty, was given a much greater weight in the preference function of most developing countries compared to the objective of aggregate growth *per se*. Furthermore, this reduction in absolute poverty was to be achieved mainly through increased productive employment (or reduced underemployment) in the traditional sectors.

[Figure 1.4 about here]

By the mid-seventies, GNP as a dominant all-encompassing objective had been widely, but by no means universally, dethroned. The presumption that aggregate growth is synonymous with economic and social development or, alternatively, that it will ensure the attainment of all other development objectives, came under critical scrutiny and was rejected in many circles.

The changing meaning of development as a process that should have as simultaneous objectives growth and poverty alleviation both influenced and was influenced by a number of conceptual and empirical contributions. The first set of contributions comes

under the rubric of integrated rural and agricultural development. A whole series of empirical studies at the micro- and macro-levels combined to provide an explanation of the physiology and dynamics of the transformation process of traditional agriculture. This body of knowledge provided a rationale for a unimodal strategy in the rural areas, which is discussed subsequently under the strategy box.

A second important concept which appeared in the seventies is that of the 'informal sector'. Even though this concept had been around a long time and taken a variety of forms such as Gandhi's emphasis on traditional cottage industries, it became revitalised in a more general and formal sense in the Kenya Report of International Labour Organization (ILO 1973). A number of case studies undertaken by ILO focussing specifically on the role of the informal sector concluded that it is relatively efficient, dynamic, and often strongly discriminated against as a result of market imperfections or inappropriate national or municipal regulations. These studies suggested that the informal activities represent an important potential source of output and employment growth.

A third contribution which surfaced in the seventies includes the interdependence between economic and demographic variables and the determinants of the rural--urban migration. A number of empirical studies, mainly at the micro level, attempted to throw some light on the relationship between such sets of variables as (i) education, nutrition and health and (ii) fertility, infant mortality and, ultimately, the birth rate. The hypotheses that were generated by these studies highlighted the complex nature of the

causal relationship between population growth and economic development.

With regard to the determinants of migration, the initial Harris--Todaro (1970) formulation triggered a series of empirical studies and simple models of the migration process. In general, migration was explained as a function of urban--rural wage differentials weighted by the probability of finding urban employment.

A somewhat parallel set of contributions at the micro-level consists of the attempt at incorporating socio-economic objectives - such as employment and income distribution - among investment criteria and in the appraisal and selection of projects (Little and Mirrlees 1974).

A review of contributions to the state of the art in development economics would not be complete without at least a reference to the neo-marxist literature on underdevelopment and dependency theories. The essence of these theories is that underdevelopment is intrinsic in a world trading and power system in which the developing countries make up the backward, raw-material-producing periphery and the developed countries the modern industrialised centres. A neo-colonial system of exploitation by indigenous classes associated with foreign capital (e.g. multinational corporations) is considered to have replaced the previous colonial system.

After this review of major contributions to development theory, only a few words need be said about the nature of models which appeared in the seventies. A major

characteristic of these models was to explain, at the sectoral and multi-sectoral levels, the simultaneous determination of output, employment and income distribution. Most of these models were partial in the sense that they did not capture the complete interdependence among these variables.

The coverage and quality of the data available improved substantially in the seventies as compared to the previous decades. By the mid-seventies survey-type information on variables such as employment, income, consumption and saving patterns were becoming available. A variety of surveys covering such diverse groups as urban, informal and rural households started to provide valuable information on the consumption and savings behaviour of different socio-economic groups. In a number of developing countries it became possible, for the first time, to estimate approximately the income distribution by major socio-economic groups.

After having reviewed the changing development objectives, conceptual contributions and data sources which marked the seventies, the next logical step is to describe and analyse briefly the new development strategies that emerged. From a belief that growth was a necessary and sufficient condition for the achievement of economic and social development, it became increasingly recognised that even though necessary, growth might not be sufficient. The first step in the broadening process of moving from a single to multiple development objectives was a concern with, and incorporation of, employment in development plans and in the allocation of foreign aid to projects and technical assistance.

One possible attraction of using employment as a target was that it appeared, on the surface, to be relatively easily measurable - in somewhat the same sense as the growth rate of GNP had provided previously a simple scalar measure of development. The real and fundamental issue was an improvement in the standards of living of all groups in society and, in particular, that of the poorest and most destitute groups.

Two partially overlapping variants of a distributionally oriented strategy surfaced during this decade. These were 'redistribution with growth' and 'basic needs'. The first one was essentially incremental in nature, relying on the existing distribution of assets and factors and requiring increasing investment transfers in projects (mostly public but perhaps even private) benefiting the poor (Chenery et al. 1974). The first step in this strategy was the shift in the preference (welfare) function away from aggregate growth *per se* toward poverty reduction. This strategy, which was favoured by the World Bank, focussed on the redistribution of at least the increments of capital formation in contrast with the initial stock of assets. Since the bulk of the poor are located in the rural sector and the informal urban sector, this strategy had to be directed toward increasing the productivity of the small farmers and landless workers and making small-scale producers (mainly self-employed) in the informal urban sector more efficient.

The second alternative strategy inaugurated during the seventies was the basic needs strategy, which was particularly advocated by the ILO.<sup>5</sup> It entailed structural changes and some redistribution of the initial ownership of assets - particularly land reform - in addition to a set of policy instruments, such as public investment. Basic needs, as

objectives defined by ILO, include two elements: (i) certain minimal requirements of a family for private consumption, such as adequate food, shelter and clothing and (ii) essential services provided by and for the community at large, such as safe drinking water, sanitation, health and educational facilities.

A third type of development strategy follows from the neo-marxist underdevelopment and dependency theories, which have been previously touched upon. This approach is radical, if not revolutionary, in nature. It calls for a massive redistribution of assets to the state and the elimination of most forms of private property. It appears to favour a collectivistic model - somewhat along the lines of the Chinese example - based on self-reliance and the adoption of indigenous technology and forms of organisation.

#### *Role of foreign aid*

The launching of the World Employment Programme by the ILO in 1969 signalled that the primary objective of aid should be to raise the standard of living of the poor through increased employment opportunities. The generation of new or greater productive opportunities was considered a means toward the improvement of the welfare of the poor.

Under the impetus of applied research undertaken under the auspices of ILOs World Employment Programme and the World Bank, focussed on such issues as the relationship between population growth and employment; appropriate labour-intensive

technologies; the relationships between the educational system and the labour market and employment and income distribution; the informal sector; the determinants of rural-urban migration and the role of traditional agriculture in the development process.

The fruits of the highly applied research endeavour encouraged and, ultimately, led to a fundamental re-examination of the function and goal of foreign aid. As Brown (1990: 115-6) put it,

If development was no longer so closely identified with economic growth then aid should not be perceived so exclusively as a source of domestic and external savings. A greater focus on poverty, and on people's welfare in general, would require new types of investment and new forms of intervention.

The World Bank and USAID - two major donors - became very vocal in their advocacy of anti-poverty programmes. The major changes in their foreign aid strategies took two forms: first, a shift away from investment projects in power, transport and telecommunications and toward projects in agriculture and rural development and social services including housing, education and health (Brown 1990); and second, a much greater emphasis on direct interventions to benefit the poor and on technical assistance projects. Examples of direct interventions include food for the malnourished, mass inoculation programmes, adult literacy campaigns and credit provision for small farmers.



