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Book Review — Digitized Version

[Book Review of] Easterly, William: The elusive quest for growth: economists' adventures and misadventures in the tropics: Cambridge, MA: MIT Press, 2001

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BOOK REVIEWS

Easterly, William, *The Elusive Quest for Growth. Economists' Adventures and Misadventures in the Tropics*. Cambridge, Mass. 2001. MIT Press. 342 pp.

Easterly has written a unique book about the international differences in the standard of living, which have never been larger in the history of mankind than today. What makes Easterly's book unique is the masterly mixture of four elements: a first-hand knowledge of developing countries, a rigorous application of analytical concepts, a deep compassion for the people behind the statistical numbers, and an irresistible sense of humor and irony. For instance, Easterly notes that he was optimistic about the growth prospects of Ghana when he lived there for a year in 1969–1970, but that his projections did not receive a great deal of public notice, which, as he mentions in passing, probably resulted because he had just finished elementary school.

The point is that Easterly was not alone in his assessment at the time. Many well-known economists were also optimistic about the growth prospects of Ghana in the first decade after independence in 1957. The reason for their optimism was a certain theoretical model that predicted a simple formula for growth. With the benefit of hindsight, it is of course fairly simple to understand why this particular model was wrong. What is probably more difficult to accept for development economists is the general lesson of the book. New magic strategies for growth and development come and go, but obviously all of them have failed to make poor countries rich. This insight may not be entirely new, but it is presented in a way that helps to clarify one's one misconceptions about the benefits of this or that development strategy. It is Easterly's unparalleled combination of facts, theory, passion, and humor that does the trick.

Easterly starts with some facts which highlight the differences in the standard of living between poor and rich countries. Today, about 900 million people live in prosperity as compared to about 1.2 billion people living in extreme poverty on less than 1 dollar per day. Poverty is not just low income, extreme poverty means high child mortality, malnutrition, and generally discrimination of the poor by the rich. In principle, poverty could be reduced either by redistributing income from the rich or by overall growth. Easterly points out that growth has been much more of a life saver to the poor than redistribution. His evidence shows that there is a strong empirical link between economic growth and poverty reduction, and that higher growth in average per capita income apparently translates one-for-one into higher per capita income of the poor. These facts set the stage for the quest for growth: what economic policies would free the poor from hunger and disease or, more generally, what economic policies would make poor countries rich?

An amazingly simple answer was provided by the Harrod–Domar growth model. According to that model, growth will be proportional to the share of investment spending in GDP. So the model could be used to identify a so-called financing gap for each and every poor country. The factor of proportion could simply be estimated from the relation between the growth rate and the share of investment and used to calculate the required amount of “needed” investment necessary to achieve a targeted growth rate. Working for the World Bank until recently, Easterly knows that the financing gap approach has been widely applied by the international financial institutions in order to channel large amounts of foreign aid to poor countries, but unfortunately was never checked against actual experience.

In fact, the idea of aid for investment for growth did not work out in reality. As it seems, the experience of Tunisia is the only case out of a sample of 138 countries where the model's predictions are somehow in line with the empirical facts. Hence, Easterly safely concludes that the model does not make any sense. Nevertheless, the ghost of this

model still lives on in many circles, as revealed by occasional statements of international financial institutions about increases in investment “needed” to achieve higher growth rates.

As pointed out by Easterly, the reason for the model’s complete failure is obvious: it ignores that people respond to incentives. Giving aid in order to fill a presumed financing gap does not change the incentives to invest for the future. Without a change in incentives, the recipients of aid will not increase their investment; they will only increase their consumption. What is worse, the availability of aid may even change incentives in the wrong direction because a country is likely to get more aid the lower its saving rate. So in the end, the strategy of aid for investment for growth may induce incentives that get countries caught in poverty traps.

This is Easterly’s recurring theme: people respond to incentives. Hence any successful development strategy has to create incentives for growth for the trinity of governments, donors, and individuals. Taken at face value, hardly a new insight, but truly revealing when applied in context to all the failed strategies for growth and development that have been attempted in the past. And since the demolition of various development strategies is backed by hard facts, enlightened by insightful anecdotal evidence from field work, and salted by a style of writing which is quite uncommon in the economics literature, Easterly’s book is a pleasure to read.

After annihilating the idea that there is something like a financing gap in poor countries that could be easily filled with aid to achieve growth in the next period, Easterly turns to the idea that investment may at least be an important determinant of long-run growth. The Solow growth model explains why this idea, sometimes called capital fundamentalism, is also wrong. To see why, read about Easterly’s failed attempt to sustain the growth of pancake production, as more and more friends of his kids arrive for breakfast, by adding only one of many production factors. Such a strategy cannot work in the long run because of diminishing returns. And since capital accounts for only one third of production in poor and rich countries alike, decreasing returns to investment will set in very fast. Back to Easterly’s main theme: investing in additional machinery is useless when incentives for growth are lacking.

