Chapter 2: Freedom versus Collectivism in Foreign Aid

by William Easterly[1]

1 The New Collectivism

Marx was right about at least one thing: "History repeats itself, first as tragedy, second as farce." The 21st century has seen a farcical version of the collectivist utopian fantasies that led to such disasters in the 20th century. Fortunately, the new collectivism is far more tepid—less extreme, less powerful, and less coercive—than the ideologies that caused so much tragedy in the Communist bloc in the 20th century. The collapse of communism in Europe with the fall of the Berlin Wall, and the great success of the movement away from central planning towards markets in other places like China and Vietnam that remain nominally Communist (along with the poverty of the unrepentant Communist states in Cuba and North Korea) discredited the Communist notion of comprehensive central planning once and for all. Yet, by an irony that is not so amusing for its intended beneficiaries, the new farcical collectivism is still alive for the places that can afford it the least—the poorest nations in the world that receive foreign aid. Instead of the Berlin Wall, we have an "Aid Wall," behind which poor nations are supposed to achieve their escape from poverty through a collective, top-down plan.[2] Instead of the individual freedom to prosper in markets, the successful approach of the nations that are now rich, the poor must let the international experts devise the collective solution to their miseries.[3]

Jeffrey Sachs and *The End of Poverty*

Lest you think I exaggerate, consider some of the statements of the most prominent and extreme spokesman of the new collectivism for poor nations, Jeffrey Sachs. In his 2005 book, *The End of Poverty*,[4] he says in the opening pages:

> I have … gradually come to understand through my scientific research and on the ground advisory work the awesome power in our generation's hands to end the massive suffering of the extreme poor … Although introductory economics textbooks preach individualism and decentralized markets, our safety and prosperity depend at least as much on collective decisions to fight disease, promote good science and widespread education, provide critical infrastructure, and act in unison to help the poorest of the poor … Collective action, through effective government provision of health, education, infrastructure, as well as foreign assistance when needed, underpins economic success. (Pp. 2–3)

Sachs says that each poor country should have five plans, such as an "Investment Plan, which shows the size, timing, and costs of the required investments" and a "Financial Plan to fund the Investment Plan, including the calculation of the Millennium Development Goals Financing Gap, the portion of financial needs the donors will have to fill" (p. 273). These plans will be helpfully supported by the "international community":

> each low income country should have the benefit of a united and effective United Nations country team, which coordinates in one place the work of the UN specialized agencies, the IMF, and the World Bank. In each country, the UN country team should be led by a single United Nations resident

1 I am grateful for research assistance to Julia Schwenkenberg, and for comments. Some parts of this paper also draw on joint work with Ariell Reshef and Julia Schwenkenberg. Other parts draw on my book, *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good* (Penguin, 2006).

2 William Duggan of Columbia Business School suggested the notion of the "Aid Wall" to me in private conversation.

3 These themes are developed at greater length in William Easterly, *The White Man's Burden*.

4 Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time* (Penguin USA, 2005).

> coordinator, who reports to the United Nations Development Program, who in turn reports to the UN secretary-general. (P. 285)

Everything will fit together in one great global plan run by "the UN Secretary General, [who] should ensure that the global compact is put into operation" (p. 269).

Like his collectivist predecessors, Sachs sees the achievement of prosperity as mostly a technical problem: "I believe the single most important reason why prosperity spread, and why it continues to spread, is the transmission of technologies and the ideas underlying them … science-based ideas to organize production" (p. 41). Africa's problems … are … solvable with practical and proven technologies" (p. 208).

He sees one kind of scientific expert—the medical doctor—as the model for how to solve the problems of poverty:

> Development economics today is not like modern medicine, but it should strive to be so. It can improve dramatically if development economists take on some of the key lessons of modern medicine, both in the development of the underlying science and in the systematization of clinical practice, the point where science is brought to bear on a particular patient. (P. 75)[5]

Of course, there are such things as public goods, which require solving a collective action problem to supply them. There is a role for government to supply such goods. However, Sachs (and the other collective approaches described below) seem to make little distinction between a lack of public goods and a lack of private goods, which is called poverty.

The United Nations' Millennium Development Goals

The United Nations is the main official sponsor of today's collectivist fantasies. These are called the Millennium Development Goals (MDGs), described on the United Nation's web site as follows:

> The eight Millennium Development Goals (MDGs)—which range from halving extreme poverty to halting the spread of HIV/AIDS and providing universal primary education, all by the target date of 2015—form a blueprint agreed to by all the world's countries and all the world's leading development institutions. They have galvanized unprecedented efforts to meet the needs of the world's poorest.[6]

Secretary-General Kofi Annan uses the collectivist "we":

> We will have time to reach the Millennium Development Goals—worldwide and in most, or even all, individual countries—but only if we break with business as usual. We cannot win overnight. Success will require sustained action across the entire decade between now and the deadline. It takes time to train the teachers, nurses and engineers; to build the roads, schools and hospitals; to grow the small and large businesses able to create the jobs and income needed. So we must start now. And we must more than double global development assistance over the next few years. Nothing less will help to achieve the Goals.[7]

The Secretary-General uses "grow" as an active verb applied to business, something that "we must start now." Somehow collective action will create jobs and income, as opposed to the decentralized efforts of individual entrepreneurs and firms operating in free markets.

Insofar as the MDG campaign mentions private entrepreneurs, they are "partners" subject to "our" resolve:

> We resolve further: … To develop and implement strategies that give young people everywhere a real chance to find decent and productive work … To develop strong partnerships with the private sector and with civil society organizations in pursuit of development and poverty eradication.[8]

Part of the reason for this campaign is not just to help the world's poor, but to help the UN, as Kofi Annan made

5 Sachs sees himself as the heir to the 18th century Enlightenment, suggesting that "many of its sweetest fruits are just within our reach." Unfortunately, the branch of the Enlightenment he follows is the one with a hubristic faith in the power of "our" reason to redesign society, which led right away to the excesses of the French Revolution and have since misbegotten various utopian experiments. He seems to have missed out on the individualist branch of the Enlightenment, the one that gave us Adam Smith and the US Constitution. This part of the Enlightenment understood that individuals spontaneously pursuing their own activities accomplish more than rationalist collectivism.

6 <http://www.un.org/millenniumgoals/>.

7 <http://www.un.org/millenniumgoals/>.