Thus, increasingly in the rural areas, aid was combined into a package of capital and technical assistance projects constituting integrated rural development programmes. This process of integrated rural development became even more successful as it was linked to the dissemination of the green revolution technology. In a nutshell, the new approach centred on lending and technical activities benefiting directly the traditional sector. This aid strategy conformed to a broader so-called unimodal agricultural development strategy (Johnston and Kilby 1975). The latter relied on the widespread application of labour-intensive technology to the whole of agriculture. In this sense, it was based on the progressive modernisation of agriculture 'from the bottom up'. This strategy can be contrasted with a bimodal strategy, which encourages the growth of the modern, commercial, large-scale, relatively capital-intensive sub-sector of agriculture while ignoring for all practical purposes the traditional subsistence sub-sector. Under the unimodal approach, agricultural development was spread relatively evenly over the mass of the people through a combination of appropriate agricultural research and technology, land redistribution, the provision of rural infrastructure, the growth of rural institutions and other measures.

In both instances (i.e. mono-type anti-poverty direct interventions and integrated rural development packages), the participation and involvement of the poor was considered an almost necessary condition of sustainability.

The shift in emphasis toward poverty-alleviation aid is evidenced by the share of poverty-oriented lending rising from 5 per cent of the total in 1968-70 to 30 per cent in

1981-3. Also, a relatively new instrument of channelling aid - sector loans (particularly to agriculture and education) - became more extensively used.

### **The development doctrine in the eighties**

A combination of events including an extremely heavy foreign debt burden - reflecting the cumulative effects of decades of borrowing and manifested by large and increasing balance-of-payments and budget deficits in most of the developing world - combined with higher interest rates and a recession in creditor countries changed radically the development and aid environment at the beginning of the eighties. The Mexican financial crisis of 1982 soon spread to other parts of the third world. The magnitude of the debt crisis was such that, at least for a while, it brought into question the survival of the international financial system.

Suddenly, the achievement of external (balance-of-payments) equilibrium and internal (budget) equilibrium became the overarching objectives and necessary conditions to the restoration of economic growth and poverty alleviation. The debt crisis converted the eighties into the 'lost development decade'. Before the development and poverty alleviation path could be resumed, the third world had to put its house in order and implement painful stabilisation and structural adjustment policies.

Notwithstanding the fact that the development process was temporarily blocked and most of the attention of the development community was focussed on adjustment issues,

some important contributions to development theory were made during this decade (see Figure 1.5).

[Figure 1.5 about here]

The first one greatly enriched our understanding of the role of human capital as a prime mover of development. The so-called endogenous growth school (Lucas 1988 and Romer 1990) identifies low human capital endowment as the primary obstacle to the achievement of the potential scale economies that might come about through industrialisation. In a societal production function, raw (unskilled) labour and capital were magnified by a term representing human capital and knowledge, leading to increasing returns. This new conception of human capital helped convert technical progress from an essentially exogenously determined factor to a partially endogenously determined factor. Progress was postulated to stem from two sources: (i) deliberate innovations, fostered by the allocation of resources (including human capital) to research and development (R&D) activities and (ii) diffusion, through positive externalities and spillovers from one firm or industry to know-how in other firms or industries (Ray 1998: ch. 4). If investment in human capital and know-how by individuals and firms is indeed subject to increasing returns and externalities, it means that the latter do not receive the full benefits of their investment resulting, consequently, in under-investment in human capital (the marginal social productivity of investment in human capital being larger than that of the marginal private productivity). The market is likely to under-produce human capital and this provides a rationale for the role of the

government in education and training.

A second contribution based on a large number of quantitative and qualitative empirical studies - relying on international cross-sectional and country-specific analyses of performance over time - was the robust case made for the link between trade and growth. Outward-orientation was significantly and strongly correlated with growth. Countries that liberalised and encouraged trade grew faster than those that followed a more inward-looking strategy. The presumed mechanism linking export orientation to growth is based on the transfer of state of the art technology normally required to compete successfully in the world market for manufactures. In turn, the adoption of frontier technology by firms adds to the human capital of those workers and engineers through a process of 'learning-by-doing' and 'learning-by-looking' before spilling over to other firms in the same industry and ultimately across industries. In this sense, export orientation is a means of endogenising and accelerating technological progress and growth. Furthermore, to the extent that outward orientation in developing countries normally entails a comparative advantage in labour-intensive manufactures, there is much evidence, based on the East and Southeast Asian experience, that the growth path that was followed was also equitable - resulting in substantial poverty alleviation.

A third set of contributions that surfaced in the eighties can be broadly catalogued under the heading of the 'new institutional economics' and collective action (North 1990, Williamson 1991 and Nabli and Nugent 1989). As de Janvry et al. (1993: 565) noted, 'The main advance was to focus on strategic behavior by individuals and organised

groups in the context of incomplete markets. The theories of imperfect and asymmetrical information and, more broadly, transaction costs gave logic to the role of institutions as instruments to reduce transactions costs.’ The neo-institutional framework, in addition to reminding the development community that appropriate institutions and rules of the game are essential to provide pro-development and anti-corruption incentives, also suggested broad guidelines in building institutions that reduced the scope for opportunistic behaviour.

Another contribution of this approach was to provide a clear rationale for the existence of efficient non-market exchange configurations, particularly in the rural areas. Prototypical examples of such institutions include intra-farm household transactions; two-party contracts (e.g. sharecropping and interlinked transactions), farmers’ co-operatives and group organisations, mutual insurance networks and informal credit institutions (Thorbecke 1993). Those exchange non-market configurations - called agrarian institutions by Bardhan (1989) - owe their existence to lower transaction costs than those that would prevail in an alternative market configuration providing an equivalent good, factor or service. In most instances market imperfections or, at the limit, market failure (in which case there is no alternative market configuration and transaction costs become infinite) are at the origin of non-market configurations.

A final contribution worth noting - which can be subsumed under the ‘new institutional economies’ heading - is that of interlinked transactions (Bardhan 1989). An interlinked contract is one in which two or more interdependent exchanges are simultaneously

agreed upon (e.g. when a landlord enters into a fixed-rent agreement with a tenant and also agrees to provide credit at a given interest rate). In a more general sense, this type of contract leads to interlocking factor markets for labour, credit and land. In retrospect it is somewhat ironical that during a decade dominated by a faith in the workings of markets - as is discussed subsequently - important theoretical contributions were made that highlighted market imperfections and failures.

Some important contributions to general equilibrium modelling appeared during the eighties (Dervis et al. 1982). These models - calibrated on a base year Social Accounting Matrix (SAM) reflecting the initial (base year) socio-economic structure of the economy - proved particularly useful in tracing through the impact of a variety of exogenous shocks and policies (such as a devaluation, trade liberalisation and fiscal reforms) on the income distribution by socio-economic household groups.

Computable General Equilibrium (CGE) models became an important tool to simulate the disaggregated impact of structural adjustment policies on growth and equity. In fact, these models provided the only means to compare the impact of adjustment scenarios to the counterfactual of no- or limited-adjustment scenarios. Since most applied CGEs were built in the nineties, they are discussed in the next section.

The eighties witnessed a proliferation of statistical information on a variety of dimensions of development and the welfare of households. Besides more elaborate and disaggregated employment, manufacturing, agricultural and demographic surveys and

censuses, large-scale household income and expenditure surveys produced by statistical offices of most developing countries - and often designed and funded by the World Bank (e.g. the Living Standard Measurement Surveys) - became available to analysts and policymakers. Perhaps for the first time, reasonably reliable and robust observations could be derived relating to the magnitude of poverty, the characteristics of the poor and the inter-household income distribution. In turn, the various data sources could be combined to build SAMs of a large number of countries.