The same holds for investing in additional human capital. Taken at face value, the strong educational expansion in almost all countries over the last four decades has not delivered the growth miracles that should have followed if more education were the key factor for a sustainable rise in the standard of living. Easterly convincingly suggests that the reason for this disappointing result is the same as before: expanding education is worth little if incentives to invest in the future are not there.

Foreign aid to finance population control – as Easterly puts it, cash for condoms – is another panacea for promoting prosperity in poor countries that did not work. At this stage of the book, the reason is already obvious: desired fertility is a function of the incentives for investment in the quantity and quality of children. More condoms as such do not change these investment incentives. Still other development strategies like channeling loans to poor countries conditional on policy reforms that should provide the right incentives for investing in the future – so-called adjustment lending – also did not work. The main reason was that the donors did not discriminate very much between more corrupt and less corrupt governments (often for non-economic reasons), and this indiscriminate lending created poor incentives for making the reforms necessary for growth.

Debt forgiveness (Jubilee 2000) is the latest panacea for relieving poverty of poor countries. This is more or less ignoring that debt forgiveness has already had a long history. So far, there have been very few success stories, for the same fundamental reason as with the other poverty-reducing strategies: debt forgiveness can do no good if it does not change the incentives to invest in the future. In fact, new borrowing was the highest in countries that got the most debt relief in the past. Hence, Easterly concludes that

high debt may remain a persistent problem just because high debt reflects irresponsible governments that remain irresponsible after debt relief is granted.

In the second major part of his book, Easterly turns to policy suggestions that might actually deliver, thereby stressing that his incentives-based views on growth should not be considered as a new panacea for development. This part is necessarily more speculative because not all underlying implications have been (or can be) estimated empirically. For instance, Easterly favors a view of development which is dominated by increasing returns to knowledge in combination with the idea that skills complement each other. Such a view may also offer insights on the incentives for accumulating skills, on the likely direction of migration, and on poverty and wealth traps (as well as on comparative advantage, as it turns out), which seem to fit the facts quite well and certainly better than models based only on diminishing returns. So the presence of increasing returns to knowledge could actually explain why there could be different incentives for skill accumulation, depending on the initial level of skill accumulation to begin with, and given that skills actually complement each other.

With a view on policy implications, the big difference between Easterly's view of the development process and a conventional view based on diminishing returns is that vicious and virtuous circles cannot form in the latter case. But with increasing returns to knowledge and skill complementarities, what matters for the productivity of individual investment decisions is the overall investment level of a society. As a result, income differences would not be explained by the individuals' effort to accumulate physical and human capital, but by differences in knowledge and matching opportunities across countries and regions. In such a view, poor people face weak incentives just because their knowledge-leaking and their skill-matching is dominated by other poor people.

The policy implication is that government intervention may be necessary to get an economy out of a poverty trap. While this may sound optimistic in principle, Easterly is eager to warn that bad government policies are in many if not most cases the very reason for a poverty trap. And even an honest government setting all the right incentives to escape from a poverty trap may not succeed because the final outcome could be sensitive to initial conditions of knowledge and skill and, most importantly, to expectations about outcomes, all of which are probably impossible to quantify in advance.

A more optimistic view would be based on the idea that backward economies may jump to new technologies which are not implemented on a large scale in advanced economies due to vested interests of workers and industries working with old technologies. Hence new technologies may be more easily introduced in countries which lack much existing technologies. The rise of Japan's steel industry relative to the U.S. steel industry after the Second World War provides an illustrative example. But as Easterly notes, possible positive effects of economic backwardness must not be overemphasized since the negative effects of backwardness on growth are also always at work. Nevertheless, poor countries do not have to invent new technologies. They can import them, either through foreign direct investment or through the import of capital goods. In this view, the possibility of technology import, with all of its potential self-enforcing effects, is the reason why openness, at least in some sectors, is a necessary prerequisite for successful economic development.

Another possibility is that new technology is complementary to old technology, which would offset any advantages of backwardness and enforce path dependencies, as in the discussion of increasing returns to knowledge. Which of the possibilities prevails depends, according to Easterly, on both luck and government policy. On understanding the importance of luck (or bad luck, for that matter), what is now held to be the reason for the extinction of the dinosaurs may provide a good example. Living in a rich country, it is indeed easy to forget how much poor people and even poor countries as a whole can suffer from natural disasters and the prevalence of diseases. Sheer luck is a constant

influence on growth and may explain a large part of the short-run fluctuations in growth. But in the long run, it seems that government policies have a strong association with growth and prosperity.

Government policies can at least fairly easily destroy the incentives for investing in the future. High inflation, high black market premiums, negative real interest rates, high budget deficits, restrictions on free trade, and inadequate public services are all measures that act like a tax on future income, which will result in slow growth or stagnation or worse, as shown with detailed evidence for single countries and for groups of countries. Yet Easterly warns again that macroeconomic reform should not be regarded as the new panacea for growth. This is because incentives are not only shaped by (bad) economic policies but also by the institutions that set the rules for transactions within a society.