8 *UN Millennium Declaration 2000* <http://www.un.org/millennium/declaration/ares552e.htm>.

clear at the September 2005 World Summit on the MDGs: "it is also a chance to revitalize the United Nations itself."[9] In this it has been successful, at least at the World Bank and the IMF. These two organizations have long preached the virtues of free markets and ignored UN bureaucrats preaching statist rhetoric. Inexplicably, the World Bank and IMF have since 2000 embraced the UN MDG exercise and a lot of its planning. An OECD-DAC document explains this palace coup in favor of collectivist planning as follows.

> In the 1990s, the field of international development entered an era of reform and reformulation as the disparities between rich and poor countries increased. World leaders, in collaboration with the UN and other multilateral institutions, recognized the need for drastic measures to ensure that developing countries benefited from globalization and that development assistance funds were used equitably and effectively to achieve the global development aims embodied in the Millennium Development Goals (MDGs) and other national development goals.[10]

In their *Global Monitoring Report 2006: Millennium Development Goals: Strengthening Mutual Accountability, Aid, Trade, and Governance*,[11] the IMF and World Bank make clear their embrace of the whole MDG planning exercise: "Donors and the international financial institutions must increase aid flows, improve aid quality, and better align their support with country strategies and systems" (p. 1). How would this be done? The World Bank and IMF reaffirm a commitment to "accountability for achieving results," which they note was already reaffirmed four years earlier in the UN Monterrey Summit. On the same page, the report notes without irony that "international financial institutions [such as the World Bank and IMF] still emphasize loans and reports rather than development outcomes" (p. 1). They are still having some difficulty, as a few pages later they cannot keep themselves from emphasizing loans, apologizing that "in 2005 lending through the concessional and non-concessional windows of the MDBs declined" (p. 9).

They plan to change their ways by "Implementing the results agenda":

> The 2004 Marrakech Roundtable on Results called for a monitoring system to assess the results orientation of the multilateral development banks (MDBs); that system is COMPAS, the Common Performance Assessment System, which draws on MDB frameworks and action plans to implement managing for development results (MfDR). (P. 9)

Managing for Development Results (MfDR)

Exactly what is MfDR? It is summed up in *Managing for Development Results Principles in Action: Sourcebook on Emerging Good Practice* (MfDR Sourcebook), prepared by the OECD and the World Bank, which contains the following helpful diagram shown in Figure 2.1. To clear up any confusion, the MfDR Sourcebook notes that "Performance management is a holistic, cultural change" (p. 8). When it does get a tad more concrete, MfDR seems to involve a lot of central planning, such as the following:

> **At the national level (see Part 2),** MfDR is used in the planning and implementation of results-based national plans, budgets, and antipoverty strategies. International agencies may support this process with technical assistance.

Figure 2.1: Managing for Results according to the MfDR Sourcebook

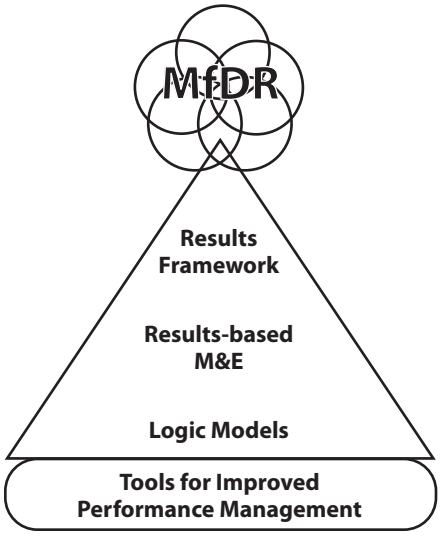


Diagram after "Performance Management," *MfDR Principles in Action: Sourcebook on Emerging Good Practice*, p. 8. Reproduced with permission

9 <http://www.un.org/summit2005/>.

10 *Managing for Development Results [MfDR] Principles in Action: Sourcebook on Emerging Good Practice* (OECD-DAC, 2006), <http://www.mfdr.org/Sourcebook.html>, p. 4.

11 *Global Monitoring Report 2006: Millennium Development Goals: Strengthening Mutual Accountability, Aid, Trade, and Governance* (World Bank Publications, 2006).

> **In sector programs and projects (see Part 3),** partner countries and development agencies use MfDR in planning assistance programs or individual projects that are based on country outcomes and priorities defined in national or sector development plans. (P. 4)

It doesn't get any better reading the rest of the MfDR Sourcebook. In the table on page 134 of the MfDR Sourcebook is the sensible principle: "Keep results measurement and reporting as simple, cost-effective, and user-friendly as possible." (p.134). Below is an excerpt from the table giving the recipe for simple, cost-effective, and user-friendly results measurement and reporting:

Examples of tools being used to manage for results in development agencies
M&E systems, plans and guidelines (incorporating MIS)
Audit and risk management frameworks
Performance measurement frameworks
Program/project monitoring frameworks
Audit guidelines and tools
Evaluation guidelines and tools
Risk analysis guidelines and tools
Training and guidelines for indicator design, data collection, and analysis

The old collectivists were lethal; the new collectivists just bury life and death issues under six layers of bureaucracy.

All the MDG planners use the word "accountability" frequently, but without understanding what "accountability" is. Unlike the individual accountability that each producer faces in free markets (you satisfy the customers or you go out of business), the MDG exercise has something called "mutual accountability." This murky notion appears to involve accountability, not to the intended beneficiaries, but to the other bureaucracies involved in the MDG plan, all of whom have a stake in the current system continuing regardless of results. Instead of individual accountability, we have collective responsibility: "Development agencies are creating results-based country assistance strategies in close dialogue with national governments … During this process, multiple agencies negotiate a process for working together to support country outcomes."[12] A system in which everyone (multiple agencies and governments) are collectively responsible is equivalent to one in which nobody is individually responsible. If there are disappointing results, you can always blame someone else. Collective responsibility is to accountability what collective farms are to individual property rights.