The development strategy of the seventies - centred on redistribution with growth and fulfilment of basic needs - was replaced by an adjustment strategy. The magnitude of the debt crisis and the massive internal and external disequilibrium faced by most countries in Africa and Latin America and some in Asia, meant that adjustment became a necessary (although not sufficient) condition to a resumption of development.

The main policy objective of third world governments became macroeconomic stability, consisting of a set of policies to reduce their balance-of-payments deficits (e.g. devaluation) and their budget deficits (through retrenchment). Whereas stabilisation *per se* was meant to eliminate or reduce the imbalance between aggregate demand and aggregate supply, both externally and internally, structural adjustment was required to reduce distortions in relative prices and other structural rigidities that tend to keep supply below its potential. A typical adjustment package consisted of measures such as a devaluation, removal of artificial price distortions, trade liberalisation and institutional changes at the sector level.

Complementary elements of the prevailing adjustment strategy of the eighties included outward orientation, reliance on markets and a minimisation of the role of the government. The outward orientation was meant to encourage exports and industrialisation in labour-intensive consumer goods. In turn, to achieve competitiveness in exports, vintage technology would have to be imported, which would trigger the endogenous growth processes described previously, i.e. investment in the human capital and knowledge of workers and engineers employing those technologies and subsequent spillover effects.

Under the influence of ideological changes in the Western World (e.g. the Reagan and Thatcher administrations) developing countries were strongly encouraged - if not forced - to rely on the operation of market forces and in the process to minimise government activities in most spheres - not just productive activities.

Inherent contradictions and conflicts arose among the elements of the broad adjustment strategy of the eighties. The successful implementation of adjustment policies called for a strong government. Likewise, the rationale for a larger role of government in the education sphere to generate the social spillover effects and counteract the under-investment in education by private agents, which do not capture the positive externalities of their investment, ran counter to the objective of a minimalist state.

Another conflict was caused by the stabilisation goal of reducing the balance-of-payments disequilibrium, while simultaneously liberalising trade - mainly through



elimination of quantitative restrictions and reduction and harmonisation of tariff rates. The latter measures would invariably lead to a significant rise in imports that would make it more difficult to restore balance-of-payment equilibrium. Here again, the successful implementation of somewhat conflicting measures called for a strong state.

### *Role of foreign aid*

With the advent of the debt crisis and the debt overhang (discussed in Chapter 15), the role and conception of foreign aid changed in a fundamental way. The primary purpose of aid became (i) a stop-gap measure to salvage the shaky international financial system - by allowing third world debtor countries to service at least part of their public and private debt and keep their creditors afloat and (ii) to encourage the implementation of appropriate adjustment policies through conditionality attached to programme lending. The costs of servicing outstanding debt obligations of the developing countries (their total long-term debt was estimated at \$1 trillion at the end of the eighties) became so substantial that they tended to dwarf the inflows of concessional funds - leading to a net reverse flow (from the developing to the developed world) reaching about \$15 billion annually during 1987-9 (Brown 1990: 132).

Nonetheless, the somewhat self-serving flow of aid from the rich countries helped avoid, at least temporarily, the collapse of the financial system. In contrast, the conditionality strategy was only partially successful in 'buying' good policies - as is discussed in more detail in the next section.

In this decade, characterised by pro-market and anti-government rhetoric, there was strong sentiment to do away with aid altogether and have private capital flows substitute for it. Thus, in the early eighties, the Reagan administration created a fertile environment for conservative critics of foreign aid who felt that ‘economic assistance distorts the free operation of the market and impedes private-sector development.’ (Ruttan 1996: 143). Clearly, the debt overhang put a damper on going too far in eliminating aid. Both public and private creditors in the industrialised world had too much at stake. Furthermore, private capital was not going to flow to African and Latin American countries until some modicum of macroeconomic equilibrium had been restored. In the meantime, there was an effort in many donor countries to privatise aid through channelling greater flows to NGOs and the private sector.

### **The development doctrine in the nineties**

In the first half of the nineties, stabilisation and adjustment were still the dominant objectives (see Figure 1.6). While most of the Latin American countries (and the few Asian countries affected by the debt crisis) had gone through a painful adjustment process and were back on a growth path, the overall situation was still one of stagnation - largely caused by poor governance in sub-Saharan Africa and most transition economies in Eastern Europe. It was becoming increasingly clear to the development community that fundamental and deep-rooted institutional changes to reduce corruption and facilitate a successful transition from socialism and command economies to market economies were a precondition to successful adjustment and a resumption of

development in Eastern Europe and sub-Saharan Africa. Potentially the institutions and policies at the root of the East Asian 'miracle' could provide the model to follow.

[Figure 1.6 about here]

In the second half of the nineties the Asian financial crisis hit East and Southeast Asia with a vengeance, resulting in a sharp reversal of the long-term poverty reduction trend. Simultaneously socio-economic conditions deteriorated so drastically in the former Soviet Republics that poverty alleviation in its broadest sense - including improvements in health, nutrition, education, access to information and to public goods and a participation in decisionmaking - resurfaced as the major, if not overarching, objective of development assistance. This conception of aid was strongly and unambiguously expressed by the President of the World Bank on numerous occasions in the recent past.

Another consequence of the financial crisis was to bring into question the Washington and IMF consensus of unbridled capital and trade liberalisation and complete deregulation of the financial system. A number of East and Southeast Asian countries are still suffering from the extreme deregulation of the banking sector and capital flows that weakened the supervisory and monitoring functions of central banks and other institutions. The international monetary and financial system that still relies on the outdated Bretton Woods rules of the game needs major revamping and a new set of rules befitting the contemporaneous environment. In the meantime, a number of affected countries are restoring controls on an *ad hoc* basis.

The conceptual contribution to development theory in the nineties, in general, extended and further elaborated on earlier concepts. Perhaps the most fundamental issue that was debated during the nineties is the appropriate roles of the state and the market, respectively, in development. An inherently related issue is to identify the set of institutions most conducive to the acceleration of the process of economic growth and socio-economic development. Prior to the onset of the Asian financial crisis it was felt that the mix of institutions and policies adopted by the East Asian countries that gave rise to the East Asian miracle (World Bank 1993a) provided a broad model, with parts of it potentially transferable to other developing countries. The financial crisis led to a more sceptical appraisal - even whether the miracle, after all, was not a 'myth'.

In any case, the reliance on government actions in the previous decades to promote industrial growth on the part of East Asian countries (particularly, South Korea) appeared suspect and came under heavy criticism. Some critics argued that the already impressive growth performance would have been even better with less government intervention - and that even if those industrial policies had contributed to growth they required a strong state, an element sorely missing in other parts of the third world.

While the debate on the proper mix between the degree of government intervention and reliance on markets is still very much alive, the neo-institutional and public choice schools have helped clarify how the state can affect development outcomes. This can be done in a number of ways: (i) by providing a macroeconomic and microeconomic incentive environment conducive to efficient economic activity, (ii) by providing the

institutional infrastructure - property rights, peace, law and order and rules - that encourages long-term investment and (iii) by insuring the delivery of basic education, health care and infrastructure required for economic activity (Commander et al. 1996).