As an example of institutional failure, Easterly discusses the effects of corruption on growth. Corruption can be thought of as a tax on productive activities and hence should reduce the potential for growth. But the relation between corruption and growth appears to be rather complex. Both Indonesia and Zaire were rated as highly corrupt countries but showed very different growth records. Easterly suggests that it matters much for growth outcomes whether corruption is decentralized as in Mobutu's Zaire or centralized as in Suharto's Indonesia: corruption will be more damaging to growth in a weak state than in a strong state. The reason for the different outcomes – you guessed it – is the different set of incentives that emerges under the different systems of corruption. The way out would be to create credible institutions which substantially reduce the incentives for corruption. The obvious problem is to get things moved: a weak corrupt state would be unable to do it and a strong corrupt state would be unwilling to do it. So in most cases, relief may only come by civil war or by outside interference (or by a combination of both), which is a consequence that Easterly may be aware of but avoids to discuss.

Easterly's answer to why some governments face seemingly self-defeating incentives to destroy growth is that in many poor countries governments are coalitions representing different factions of people. Polarization in weak governments can explain why each interest group assigned to a certain policy field like export licensing, money creation, credit allocation, or government spending may try to get as many resources as possible from the assigned activity without taking into account the effects of such a policy on all other activities. Though each faction would act perfectly rational in serving the interests of its constituency, the overall outcome would be the combination of high black market rates, rising inflation, negative real interest rates, and soaring budget deficits, which is not uncommon for many crisis countries. Hence bad policies may persist for a long time in countries with multiple interest groups, because no group faces an incentive to change its behavior.

Summarizing various contributions from the field of political economy, Easterly argues that it does not make a large difference whether multiple interest groups result from high income inequality or from ethnic fractionalization. In both cases, and especially in combinations of both, the predicted outcome is lower growth than in nations with a more equal income distribution and a less ethnically divided population. It seems that this prediction is borne out by the empirical facts pretty well. Still, as Easterly notes, this interpretation of the empirical evidence heavily relies on his leaks-matches-traps view of growth. One implication of this view would be that discrimination, for instance against ethnic minorities, would appear as a rationale strategy for a single faction of people but would necessarily result in lower overall growth than would be possible otherwise.

In the end, Easterly frankly admits that trying to make poor countries rich has raised more questions than it has answered: there are no magic formulas for development.

While it is almost self-evident that prosperity will happen if all the players in the development process face the right incentives, the harder part is to devise ways and means that would achieve such a situation. What is necessary for growth is that government incentives induce investment in collective goods like education, health, and the rule of law rather than fighting over the redistribution of existing income, that donor incentives induce aid flowing to countries with proven good policies rather than to countries with nonreformist governments, and that the poor face investment incentives through welfare programs that reward rather than penalize earning income. While this is hardly an encouraging message for countries that are polarized by antagonistic interest groups, Easterly stresses that understanding the reasons for poor government incentives in polarized societies may at least hold the key for a future ending of the vicious circle of bad policies and poor growth. Preaching at poor countries to change their policies, as in the past, will not do as long as there are no incentives to change policies.

Given the proverbial disagreements between any two economists on any single topic, surely nobody will agree with all of Easterly's assessments. My personal list of disagreements is rather short and touches only minor issues. In theory, I think that it is not entirely plausible to argue that the Solow model provides a basic insight about long-run growth but cannot be applied in a cross-country context (the residual may not only include technology in a narrow sense). And I find the basic structure of the AK model of Rebelo, mentioned as one of the seminal new growth models, pretty close to the structure of the Harrod-Domar model that Easterly smashes in the first part of the book.

On empirics, there are of course endless opportunities for different assessments, but I find Easterly's interpretations of the empirical evidence very convincing, not least because it is always backed by references to peer-reviewed literature. With direct relevance to Easterly's underlying theoretical structure, I think that even if there is a strong link between changes in human capital and economic growth, which Easterly denies, his people-respond-to-incentives story would hold nevertheless (but the quantitative importance of his leaks-matches-traps idea would probably be somewhat reduced). And I am a bit skeptical whether we really have convincing empirical support for the idea that higher (public) investment in research and development actually correlates with higher growth, not to speak of a causal link.

Yet quibbles like these merely reflect that Easterly very successfully demolishes many widely held ideas about growth and development, including my own, and at the same time shows where to look for better alternatives. This is economics at work at its best. For all economists interested in growth and development (are there any other economists?), there is no chance not to get hooked to Easterly's book.

Erich Gundlach

Jovanovic, Miroslav N., *Geography of Production and Economic Integration*. Routledge Studies in the Modern World Economy 28. London, New York 2001. Routledge. 327 pp.

Over the last decade, economic integration, and its impact on the location of economic activity, has received substantial attention – both among academics and among policy makers. The developments within new trade theory and new economic geography have boosted this interest by providing an analytical framework suitable for analysis of the issue. At the same time, the fast progressing and deepening integration process of the European Union has led to a special emphasis on this subject in Europe, and placed it high on the agenda of researchers and politicians. The major question that everyone seeks an answer to is what will be the outcome of European integration: is