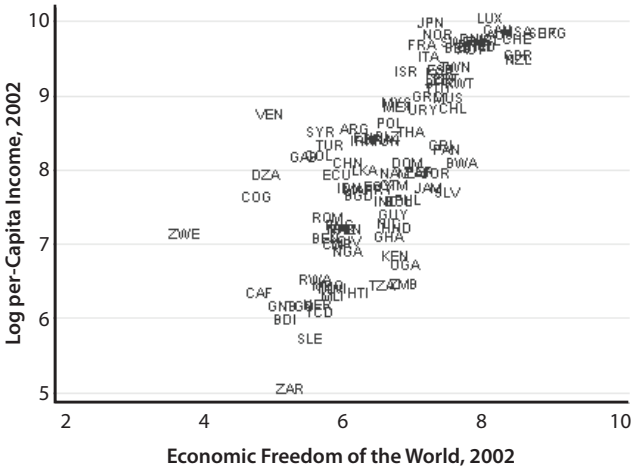
2 Freedom versus Collectivism in Economic Development: The Empirical Record

The empirical record on the difference between the economic performance of freedom and that of collectivism is fairly clear to anybody following events of the last half century. There was a period from the 1930s through the 1950s when the rapid growth of the Soviet Union (since found to have been greatly exaggerated) made observers unsure as to which system delivered superior economic results. Unfortunately, these were the formative years of development economics and foreign aid policies, which led many of the early development economists to recommend that poor countries imitate the collectivist model, stressing forced saving and investment to achieve growth, and to advocate national economic planning (somewhere in the netherworld in between central planning and free markets). Although the World Bank and the IMF had abandoned central planning as the recommended approach to poor countries by the 1980s, foreign aid has never been able to shake its collectivist origins. For one thing, the World Bank and the IMF continued to function as large planning organizations; it was just that now the top-down expert-driven plans included adoption of free-market liberalization (known as "structural adjustment"). The top-down planning by foreign experts and bureaucrats of how you should implement free markets did not lead to good results in the areas where it was most intensively practiced—Africa, the Middle East, Latin America, and (ironically) the former Soviet Union. This led to the unfortunate backlash against free markets that we are seeing today in many parts of those regions. The aid organizations retreated for self-protection into the MDG planning exercise described in the first section.

This is ironic, because the fall of the Berlin Wall and more access to information about the Soviet Union and its satellites made clear just how badly the most extreme version of collectivism had failed. Even prior to this, it was rather obvious that free societies were dramatically out-performing collectivist ones, as the most casual acquaintance with comparisons between East and West Germany, North and South Korea, or between the Soviet Union and the United States made clear.

12 *MfDR Principles in Action* (MfDR Sourcebook), p. 11.

Figure 2.2: Economic Freedom in the World, 2002, and Log per-Capita Income



Source: Author's calculations.

The Correlation between Economic Success and Economic Freedom

Today, long after the collapse of communism, there is still a huge amount of variation from free to unfree societies. To formalize the obvious, economic success is strongly correlated with economic freedom, as shown in Figure 2.2. I use the 2002 measure published in *Economic Freedom of the World: 2004 Annual Report* to match the last year for which a large sample of data on income is available.

Of course, there is a large problem of potential reverse causality—richer people might demand more economic freedom. Critics of the measures published in *Economic Freedom of the World* also might allege that they are constructed by those with strong prior beliefs that economic freedom is associated with prosperity and, hence, the indices might be unconsciously skewed to give higher scores to countries known to be success stories. (I don't know of any reason to doubt the Index published in *Economic Freedom of the World*, which uses only third-party data and includes no subjective judgments, but I bend over backwards to anticipate possible critiques.) Any such skewing would introduce a second kind of reverse causality. To address these possible objections, I show an instrumental variables regression in Table 2.1. Since the institutions of economic freedom originated in Europe and then spread to other temperate regions where Europeans settled (with some exceptions), I use distance from the equator as one instrument for economic freedom. Since different legal traditions (especially the British) favored economic freedom while others did not (obviously the socialist legal tradition), I use legal origin as another set of instruments for freedom. The test statistics on the validity of the instruments are mostly satisfactory, and we still show a very strong association between economic freedom and per-capita income.

The "Poverty Trap" and the "Big Push"

Although economic freedom seems well established as a path to prosperity, advocates of collectivist solutions to world poverty allege that poor countries are in a "poverty trap." The poverty trap would prevent poor nations from experiencing economic growth even if they do have economic freedom, requiring a collectivist rescue operation. It is, again, Sachs who is the leading exponent of the "poverty trap" hypothesis. In *The End of Poverty*, he suggests three principle mechanisms. The first is that poor people do not save enough.

> When people are … utterly destitute, they need their entire income, or more, just to survive. There is no margin of income above survival that can be invested for the future. This is the main reason why the poorest of the poor are most prone to becoming trapped with low or negative economic growth rates. They are too poor to save for the future and thereby accumulate the capital that could pull them out of their current misery. (Pp. 56–57)

Sachs' second reason for a poverty trap "is a demographic trap, when impoverished families choose to have lots of children" (p. 65). Population growth is so high that it outpaces saving (which was already too low, according to the first reason).

Table 2.1: IV Regression of Log per-Capita Income (lpcy) in 2002 on Economic Freedom Ratings

	lpcy2002
Economic freedom in the world, 2002 (from *Economic Freedom of the World: 2004 Annual Report*)	1.343 (8.48)**
Constant	–0.495 (–0.47)
Observations	86
*significant at 5%; ** significant at 1%	
Sargan over-identification test: p-value	0.0654
First-stage F-statistic on excluded instruments	8.25
Instruments for economic freedom: distance from equator, British, French, Socialist, or German legal origin	

The third element is increasing returns to capital at low initial capital per person (and low income per person):

> An economy with twice the capital stock per person means an economy with roads that work the year round, rather than roads that are washed out each rainy season; electrical power that is reliable twenty-four hours each day, rather than electric power that is sporadic and unpredictable; workers who are healthy and at their jobs, rather than workers who are chronically absent with disease. The likelihood is that doubling the human and physical capital stock will actually more than double the income level, at least at very low levels of capital per person. (P. 250)

Sachs gives the example of a road with half of the road paved and half impassable due to missing bridges or washed out sections. Repairing the impassable sections would double the length of road but would much more than double the output from the road. "This is an example of a threshold effect, in which the capital stock becomes useful only when it meets a minimum standard" (p. 250).