Institutional capability as evaluated from the standpoint of entrepreneurs depends, in turn, on such indicators as predictability of rule-making, perception of political stability, crime against persons and property, reliability of judicial enforcement and freedom from corruption (Brunetti et al. 1997 and Chibber 1998).

The role of institutions as a precondition to following a successful development path becomes even more critical if one subscribes to the new approach to political economy that takes institutions as largely given exogenously and argues that policies tend to be determined *endogenously* within a specific institutional context (Persson and Tabellini 1990). Thus, for example, if the central bank and the ministry of finance are not independent or are operating under loose discretionary rules, the monetary and fiscal policies that result will depend on political and social factors (or according to the political power of the different lobbies in society and the public choice formulation).

Two additional contributions worth highlighting in this decade are the concept of social capital and a better understanding of sources of growth (total factor productivity) and the need to explain the residual. Social capital was devised as a concept to complement human capital. If individuals are socially excluded, or marginalised, or systematically discriminated against, they cannot rely on the support of networks from which they are

sealed off. Alternatively, membership in group organisations brings about benefits that can take a variety of forms (e.g. the provision of informal credit and help in the search for employment). The acquisition of social capital by poor households is particularly important as a means to help them escape the poverty trap.

The spectacular growth of East Asian countries prior to 1997 renewed the interest in identifying, explaining and measuring the sources of growth. Recent studies tended to demystify the East Asian miracle by suggesting that the rapid growth of these economies depended on resource accumulation with little improvement in efficiency and that such growth was not likely to be sustainable (Krugman 1994, Kim and Lau 1994 and Young 1995). This conclusion was based on estimates of total factor productivity (TFP) growth and depends crucially on the form of the production function used and on an accurate measurement of the capital and labour inputs. Whatever residual is left over is ascribed to technological progress. Some critics argue that typical TFP calculations significantly underestimate organisational improvements within firms or what Leibenstein call X-efficiency.

The nineties witnessed an increased interest in CGE-models used to simulate the impact of exogenous shocks and changes in policies on the socio-economic system and particularly income distribution. A key issue explored in those models was that of the impact of adjustment policies on income distribution and poverty. The general equilibrium models provide the only technique to compare the impact of alternative (counterfactual) policy scenarios, such as a comparison of the effects of an adjustment

programme versus a counterfactual non-adjustment programme (e.g. Thorbecke 1991 for Indonesia and Sahn et al. 1996 for Africa).

This decade was marked by a proliferation of statistical information relating particularly to the socio-economic characteristics and welfare of households - in addition to the more conventional data sources previously collected (see data box in Figure 1.6). A large number of quantitative poverty assessments based on household expenditure surveys were completed, as well as more qualitative participatory poverty assessments. Furthermore the availability of demographic and health surveys for many developing countries provided information on health and nutritional status, assets and access to public goods and services to supplement information on household consumption. Also, perhaps for the first time, the availability of multiple-year surveys and panel data for many countries allowed reliable standard of living and welfare comparisons to be made over time.

In many respects, the development strategy of the nineties was built upon the foundations of the preceding decade and retained most of the latter's strategic elements - at least in the first half of the decade. However, as the decade evolved, the adjustment-based strategy of the eighties came under critical scrutiny that led to major changes - particularly in the wake of the Asian financial crisis.

In sub-Saharan Africa, the great majority of the countries were still facing serious adjustment problems. A widely debated issue was whether adjustment policies *per se*

without complementary reforms - within the context of Africa - could provide the necessary initial conditions for a take-off into sustained growth and poverty alleviation. Two conflicting approaches to adjustment and diagnoses of its impact on performance were put forward. The 'orthodox' view, best articulated by the World Bank (at the beginning of the decade but subsequently modified), argued that an appropriate stabilisation and adjustment package pays off. Countries that went further in implementing that package, experienced a turnaround in their growth rate and other performance indicators.

In contrast, the 'heterodox' approach - best articulated by the concept of 'adjustment with a human face', embraced by the Unicef (see Cornia et al. 1987) - while supporting the need for adjustment, argued that the orthodox reforms focus extensively on short-term stabilisation and do not address effectively the deep-rooted structural weaknesses of African economies that are the main causes of macro instability and economic stagnation. Accordingly, major structural changes and institutional changes are needed to complement adjustment policies to induce the structural transformation (such as industrialisation, diversification of the export base, the build-up of human capital and even land reform) without which sustainable long-term growth in Africa (and by extension in other developing countries facing similar initial conditions) is not possible.

The Unicef and heterodox critical evaluation of the impact of adjustment policies on long-term growth and poverty alleviation - even when it was not appropriately justified on empirical grounds - sensitised multilateral and bilateral donors to the need to focus



significantly more on the social dimensions of adjustment. It made a strong case for the implementation of a whole series of complementary and reinforcing reforms, ranging from greater emphasis on and investment in human capital and physical infrastructure to major institutional changes - particularly in agriculture and industry - benefiting small producers. In turn, the orthodox approach has made a convincing case that appropriately implemented adjustment policies are not only a necessary condition to the restoration of macroeconomic equilibrium but can also contribute marginally to economic growth and poverty alleviation, in the short run.

In 1993, the World Bank published a very influential report on the East Asian miracle (World Bank 1993a). The report analysed the success elements of the high performing Asian economies and argued that many of them were potentially transferable to other developing countries. In brief, these success elements consisted of (i) sound macroeconomic foundations and stable institutions aiming at a balanced budget and competitive exchange rates, (ii) technocratic regimes and political stability that provided policy credibility and reduced uncertainty - an important factor for foreign investors, (iii) an outward (export) orientation, (iv) reliance on markets, (v) a more controversial set of industrial policies with selective government interventions often using 'contests' among firms as proxy to competition, (vi) high rates of investment in building human capital, (vii) high physical investment rates, (viii) a process of technology acquisition consistent with dynamic comparative advantage and (ix) a smooth demographic transition. In particular, the outward orientation, encouraging exports was applauded as a means of acquiring state of the art technology which in turn would trigger a 'learning-

by-doing' and 'by-looking' (e.g. reverse engineering) process that would lead to spill over effects on human capital and positive externalities among firms within an industry and among industries.

The East Asian miracle also provided a convincing example of the essential importance of sound institutions (such as the balanced budget presidential decree in effect in Indonesia between 1967 and 1997) as preconditions to a sustainable process of growth with equity. The absence of institutions appropriate to a smooth transition from command to market economies in much of Eastern Europe and the fragility of existing institutions in much of sub-Saharan Africa provide painful counter examples of the enormous human costs of a weak institutional framework.

The Asian financial crisis that wrought havoc to much of East and Southeast Asia in 1997, forced a critical re-examination of an international trade and financial system based on excessive trade and capital liberalisation and financial deregulation. The large increase in the incidence of poverty that followed in the wake of the crisis sensitised the development community to again focus on poverty alleviation and improvements in the socio-economic welfare of vulnerable households as the overarching objective of development. Thus, at the end of the decade, the World Bank made it clear that poverty reduction - in its broadest sense - measured in terms of outcomes (e.g. health, education, employment, access to public goods and services and social capital) rather than inputs was the primary goal to strive for.

The crisis also triggered a re-examination of the role of government in protecting the economy from major shocks originating abroad (see Chapter 2). In particular, it pointed towards strengthening financial institutions and the provision of the minimum set of rules and regulations (e.g. improved monitoring and supervision of the banking sector) to reduce corruption and speculative borrowing from abroad; and the establishment of institutional safety nets that could act as build-in-stabilisers following a crisis.

