1 Introduction

In a famous 1988 essay, economist Robert Lucas suggested that the inability of the poorest economies of the world to grow was the most interesting intellectual puzzle facing modern economics. Given a world of capital mobility and international trade, traditional economic growth theory predicts the world's national economies will all eventually converge at the same level of income. Capital will flow to the poorer economies, where it is scarcer, and thus should find higher returns. As a result, developed economies should face reduced investment flows and grow more slowly, while the poorer countries benefit from a large flow of investment and grow faster. Theory predicts that inevitably the poorer countries catch up to the richest, and there is a convergence of the world's economies. Yet, as Lant Pritchett (1997) has put it, far from convergence, over the last half-century, the world economy has presented us with "divergence, big time." With a small number of exceptions, the poorest economies have not grown faster than the richest and do not appear to be catching up. In fact, some of the poorest countries have fallen further behind during the last couple of decades.

Why is this and what can be done about it? For 50 years, foreign aid has been the central policy instrument with which the international community has promoted economic development. The main justification for aid has always been that the poorest countries could not develop without it. Theories of economic development in the 1950s and 1960s viewed low-income countries as trapped in a low-level equilibrium, which they would not escape without external assistance. That the external impulse of financial and technical assistance could and should play a critical role in development has been a public policy adage that sustained growing

volumes of aid from the end of World War II to the early 1990s. Yet, despite a large volume of aid and some striking individual aid success stories, a core set of the poorest countries has known little improvement in poverty rates, little or no economic growth, and a consistently poor governance record. A well-known paradox about aid has become that it tends to work best in the countries that need it least. For all its successes, aid has appeared to be the least successful in the poorest economies, where the needs are greatest.

The international aid community's failure to promote economic development in the poorest states of the developing world has shaken the policy community and led to something of a crisis of faith about foreign aid during the 1990s. A number of papers, books, and reports raised serious doubts about aid effectiveness.[1] While it rarely denied that aid had achieved many successes, this literature pointed to numerous flaws in aid design and implementation and called into doubt the ability of foreign aid to engineer the development of the poorest countries without substantial reform. Too often, large amounts of aid had been provided to incompetent dictators with wrong-headed economic policies. Some critics argued that aid was actually delaying economic reform in many of these countries and that private-sector promotion and commercial development would better serve these countries than traditional forms of aid. They argued that "trade, not aid" was the preferred instrument of rapid development. As a consequence, the second half of the 1990s witnessed much discussion of aid modalities and a serious attempt to bring about new dynamics on the ground and within aid agencies. Several programs were implemented specifically to promote trade possibilities for low-income countries. Aid appeared to be in crisis in the mid-1990s, with overall aid volumes recording the first sustained declines since the end of World War II.

Inevitably, the policy pendulum has now swung back to a position more favorable to foreign aid. The emergence of Jubilee 2000 and other civil-society campaigns in the West have made the public more aware of the problems of poverty and debt in developing countries. The global HIV/AIDS crisis has stimulated calls for the international community to "do something." Third World countries have lobbied the West aggressively to get more aid; in Africa, for instance, African heads of state have used the New Economic Partnership for Africa's Development (NEPAD) campaign with great effectiveness to argue that they are willing to exchange governance reforms for more aid. In the aftermath of 9/11, the role of collapsed states such as Afghanistan in harboring terrorist organiza-

1. A short list of key works includes Berg (1993), Boone (1996), Bräutigam (2000), Easterly (2001), Gwin and Nelson (1997), Killick (1998), Lancaster (1999), Martinussen and Engberg-Pedersen (1999), Tarp (2000), van de Walle and Johnston (1996), White (1998), and World Bank (1998).

tions has offered a new foreign policy motivation for foreign aid (Sachs 2002).

As a result, the political climate for increasing budgetary allocations for aid has improved. The Millennium Declaration adopted at the UN summit in September 2000 laid out an ambitious agenda of poverty reduction and improvements in education and health. The commitment of rich-country governments to attain the Millennium Development Goals (MDGs) that the declaration established has engendered a new dynamic of aid volume increases. Development advocates have argued that current aid volumes need to be more than doubled if the MDGs are to be reached (Stern 2003, Sachs 2002). While reaching such levels of increases appears unlikely, renewed commitment by the rich countries to increase their levels of assistance has reversed the declines of the mid-1990s. In 2002 and 2003, official development assistance (ODA) increased 11 percent in real terms, and donors have pledged to increase their aid by another 25 percent by 2006 (OECD 2004). ODA in 2003 reached $68.5 billion, the highest level ever, in both nominal and real terms (OECD 2004).

In 2001, the United Nations established the Global Fund to Fight HIV/AIDS, Tuberculosis, and Malaria in developing countries, and by mid-2003, the fund had received funding commitments of $3.4 billion from 32 countries (Summers 2003). The George W. Bush administration has led these efforts with an initial commitment of $500 million in 2001 and has promised an additional $550 million in the 2004 federal budget, in addition to the $2.4 billion set aside for its bilateral programs in the same budget.