The role of foreign aid is to increase the capital stock enough to cross the threshold level, in what became known as "the Big Push": "if the foreign assistance is substantial enough, and lasts long enough, the capital stock rises sufficiently to lift households above subsistence … Growth becomes self-sustaining through household savings and public investments supported by taxation of households" (p. 246). Without foreign aid, according to Sachs, "many reasonably well governed countries are too poor to make the investments to climb the first steps of the ladder."[13]

Even before testing this hypothesis, it is worth noting that these ideas are not new. In fact, they were part of the founding ideas of development economics in the 1940s and 1950s and development economists used them to insist foreign aid was necessary for economic growth then, just as Sachs does now half a century later.[14] After $568 billion in aid to Africa combined with the continent's economic stagnation over the past four decades, combined with the success of poor countries getting much smaller amounts of aid as a percent of their income in East Asia, one might have thought a little skepticism was in order before repeating the ideas of the 1950s.[15]

Table 2.2: Test of Poverty-Trap and Economic-Freedom Hypotheses for Economic Growth

Instrumental variables regression	Dependent variable: per-capita growth, 1960–2002
Economic freedom in the world, averaged over 1970–2002	0.022 (2.63)*
Log of initial per capita income	–0.014 (2.21)*
Constant	0.001 (–0.05)
Observations	85
Sargan overidentification test: p-value	0.0542
First-stage F-statistic on excluded instruments	9.63
* significant at 5%; ** significant at 1%	
Instruments for economic freedom: distance from equator, British, French, Socialist, or German legal origin	

Given the publicity that these revived, old ideas about foreign aid are receiving, let us test the hypothesis of the poverty trap and the necessity of the "Big Push" against the explanation that countries prosper because of economic freedom. The poverty-trap hypothesis would say that poor countries have low growth and rich countries have high growth, so there would be a positive association between initial income and growth. This positive association should hold up when we control for whether the country is "reasonably well governed" (such as whether the government facilitates economic freedom). So I do a regression combining economic freedom with initial income; as before I need to instrument for economic freedom to address possible reverse causality. A high value of (the average level of) economic freedom relative to initial income indicates that income potential is high (if the eco-

13 *UN Millennium Project Report, Investing in Development: A Practical Plan to Achieve the Millennium Development Goals: Main Report* (United Nations Development Program, 2005), p. 34.

14 Likewise, many of the criticisms of aid in my work draw on insights first stated in the 1960s and 1970s, most notably by Lord Peter Bauer.

15 Aart Kraay and Claudio Raddatz have recently tested directly whether the savings and increasing returns mechanisms hold in the data (see *Aid, Poverty Traps, and Growth* [World Bank Policy Research Paper 3631, 2005]). They point out that saving would have to follow an S-curve to generate a poverty trap, first increasing little with income, then increasing steeply, then flattening out again. They reject the S-curve in the data on saving and per-capita income. They also fail to find evidence of the technological non-convexities that also are necessary to create the poverty trap. They conclude there is little evidence for a poverty trap based on these mechanisms.

nomic-freedom hypothesis is correct) compared to actual income and so would predict faster growth.

The results are shown in Table 2.2. The poverty-trap hypothesis loses out decisively to the economic-freedom explanation as to who prospers. Actually, initially poor countries grow *faster* than rich ones, once you control for economic freedom.[16]

What about the role of foreign aid in launching the growth out of poverty? Does a "Big Push" of foreign aid lead to growth? There is a huge empirical literature on foreign aid and growth, with the latest verdicts being that foreign aid does *not* have any measurable impact on growth.[17] I go back to the well one more time to see how aid flows affect the simple hypothesis testing introduced in Table 2.2

In Table 2.3, I add foreign aid received as a ratio to Gross National Income of the recipient as an explanatory variable. Once again, there is the problem of reverse causality. I use the log of population size as an instrument for aid, taking advantage of a quirk in the the aid system such that small countries receive large shares of their income as aid, unrelated to their economic performance or needs. Instrumenting for two right-hand-side variables at once leads to more complicated problems of identification and weak instruments, so let us treat this exercise as illustrative rather than definitive.

Controlling only for initial income and not for economic freedom, aid has no significant effect on economic growth. Once you control for economic freedom, aid has a negative and significant effect on growth. I am hesitant to stress this result too strongly, as the previous literature has generally found a zero effect of aid on growth, not negative. Much greater robustness testing is needed before the negative result can be taken too seriously, and the problem of weak instruments also needs much more examination. At the very least, however, this illustrative exercise is consistent with the previous literature that aid does not have a *positive* effect on growth.

Table 2.3: Per-Capita Growth 1960–2002 as Function of Aid, Initial Income, and Economic Freedom: Instrumental Variables Regressions

	Regression 1	Regression 2
Aid/GNI 1960-2001	−0.001 (−1.43)	−0.003 (3.32)**
Log of initial income, 1960	−0.001 (−0.29)	−0.024 (2.68)**
Economic Freedom in the world, averaged 1970-2002		0.024 (2.09)*
Constant	0.025 (−0.95)	0.081 (−1.95)
Observations	94	65
Sargan overidentification test p-value		0.5718
* significant at 5%; ** significant at 1%		
Instrument for aid: Log of population in 1980		
Instruments for economic freedom: distance from equator, British, French, Socialist, or German legal origin		

3 Hayek and the iPod:[18] Why a World of Uneven and Unpredictable Economic Success Needs Economic Freedom

What the collectivist vision always misses is that success is rare, failure is common. Economic success is always very uneven and unpredictable, across almost any possible unit of analysis one might consider.[19] Economic freedom permits the decentralized search for success that is the hallmark of free markets. It is seldom known in advance what will succeed. Many thousands of searchers mount myriads of different trials as to what will please consumers. A free-market system gives rapid feedback as

16 This contradicts a result by Sachs in *The End of Poverty* (p. 320), who showed a lack of a simple correlation between economic freedom and growth. He forgot to control for his own hypothesis of a poverty trap by including initial income.

17 See the survey in W. Easterly, "Can Foreign Aid Buy Growth?", *Journal of Economic Perspectives*, 17, 3 (Summer 2003), pp. 23–48, as well as W. Easterly, R. Levine and D. Roodman, "New Data, New Doubts: A Comment on Burnside and Dollar's 'Aid, Policies, and Growth'" [2000], *American Economic Review*, 94, 3 (June 2004), pp. 774–78. For the latest take on this literature, see Raghuram G. Rajan and Arvind Subramanian, *Aid and Growth: What Does the Cross-Country Evidence Really Show?,* (NBER Working Paper 11513, August 2005).