### *Role of foreign aid*

The decade of the nineties was marked by a strong and lingering case of ‘aid fatigue’ evidenced by the absolute decline in net disbursements of official development assistance (ODA) after 1992 and decline in the net ODA disbursements expressed as a ratio of donor GNP from 0.38 per cent in 1982 to 0.22 per cent in 1997. Private flows had largely replaced aid flows with a share of the former to net disbursement of ODA plus private flows rising from 26 per cent in 1987-92 to 55 per cent in 1993-97.

Simultaneously, the sectoral composition of foreign aid switched towards a significantly larger proportion channelled to social infrastructure and services (e.g. education, health, water supply and sanitation) and economic infrastructure and away from productive sectors.

The above trends (considered in more detail in Chapter 3) reflected the strong faith in the operation of markets and scepticism regarding governments’ (both aid donors and recipients) involvement in productive sectors such as agriculture and industry. Fatigue

was also influenced by the rising fear that foreign aid was generating aid dependency relationships in poor countries and, as such, would have the same type of negative incentive effects that welfare payments have on needy households whose recipients might be discouraged from job searching.

A related issue that was critically debated in the nineties was that of the effectiveness of aid conditionality (see also Chapter 18). First of all, given fungibility, is it really possible to use aid to 'buy' good policies, or even a sound programme of public (current and capital) expenditures from aid recipients? From the standpoint of the political economy of external aid, structural adjustment can be looked at as a bargaining process between bilateral and multilateral donors, on the one hand, and debtor governments, on the other. Both sides may have a vested interest in following soft rules in their lending and borrowing behaviour, respectively. This tends to foster and continue a dependency relationship that may well be fundamentally inconsistent with a viable long-term development strategy for the recipient countries (particularly in sub-Saharan Africa). The process of extending aid can be modelled as a strategic game in which the 'bureaucratic' interests of international organisations and the 'political' interests of the national governments are far from being contradictory. As Lafay and Lecaillon (1993: 13) indicated, 'each of the participants in their negotiation has a direct interest in defining a conditionality that is both economically effective and politically feasible.'

The conditionality debate fuelled a number of econometric studies of aid's effectiveness based on international cross-sectional data. Perhaps the most influential one was that of

Burnside and Dollar (1997) which concluded that aid can be a powerful tool for promoting growth and reducing poverty but only if it is granted to countries that are already helping themselves by following growth-enhancing policies. In contrast, Guillaumont and Chavet (1999) find that aid effectiveness depends on exogenous (mostly external) environmental factors such as the terms-of-trade trend, the extent of export instability and climatic shocks. Their results suggest that the worse the environment, the greater the need for aid and the higher its productivity. Hansen and Tarp (1999), using essentially the same cross-sectional data set as does Burnside and Dollar, argue that when account is taken of unobserved country-specific fixed effects and the dynamic nature of the aid--growth relationship, the Burnside--Dollar conclusion fails to emerge. Country-specific characteristics of aid recipient countries - aside from the policy regime followed by those countries - have a major impact on aid's effectiveness.

The socio-economic havoc created by the Asian financial crisis engendered a fundamental re-examination of the role of aid and the uncritical acceptance of rules of the game, based on the outdated international trade and monetary system designed at Bretton Woods and the 'Washington consensus' no longer consistent with the contemporaneous conditions.

The sudden increase in the incidence of poverty in such countries as Indonesia, Thailand and South Korea, after 1997, and the lack of appropriate safety nets provided a strong rationale for redirecting aid flows to alleviate poverty and improve human welfare, and

for using foreign aid to help build institutions that could help reduce recipient countries' vulnerability to exogenous shocks. Although very little progress has yet been made in revamping the international financial system, both the IMF and the World Bank are well aware of the need to modify existing practices.

Reflective of the trend towards using aid as an instrument to fight poverty is the recent study by Collier and Dollar (1999) that develops criteria for allocating aid when the objective is to maximise poverty alleviation.

## **Conclusions**

The retrospective appraisal undertaken in this chapter revealed the close interdependence throughout the last five decades among (i) development objectives, (ii) the conceptual framework and models, (iii) data systems and information, (iv) strategies and (v) the role of the developmental part of aid. In each period, the nature and scope of the prevailing development strategy and the role of aid were largely predetermined by the conceptual state of the art, the available data systems and the prevailing conditions at the time. Thus, for example, a very limited analytical framework such as the totally aggregate (one-sector) model of the fifties and the predominance of a data system relying almost exclusively on national income accounts, predetermined that the corresponding development strategy would be couched within a uni-sectoral setting. In contrast, the multi-sectoral framework of the nineties based on a much clearer understanding of the elements and mechanisms (some endogenous) influencing the

development process and the availability of an extremely disaggregated set of socio-economic data allowed the design of a stabilisation-cum-growth-cum-poverty alleviation strategy.

The conception of the role of developmental aid evolved in parallel with the evolution of the development doctrine. In the fifties, the role of aid was seen mainly as a source of capital to trigger economic growth through higher investment. Faith in the capacity of recipient governments to plan successfully and use aid efficiently was strong. In the sixties, the role of foreign assistance, in the light of the two-gap models, was considered important in removing either a savings deficiency through an increased flow of foreign savings or a deficit in the current account of the balance-of-the payments by providing the necessary foreign exchange. The seventies witnessed a major change in the role of aid, i.e. that the primary objective of foreign assistance should be to raise the standard of living of the poor largely through increased employment. The focus on poverty alleviation required new types of investment and new forms of intervention.

With the advent of the debt crisis and the debt overhang, in the eighties the role and conception of aid changed in a major way. The primary purpose of aid became twofold; as a stop gap measure to salvage the shaky international financial system and to encourage the implementation of appropriate adjustment policies in third world countries through conditionality attached to programme lending. In that decade, characterised by pro-market and anti-government rhetoric, there was strong sentiment to reduce aid drastically and have private capital flows substitute for it.

Finally, the decade of the nineties was marked by a strong and lingering case of ‘aid fatigue’ influenced by the rising fear that foreign assistance was generating aid dependency relationships in poor countries. The issue of the effectiveness of aid conditionality was also critically debated. The socio-economic havoc created by the Asian financial crisis engendered a fundamental re-examination of the role of aid and the uncritical acceptance of the Bretton Woods rules of the game and the ‘Washington consensus’. The World Bank, in particular, took the leadership in advocating poverty alleviation and improvement in human welfare as the overarching objective of development and of foreign assistance.

## Notes

<sup>1</sup> There are two additional reciprocal relationships denoted by arrows in Figure 1.1. The first one is the interaction between development theories and hypotheses and development models. Models are typically based on theoretical hypotheses, which often are of a partial nature. By integrating various hypotheses into a consistent framework, which the model provides, some new insights may be derived which could lead to a modification of the initial hypotheses. The second bi-directional arrow is the one linking development objectives and data systems. Clearly, the choice of development goals both predetermines the kind of data systems that is required and is affected by it. Many concrete examples of these interrelationships are described and analysed next in the application of the conceptual framework in Figure 1.1 to the five decades spanning the period 1950-2000.