During his run for the presidency in 2000, President Bush had seemed relatively hostile to foreign aid. His aides dismissed foreign aid as a nation-building tool that was unlikely to be successful and not particularly in the United States' national interest. In office, however, the Bush administration reacted to the new climate with promises of substantial aid increases. In addition to committing to provide substantial funding for the HIV/AIDS initiative, his administration promised in March 2002 to establish a Millennium Challenge Account (MCA) of an additional $5 billion by 2006 in support of the MDGs in the poorest countries, provided these countries adopted good governance practices and sound economic policies ("Bush, Hero or Hypocrite?" *The Economist*, May 31, 2003). The extent to which the Bush administration will come through with these funding commitments is in some doubt at the time of writing. The White House's actual budgetary proposals have been more modest than initially announced, and the administration has done little to defend its proposals on Capitol Hill. Growing budget deficit pressures also may well reduce the total new resources available for the MCA initiative ("New System Begins Rerouting U.S. Aid for Poor Countries," *New York Times*, February 22, 2004). Nonetheless, this is an impressive turnaround for an administration that came to power with the stated intention of cutting foreign aid.

This renewed commitment of rich countries to foreign aid expresses a particular concern for the poorest economies. All contend that foreign aid should be directed primarily at the several dozen least developed states, where the problems of poverty are the most severe and where, it is argued, large infusions of aid are vital to bring about economic growth. A number of observers have recently resurrected the argument about a "poverty trap" (e.g., UNCTAD 2002; Sachs 2001, 8–9). Jeffrey Sachs defines a poverty trap as a "condition, seemingly paradoxical, in which a poor country is simply too poor to achieve sustained economic growth." Different observers have advanced different theories regarding the causes of this poverty trap. In the original formulation, very poor economies could not generate enough capital surplus to reinvest in the economy. An external infusion of capital was needed to start the engine of growth. In more recent formulations, the poverty trap results from a complex of economic and institutional failures that are generated at certain low levels of economic wealth. Poverty brings about low human capital, which results in low-performing public institutions, which then undermines economic growth and maintains poverty. Many low-income economies appear to be caught in a vicious cycle in which a deficiency in one area makes success harder in others.

In an eloquent essay, Sachs (2001) argues that the existence of a poverty trap justifies a massive new infusion of foreign aid. Without the impulse of external financial and technical support, these countries are condemned to remain in poverty. Noting that aid declined substantially in the 1990s, he maintains that a massive increase in foreign aid is necessary to put the poorest countries on the path to rapid growth. The problems of the poorest countries could be overcome only if they received more aid. He points to the decline in aid levels since the mid-1990s to explain the economic records of these countries. This is debatable. In fact, declining aid in the 1990s did not prevent the best growth performance in the low-income countries since the 1970s. Indeed, the 1980s was called "the lost decade" on account of the disastrous record of economic growth, despite the fact that foreign aid was growing rapidly throughout that decade.

Proponents of large new infusions of aid dismiss as largely irrelevant the argument that large amounts of aid have not proved all that effective in the past, insisting that recent reforms in the allocation and modalities of aid will ensure that aid is more effective in the future. In 2003, Nicholas Stern, then chief economist and vice president for development economics at the World Bank, asserted that "aid is more effective today than ever before" (Stern 2003). But this too is far from clear.

This book argues that the recent reforms in aid practices, while significant, are still incomplete and partial. Their progress, moreover, has been the least in the poorest countries, where new infusions of aid are supposed to be directed. Some of the reforms constitute largely "old wine

in new bottles," where a new discourse disguises how little has really changed. Other reforms are laudable but are not being fully implemented because of bureaucratic interests and political pressures within the donor community. Yet others appear mutually inconsistent, where progress in one area is likely to undermine that in another.

Large new infusions of foreign aid will largely be wasted unless the current agenda of reform is pushed forward much more aggressively. I agree with the proponents of aid and not the free-market enthusiasts who would replace aid with the magic of markets, foreign trade, and the private sector. Foreign aid has to play a critical role in any successful development strategy for these countries, but the last three decades of foreign assistance demonstrate that traditional aid programs are not effective in a number of desperately poor countries. A much more radical reform of aid remains necessary. For aid to become more effective donors must take much more careful account of the local political dynamics that undermine development in the poorest countries.

Chapter 2 identifies the several dozen most intractably unsuccessful economies in the world. It reviews the nature of governance and policymaking in these states and shows that they share political dynamics that are highly dysfunctional for economic growth. The chapter then examines the relationship between these countries and the international aid community. It argues that current aid strategies and practices have failed and need to be rethought in a radical manner. Chapter 3 discusses current aid reform proposals, and chapter 4 examines why reform of the aid system has proved so difficult. Chapter 5 offers a set of proposals for the international community to promote economic development in these countries.