18 "iPod" is a trademark of Apple Computer, Inc., registered in the United States and other countries.

19 A very thoughtful and entertaining discussion of this theme is in Virginia Postrel, *The Future and Its Enemies: the Growing Conflict over Creativity, Enterprise, and Progress* (Touchstone, 1998). She stresses a dichotomy between "stasis" and "dynamism" that is related to the dichotomy here between "collectivism" and "freedom." Another insightful treatment of the need for economic freedom in a dynamic world is Brink Lindsey, *Against the Dead Hand: The Uncertain Struggle for Global Capitalism* (Wiley, 2002).

to which products are succeeding and which are not, and searchers adjust accordingly. Those activities that succeed attract more financing and more factors of production so that they can be scaled up enormously; those activities that fail to please consumers are discontinued. Planners don't have a search-and-feedback mentality; rather, they implement a preconceived notion of what will work and keep implementing it whether it is working or not.

Economic success stories are often unexpected and unpredicted. MP3 players were invented several years ago and seemed to offer great promise as a great new way for music lovers to listen to large amounts of their favorite music. Despite this promise, none of the early MP3 players caught consumers' fancy. (I was an "early adopter," buying one of these at a high price so I could see it die quickly.) Apple Computer, Inc., was known mainly for its strange failures in the PC market. It was a surprise when Apple Computer suddenly found a huge hit in the iPod mobile digital device, which as of March 2006 had 78% of the market for MP3 players. So far, Apple has sold 50 million iPods. The matching iTunes[20] application program for selling songs on-line via down-load to an iPod accounts for 87% of the legal music downloads in the United States.[21]

Ray Kroc was a salesman in the 1950s peddling Multimixers, a machine that mixed six milk shakes at a time. His original idea was to sell as many Multimixers as possible. In 1954, he visited a restaurant called "McDonald's" in San Bernadino, California. He noticed that the McDonald brothers kept eight Multimixers operating at full capacity around the clock. At first, he wanted to recommend their methods to his other clients, increasing the demand for his Multimixers. But then he changed his mind: he saw that preparing hamburgers, fries, and milk shakes on an assembly line was a way to run a successful chain of fast-food restaurants. He forgot all about Multimixers and the rest is Golden Arches stretching as far as the eye can see.[22] How many Ray Krocs has foreign aid lost by its emphasis on Plans?

Many consumer markets in the United States are similarly dominated by a small number of successful brands. The Coca-Cola and Pepsi-Cola companies together have 75% of the American market for carbonated soft drinks. Dr Pepper/Seven Up is in third place with another 15%. The remaining 10% of the market is split up among a large number of much smaller firms.[23] Casual observation suggests many examples of brand dominance: Microsoft®, Starbucks®, Amazon.com®, Borders®, Barnes and Noble®, and so on. While brand dominance may reflect many factors about industrial organization, it also shows the incredible unevenness of product success associated with particular firms (as we will see in a minute), perhaps reflecting the kind of serendipity illustrated by the iPod and McDonald's®.

The uneven success of products is closely related to the uneven success of firms. Just 0.3% of firms in the United States accounted for 65% of all firm sales in 2002.[24] Firm size is well known to follow Zipf's law (also known as a power law), in which the log of the size is a negative linear function of the frequency of this size occurring (or equivalently the rank). Power laws have generated a lot of hype; for the purposes of this paper, it is enough to point out how large-scale success is rare, while failure is common. In other words, the frequency distribution of firms (or whatever unit we are interested in) has a fat and long right-hand side tail, of which there are many special cases such as a log-normal distribution and a power law (Pareto distribution).[25] In other words, most of the distribution is concentrated at some mediocre level, then there are a small number of firms that are just totally off the charts—way above what something like a standard bell curve would predict.

Even though large firms dominate the marketplace, it is not so easy to be a large firm. Of the world's largest 100 companies in 1912, some like Proctor & Gamble® and British Petroleum were many times larger in 1995. However, they were the exception, as 1912's big 100 firms also included such dinosaurs as Central Leather and Cudhay Packing in the United States. Only 19 of the top 100 in

20 "iTunes" is a trademark of Apple Computer, Inc., registered in the United States and other countries.

21 *Apple's Music Biz, iPod Share Grows* [sic], April 20, 2006, <http://www.macnn.com/articles/06/04/20/apples.music.business/>.

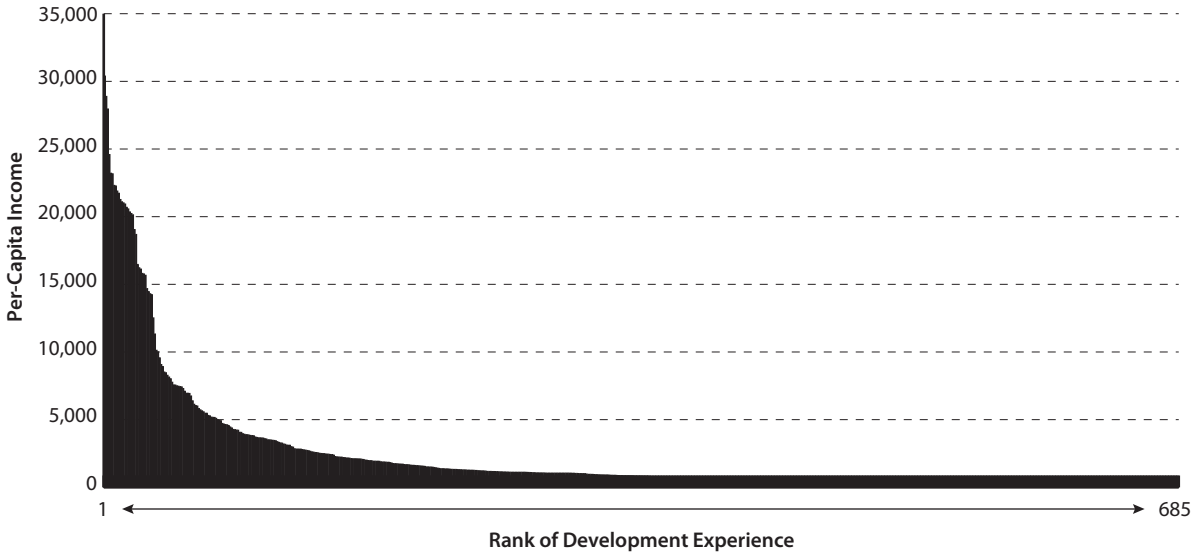
22 This story is taken from William Duggan, *The Art of What Works: How Success Really Happens* (McGraw Hill, 2003).