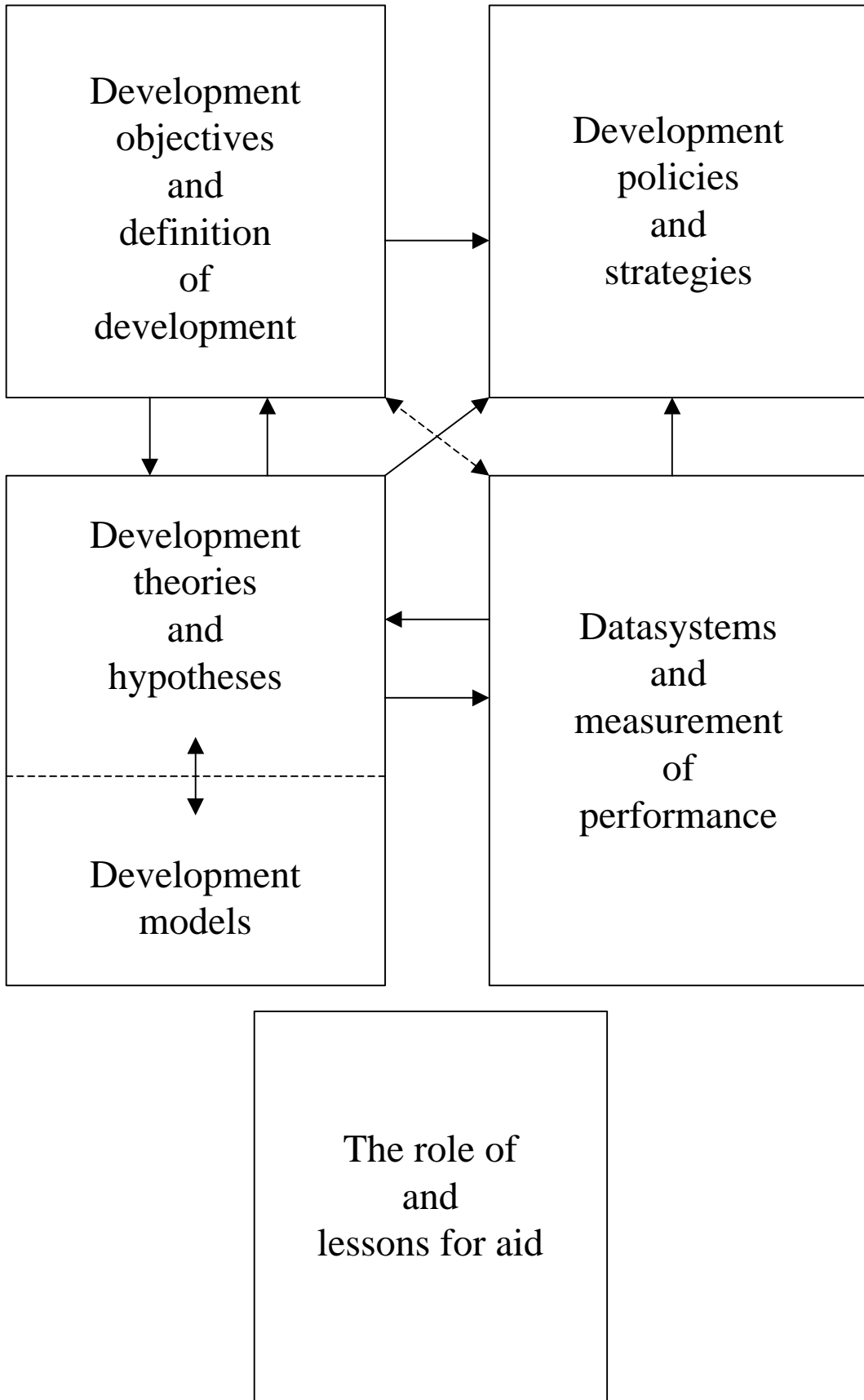
<sup>2</sup> In particular, certain conceptual and theoretical contributions may have been formulated before they became part of the conventional wisdom. An example of this is the seminal article of W. A. Lewis (1954), which triggered the economic dualism concept which became a major element of the development paradigm of the sixties rather than of the fifties.

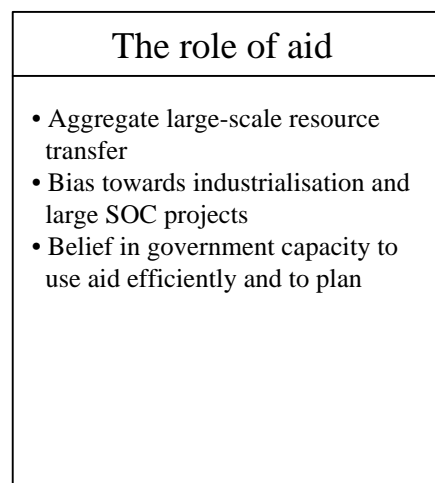
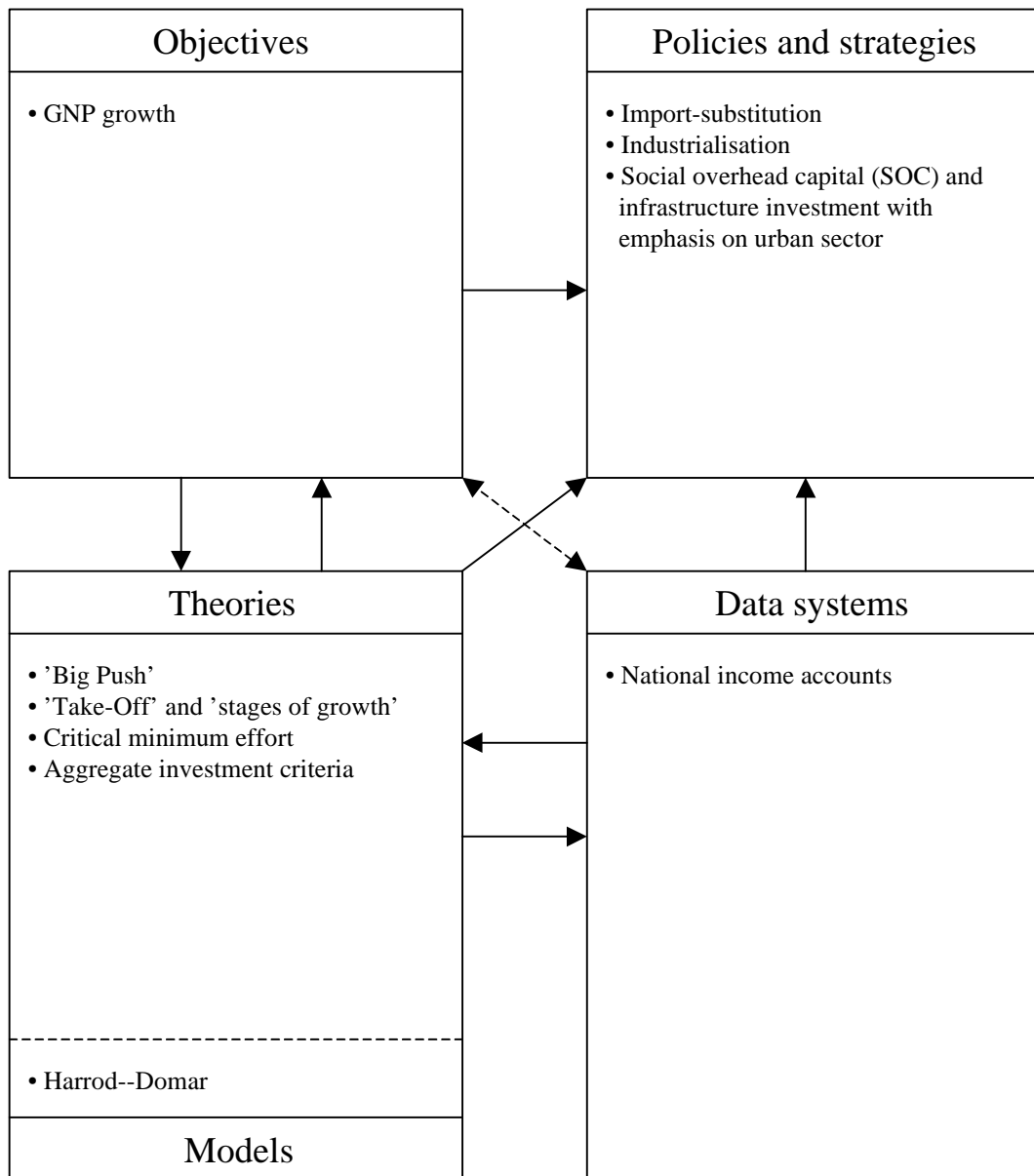


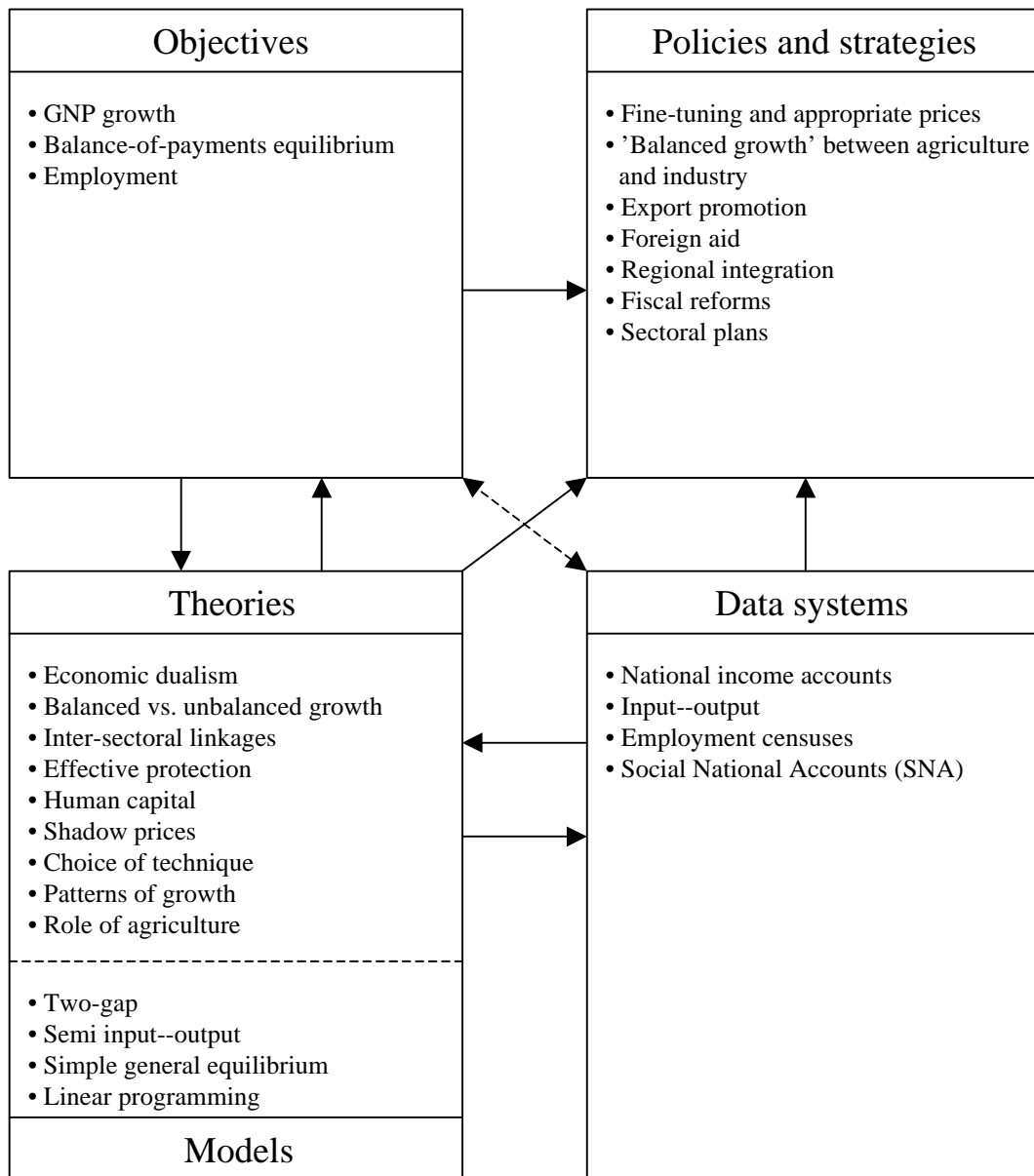
<sup>3</sup> Here again the emphasis on industrialisation was greatly influenced by the Soviet model.

<sup>4</sup> Public Law (PL) 480 refers to the *Agricultural Trade Development and Assistance Act* passed in the United States in 1954, marking the inception of food aid programmes.