23 "1997 Top-10 Soft Drink Companies and Brands," Editorial, *Beverage Digest* (February 12, 1998), <http://www.beverage-digest.com/editorial/980212.html>. Data refer to 1997.

24 US Small Business Administration, Office of Advocacy, *Firm Size Data: Statistics of U.S. Businesses and Nonemployer Statistics* [2003], <http://www.sba.gov/advo/research/data.html>.

25 Lada A. Adamic, Zipf, *Power-laws, and Pareto - a ranking tutorial* (Information Dynamics Lab, HP Labs), <http://www.hpl.hp.com/research/idl/papers/ranking/ranking.html>, is a helpful primer on power laws.

Figure 2.3: Per-capita Income by Rank of Development Experience



Note: Per-capita income in pooled cross-country sample, 1820, 19870, 1913, 2001.
Source: Angus Maddison, *The World Economy: A Millennial Perspective* (Organisation for Economic Cooperation and Development, 2001).

1912 were still in the top 100 in 1995, and 48 of 1912's big 100 had disappeared altogether by 1995.[26] Business books lay out the secrets for success of a few large companies celebrated by the author, only to see the firms fall upon hard times after the book is published. Business writers celebrated Enron® for its innovative approach right up to the last minute.[27] Even the most successful business gurus have their embarrassments: Tom Peters' 1982 mega-best-seller, *In Search of Excellence*, included among its celebrated companies some that would later go bankrupt such as Atari Corporation, Wang Laboratories, and Delta Air Lines.

The difficulty of achieving and maintaining success is not peculiar to large firms. Every year about 10% of existing firms of all sizes go out of business. Not that it is so easy to start a new firm to replace the ones that go out of business. More than half of new firms fail within four years of the founding in the United States.[28]

The economic success and failure of individuals is also well known to follow the same skewed tendencies. The distribution of individual income within countries generally follows a log-normal distribution for most of the range of income (covering 97–99 percent of individuals), with a power law covering the upper 1–3 percent of income earners.[29]

Moving to international data, economic development is of course spectacularly uneven across countries, as well as across time. Observations of high average income are confined to a few countries in recent periods, with large parts of the world and large parts of human history bereft of this kind of success. If we treat observations on all countries for the time periods 1820, 1870, 1913, 1950, and 2001 as separate development experiences, and rank them from highest to lowest income, we get the graph shown in Figure 2.3.[30] A small minority of episodes attain very high income but this falls off almost vertically as we move down the ranks.

26 Paul Ormerod, *Why Most Things Fail: Evolution, Extinction, and Economics* (Pantheon Books, 2005).

27 Ormerod, *Why Most Things Fail*.

28 Amy E. Knaup, "Survival and Longevity in the Business Employment Dynamics Database," *Monthly Labor Review* 128, 5 (May, 2005), pp. 50–56; Brian Headd, "Redefining Business Success: Distinguishing between Closure and Failure," *Small Business Economics*, 21, 1 (August, 2003), pp. 51–61.

29 This statement is based on F. Clementi and M. Gallegati, "Pareto's Law of Income Distribution: Evidence for Germany, the United Kingdom, and the United States," in A. Chatterjee., S. Yarlagadda, and B.K. Chakrabarti, *Econophysics of Wealth Distributions* (Springer-Verlag Italia, 2005), pp. 3–14). Digital versions available at <http://arxiv.org/abs/physics/0504217>. This article also provides a nice summary of the literature.

30 Of course, these development experiences are not independent observations across either time or space.

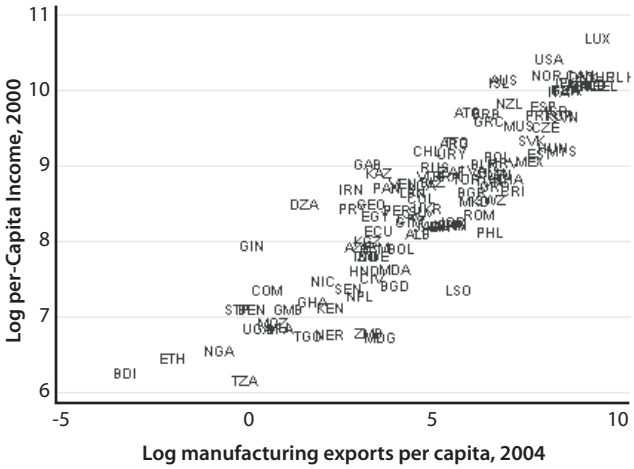
Manufacturing Exports per Capita

An indicator of development that shows even greater variation across countries is manufacturing exports per capita.[31] This reflects many different factors: the transition from agriculture to manufacturing as countries develop, the many factors that influence openness to international trade and competitiveness in international markets, the gravity model of trade flows, and so on. At some more basic level than as a trade indicator, however, manufacturing exports reflects something that all countries can potentially do, and they are all competing in the same global marketplace. As an indicator, it also has the advantage of being evaluated at world market prices, unlike national incomes with different domestic prices, which are notoriously difficult to compare. Moreover, manufacturing exports are overwhelmingly dominated by the private sector and face a market test, unlike some of the components of GDP, such as a large government sector that is measured at cost rather than according to the value that individuals place on it. Success at exporting manufactures ranges all the way from Singapore's over $25,000 per capita to Burundi's 2¢ per capita (Table 2.4).[32]

Whatever the advantages and disadvantages of manufacturing exports as a measure of success, manufacturing exports per capita are themselves highly correlated with the log of per-capita GDP, as shown in Figure 2.4. Not only is manufacturing export success itself spectacularly uneven across countries, it is also very uneven within each country across product categories. Data is available on manufacturing exports at the 6-digit product-classification level. Countries export as many as 2,236 different manufacturing products, with the average in the sample being 1,177 (Table 2.5). The top three out of this array of products account, on average, for 35% of export value, while the top 1% of products account for over half of exports. The distribution of export value across products is log normal, with the value within the top 20% of products (accounting for 94% of export value) following a power law.[33]

In other words, the big difference between Ireland and Burundi (both small populations, with Burundi larger) is not that Ireland performs better on everything, but that it found three manufacturing export products (parts and accessories of data processing equipment, monolithic integrated circuits except digital, and sound recordings other than photographic products) that earned it $15 billion, while Burundi's top three (automobile spark ignition engine of 1500–3000 cc, sheet/tile and asbestos/cellulose fibre cement, and corrugated sheets of asbestos/cellulose fibre cement) earned it $151,000.[34]

Figure 2.4: Log per-Capita Income and Log Manufacturing Exports per Capita



Source: Author's calculations.