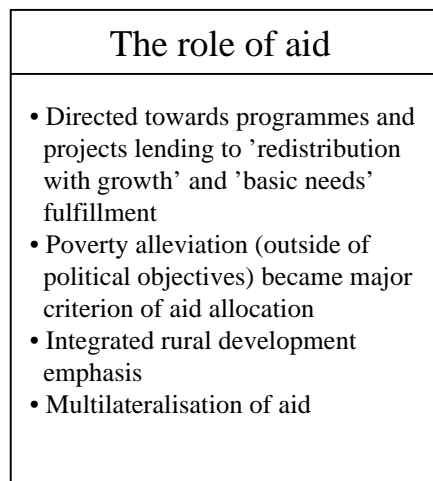
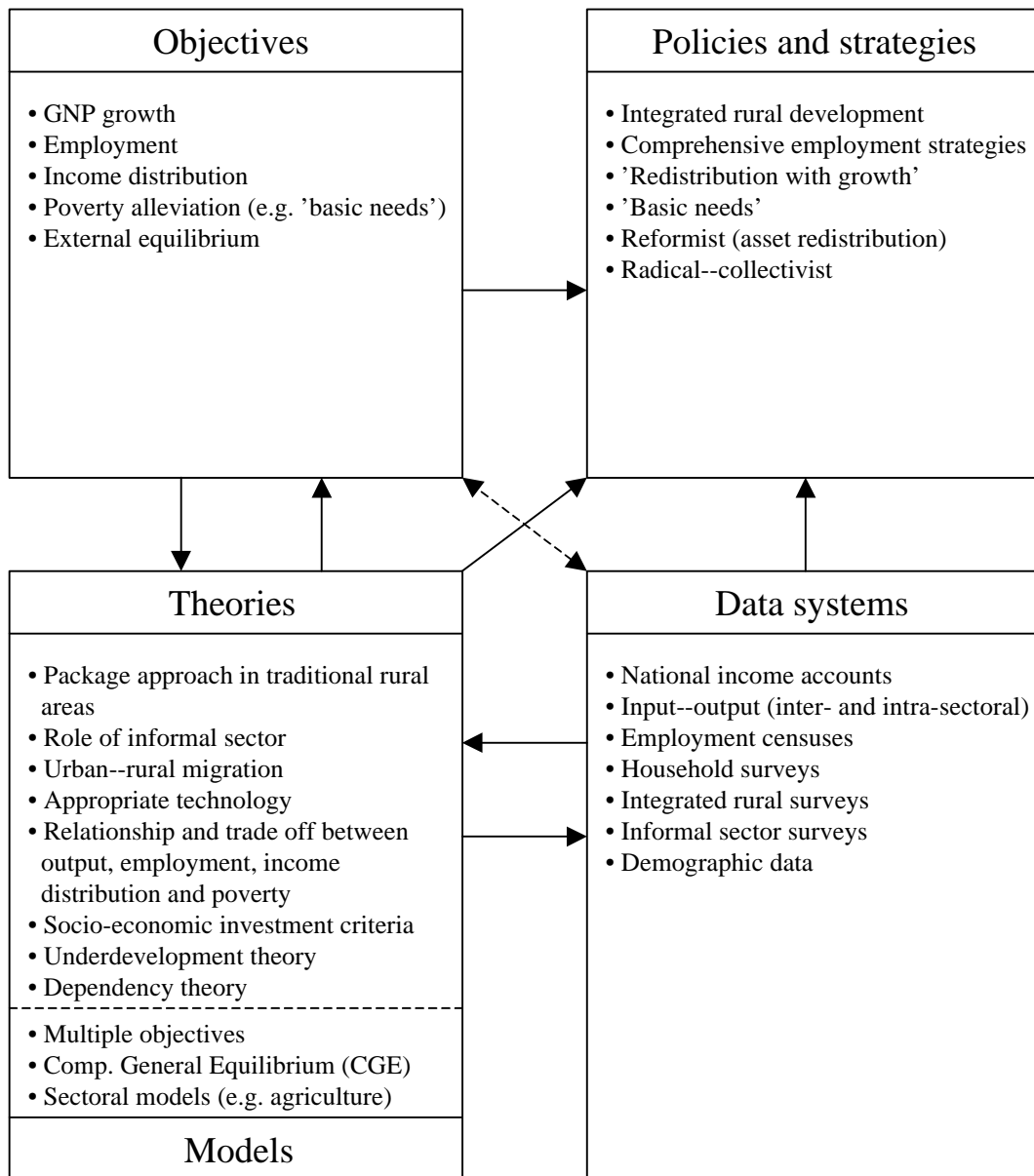
<sup>5</sup> Far from originating with ILO, the concept of basic needs and planning for poverty alleviation had already been expressed and formulated very clearly by the Indian planner Pitambar Pant as early as 1962 (see Pant 1974).

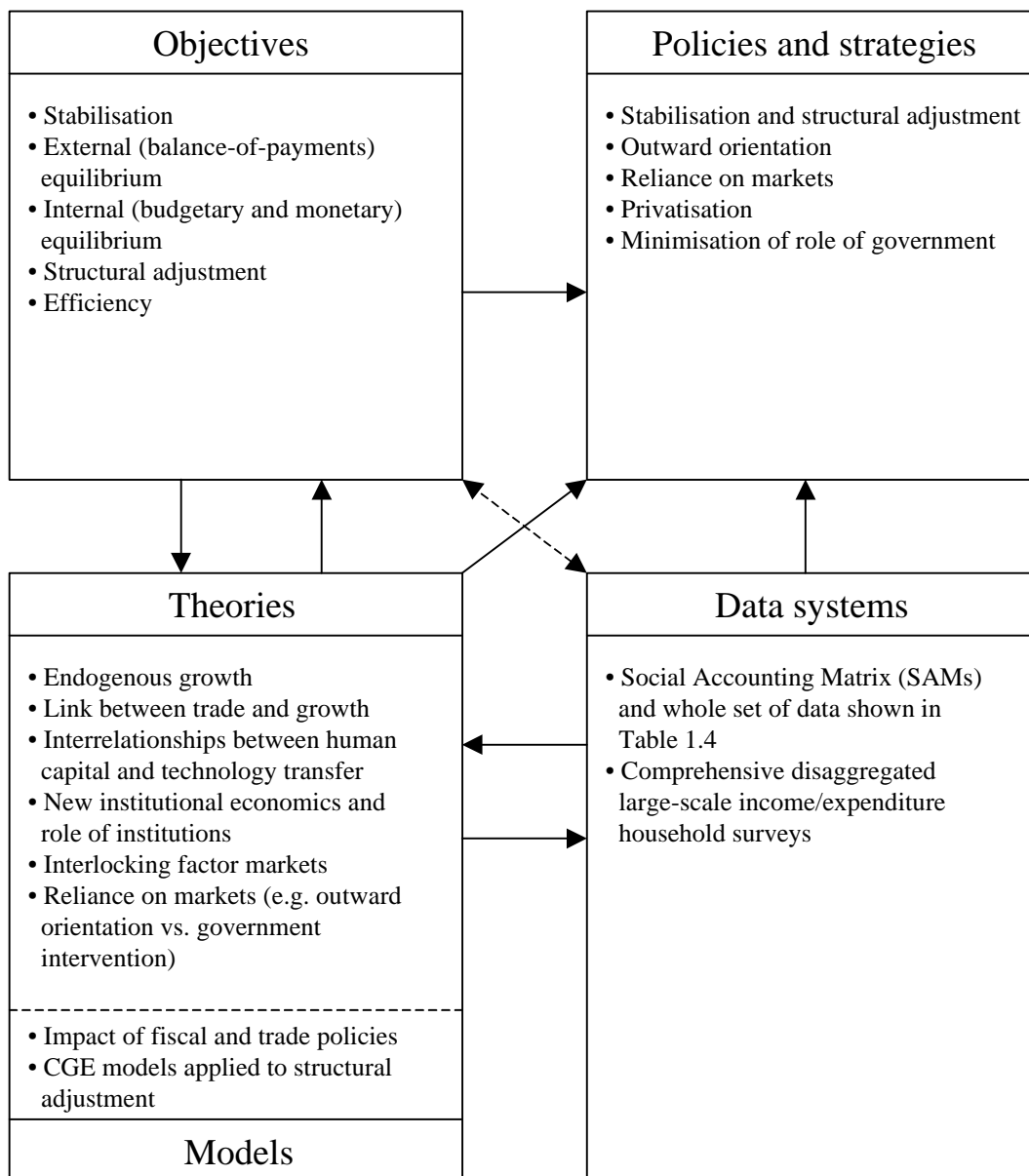






<b>The role of aid</b>
<ul style="list-style-type: none"> <li>• Two-gap model provides allocation criteria: I-S or M-X gaps may be binding</li> <li>• Contribution to 'balanced growth'</li> <li>• Beginning of sector (e.g. agriculture and education) and programme lending</li> <li>• Enhanced role of technical assistance to help build human capital</li> </ul>





<b>The role of aid</b>
<ul style="list-style-type: none"> <li>• Reversal of net aid flows because of massive indebtedness</li> <li>• Main objectives: structural adjustment and stabilisation</li> <li>• Programme lending and conditionality</li> <li>• Macro emphasis - abandonment of poverty alleviation as goal</li> <li>• Minimisation of role of government: greater privatisation of aid (role of NGOs and aid to private sector)</li> </ul>