How do you achieve large-scale success on a few products? Again it is economic freedom that fosters success, finding the particular niche in international markets where the country can achieve enormous scale in exports. Burundi has one of the world's worst scores on economic freedom, while Ireland has one of the best. Economic freedom is highly correlated with manufacturing exports per capita (Figure 2.5). When we address causality by using the same instruments as above for economic freedom, we still find that economic freedom predicts success at manufacturing exports.

Why is economic freedom so conducive to large-scale manufacturing exports and to development in general? Why do planners fail so badly? In a world of great uncertainty and unpredictability, economic freedom succeeds for the following reasons.

31 The work on manufacturing exports per capita draws on joint work with Ariell Reshef and Julia Schwenkenberg.

32 Singapore's and Hong Kong's export numbers are unusual in that they involve significant re-exports.

33 See William Easterly, Ariell Reshef, and Julia Schwenkenberg, "Export Specialization and Economic Development," unpublished manuscript, New York University (2006).

34 The hyperspecialization of exports was previously pointed out by Ricardo Hausmann and Dani Rodrik, "Economic Development as Self-Discovery," unpublished manuscript, Harvard Kennedy School of Government (April 2003). This work inspired the exercises with exports here.

Table 2.4: Ranking of Countries by Manufacturing Exports per Capita (Manfexppc)

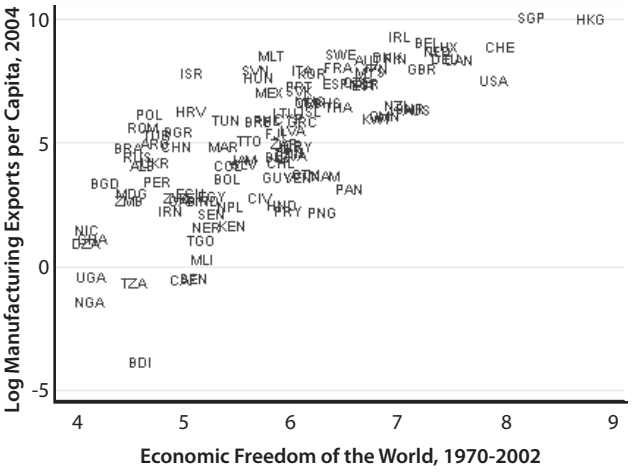
Exporter	Manfexppc	Rank	Exporter	Manfexppc	Rank	Exporter	Manfexppc	Rank
Singapore	$25,335.56	1	Cyprus	$419.24	50	Venezuela	$37.76	99
Hong Kong	$23,345.09	2	Kuwait	$408.61	51	Bolivia	$37.00	100
Ireland	$11,714.59	3	Philippines	$401.97	52	Peru	$32.62	101
Belgium	$9,230.09	4	Tunisia	$387.58	53	Bangladesh	$30.22	102
Luxembourg	$7,687.62	5	Swaziland	$382.05	54	Rep. of Moldova	$30.19	103
Switzerland	$7,667.51	6	Greece	$369.04	55	Panama	$24.48	104
Netherlands	$6,331.30	7	Barbados	$362.31	56	Kazakhstan	$20.45	105
Sweden	$5,650.80	8	Belarus	$351.22	57	Madagascar	$19.92	106
Malta	$5,229.30	9	Romania	$284.20	58	Ecuador	$19.46	107
Macao	$4,954.83	10	Macedonia	$265.09	59	Egypt	$17.71	108
Denmark	$4,901.73	11	Latvia	$263.87	60	Armenia	$16.97	109
Finland	$4,813.37	12	Bulgaria	$243.14	61	Cote d'Ivoire	$16.83	110
Germany	$4,639.47	13	Fiji	$228.84	62	Zimbabwe	$16.22	111
Austria	$4,540.26	14	Antigua	$225.11	63	Georgia	$15.80	112
Canada	$4,451.37	15	Turkey	$212.77	64	Zambia	$15.09	113
France	$3,216.17	16	Polynesia	$179.70	65	Turkmenistan	$14.93	114
Japan	$3,128.05	17	Lesotho	$176.12	66	Gabon	$14.61	115
United Kingdom	$3,033.86	18	Trinidad	$168.23	67	India	$14.57	116
Slovenia	$2,953.41	19	South Africa	$148.02	68	Kyrgyzstan	$14.50	117
Italy	$2,821.06	20	Argentina	$147.09	69	Honduras	$12.55	118
Malaysia	$2,810.36	21	Jordan	$142.34	70	Nepal	$11.66	119
Rep. of Korea	$2,569.26	22	China	$135.91	71	Azerbaijan	$11.50	120
Israel	$2,529.26	23	Uruguay	$135.34	72	Suriname	$10.54	121
Hungary	$2,134.28	24	Morocco	$128.73	73	Iran	$9.71	122
USA	$1,924.84	25	Brazil	$123.48	74	Paraguay	$9.69	123
Czech Rep.	$1,828.87	26	Maldives	$117.37	75	Papua New Guinea	$9.10	124
Norway	$1,760.31	27	Indonesia	$105.25	76	Senegal	$8.67	125
Spain	$1,698.14	28	Saudi Arabia	$100.43	77	Kenya	$5.25	126
Estonia	$1,607.54	29	Botswana	$93.58	78	Cuba	$5.21	127
Portugal	$1,546.50	30	Belize	$88.85	79	Niger	$5.16	128
Slovakia	$1,270.32	31	Russia	$87.83	80	Nicaragua	$4.58	129
Mexico	$1,221.76	32	Serbia	$82.59	81	Ghana	$3.19	130
Qatar	$1,092.43	33	St Vincent	$80.61	82	Togo	$2.91	131
Mauritius	$855.41	34	Jamaica	$75.55	83	Sudan	$2.72	132
Bahamas	$782.86	35	Cambodia	$74.78	84	Algeria	$2.60	133
Costa Rica	$778.15	36	Ukraine	$71.13	85	Gambia	$1.69	134
New Zealand	$687.16	37	Chile	$70.73	86	Mali	$1.39	135
Thailand	$676.73	38	New Caledo.	$67.94	87	Burkina Faso	$1.34	136
Bahrain	$626.52	39	El Salvador	$64.44	88	Mozambique	$1.12	137
Australia	$594.48	40	Saint Lucia	$63.98	89	Comoros	$0.91	138
Croatia	$563.68	41	Greenland	$62.61	90	Uganda	$0.70	139
Iceland	$554.48	42	Colombia	$61.06	91	Guinea	$0.66	140
Lithuania	$534.74	43	Albania	$59.54	92	Benin	$0.62	141
Saint Kitts	$492.98	44	Lebanon	$50.10	93	Central Afr. Rep.	$0.59	142
Poland	$492.14	45	Cape Verde	$46.99	94	Tanzania	$0.54	143
Andorra	$474.97	46	Mongolia	$44.36	95	Sao Tome	$0.44	144
Oman	$452.07	47	Guatemala	$43.93	96	Nigeria	$0.25	145
Grenada	$447.46	48	Namibia	$40.19	97	Ethiopia	$0.07	146
Dominica	$426.75	49	Guyana	$38.58	98	Burundi	$0.02	147

Table 2.5: Specialization: Share of Number of Products at 6-Digit Level Indicated in Total Manufacturing Export Value within Each Country, 2004

Variable	Average for cross-country sample
Top 3	35.0%
Top 1%	51.0%
Top 10%	86.8%
Top 20%	94.2%
Bottom 50%	0.8%
Average number of products	1177
Maximum number of products	2236
Number of countries	149

Source: Author's calculations.

Figure 2.5: Economic Freedom 1970–2002 and Log Manufacturing Exports per Capita, 2004



Source: Author's calculations.

(1) There is a tremendous difficulty in knowing what will succeed. Economic freedom fosters competition and multiple attempts to find things that work, and weeds out the many failures. After a while, the economy consists mostly of the big successes, which facilitates a high standard of living. Planners cannot have enough knowledge of the complexities of success; moreover, they suffer from the delusion that they already know the answers.

(2) Economic freedom gives markets, which are great feedback mechanisms for learning what is succeeding and what is failing. Central planning lacks feedback

(3) Economic freedom ruthlessly reallocates resources away from what is failing towards what is succeeding. Planning bureaucracies have departments that each constitute a vested interest resisting reallocation.

(4) Economic freedom makes it possible to increase the scale of a successful activity rapidly and by a huge magnitude. Financial markets allocate funds to finance an expansion in scale and the organizational form of the corporation permits replication of the same activity that worked on a small scale on a much larger scale. Financial markets and corporations require economic freedom to function well. Planning bureaucracies seldom show much flexibility in expanding successful activities on a large scale.

(5) Economic freedom makes possible sophisticated contracts that allow individuals and firms to deal with uncertainty. Given the rarity of success and the likelihood of failure, individuals and firms will only be willing to bet on finding a big hit if they have the ability to diversify risk and are protected against catastrophic consequences from failure. Limited liability in corporations, bankruptcy law, and financial markets help achieve these tasks in the world shaped by economic freedom. Risk-averse planning bureaucracies opt for low-risk, low-return activities.

Individual Freedom and Progress

The idea that individual freedom leads to more progress than state planning is not new. It is part of a long intellectual tradition opposing top-down collectivist engineering in favor of bottom-up searching for solutions that goes back to Adam Smith and Edmund Burke. F.A. Hayek presciently noted more than 60 years ago how the complexity of knowledge required economic freedom and made planning impossible. A representative quotation is:

> The interaction of individuals, possessing different knowledge and different views, is what constitutes the life of thought. The growth of reason is a social process based on the existence of such differences. It is of essence that its results cannot be predicted, that we cannot know which views will assist this growth and which will not—in short, that this growth cannot be governed by any views which we now possess without at the same time limiting it. To "plan" or "organize" the growth of mind, or for that matter, progress in general, is a contradiction in terms … The tragedy of collectivist thought is that, while it starts out to make reason supreme, it ends by destroying reason because it misconceives the process on which the growth of reason depends …

> Individualism is thus an attitude of humility before this social process and of tolerance to other opinions and is the exact opposite of that intellectual hubris which is at the root of the demand for comprehensive direction of the social process.[35]

This is not to say that economic freedom is easy to achieve. Even when such principles as private property, freedom of choice of occupation, protection against state expropriation, freedom of entry and competition in markets, prices determined by markets and not by state fiat are understood, it is difficult to implement the principles in practice. These principles rest upon a complex assortment of social norms, informal networks, formal laws, and effective institutions. To the extent that planners understand some of these principles, their characteristic mistake is to try to introduce everything at once from the top down in the self-contradictory combination of a "market plan." (Sachs, in an earlier incarnation, was the father of "shock therapy" for the ex-Communist countries, which tried to do exactly this.) Economic freedom is something that can only grow gradually within societies, with a lot of bottom-up searching for effective piecemeal reforms by political and economic actors—which helps explain why success at economic development is also relatively uncommon.

35 F.A. Hayek, *The Road to Serfdom* (University of Chicago Press, 1944), p. 181.

4 Conclusions

Alas, foreign aid has never been able to escape its collectivist origins. Today's collectivist fantasies such as the Big Push to achieve the Millennium Development Goals will fail just as badly as past varieties of collectivism. Indeed, the UN itself reports that they are already failing (it creatively sees this as a reason to solicit yet more funding for the Big Push). A peek inside the patterns of economic success shows the complexity of knowledge required to succeed, which dooms planning efforts and makes clear why economic freedom is so reliably associated with economic success.

Foreign aid could create new opportunities for the world's poorest people by getting them some of such essentials as medicines, education, and infrastructure, but only if foreign aid itself imitates the successful approach of economic freedom, by adopting a search and feedback approach with individual accountability instead of the current collectivist planning model. Even with these changes, outside aid cannot achieve the grandiose goal of transforming other societies to escape poverty into prosperity. Only home-grown gradual movements towards more economic freedom can accomplish that for the world's poor. Fortunately, that is already happening.