THE HAYEK LECTURE

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Hayek vs. The Development Experts

by

William Easterly
Professor, New York University

The Manhattan Institute for Policy Research

The Hayek Lecture

Political philosopher and Nobel laureate F. A. Hayek, author of groundbreaking works such as *The Road to Serfdom* and *The Constitution of Liberty*, was the key figure in the twentieth century revival of classical liberalism. He was also a formative influence on the Manhattan Institute. When our founder, Sir Antony Fisher, asked how best to reverse the erosion of freedom, Hayek advised him not to begin with politics *per se* but to fight first on the battlefield of ideas. Our Hayek Lecture affirms and celebrates this mission. Every spring, in the lecture series named for him, we honor our intellectual progenitor and the idea to which he dedicated his life: liberty. The speakers are selected for their pathfinding visions; for as Hayek himself wrote: “It is wherever man reaches beyond his present self, where the new emerges and assessment lies in the future, that liberty ultimately shows its value.”

WILLIAM EASTERLY & MARY ANASTASIA O'GRADY

WILLIAM EASTERLY is professor of economics at New York University and co-director of NYU's Development Research Institute. He is also a research associate of the National Bureau of Economic Research, a non-resident fellow of the Brookings Institution and the Center for Global Development, and Co-Editor of the Journal of Development Economics. After sixteen years as a World Bank economist, Easterly authored *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (2001), in which he offers a devastating critique of international efforts to spur third world development. Easterly elaborates on that theme in *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good* (2006). He holds a Ph.D. in economics from MIT.

MARY ANASTASIA O'GRADY is a member of *The Wall Street Journal* editorial board and editor of "Americas," a weekly column appearing there that deals with politics, economics and business in Latin America and Canada. She is a recipient of the Inter American Press Association's Daily Gleaner Award for editorial commentary and the Bastiat Prize for journalism. Prior to joining *The Wall Street Journal* in 1995, she was an options strategist for Advest, Thomson McKinnon Securities, and then Merrill Lynch, where she worked for 10 years. She holds a B.A. in English from Assumption College and an M.B.A. in financial management from Pace University.

INTRODUCTION

BY MARY ANASTASIA O'GRADY

The Hayek Prize is a new Manhattan Institute prize that honors the book published within the past two years that best reflects Frederick Von Hayek's vision of economic and individual liberty. This year there were some thirty books nominated. The purpose of the award is to recognize the long-running influence of the *Road to Serfdom* and to encourage other scholars to follow Hayek's example.

The winner of this year's Hayek Prize certainly fits the bill.

Hayek did not write much about foreign aid. But he did have a lot to say about central planning, which, of course, is the architecture of almost all government foreign-aid programs in the postwar period. By definition, the do-gooders in places like Washington and Geneva spend their days planning the lives of the poor. And Hayek was prescient about where such planning was bound to lead, perhaps because he had observed British efforts in the colonies.

In the *Road to Serfdom*, published in 1944, he wrote: "The experience in the colonial sphere of Great Britain, as much as any other, has amply shown that even the mild forms of planning, which Englishmen know as colonial developments, involve, whether they wish it or not, the imposition of certain values and ideals on those who they try to assist. It is, indeed, this experience, which has made even the most internationally minded of colonial experts so very skeptical of the practicability of an 'international' administration of colonies."

And Hayek wrote further in the same chapter: "It is fairly certain that in a planned international system, the wealthier and therefore most powerful nations would, to a very much greater degree than in a free economy, become the object of hatred and envy of the poorer ones; and the latter, rightly or wrongly, would all be convinced that their position could be improved much more quickly if they were only free to do as they wished."

Those words were written in 1944. More than sixty years later and after $2.3 trillion in multilateral "investment"—as the World Bank likes to call it—they are truer than they were back then.

Take a look at Africa and Latin America, and it is hard to avoid the conclusion that the most well-intentioned efforts of the rich world have been an unmitigated disaster.

But who has been able to speak such heresy? Those outside the world of foreign aid are accused of not knowing enough or not caring enough. Those inside the system have all the wrong incentives. For most, it is not just their jobs that depend on the status quo, it is their careers.

That was until William Easterly decided to break a few rice bowls. He is being recognized here tonight for *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good*.

William Easterly is a professor of economics at New York University and co-director of NYU's Development Research Institute. He is also a research associate of the National Bureau of Economic Research.

But his most important credential—and the one that doubtless makes the aid brigades cringe—is the fact that he spent sixteen years as an economist at the

World Bank. In that role, he not only had a first-person encounter with how aid was designed, he also had a hard time not noticing that the results were, shall we say, suboptimal.

He has made the devastating observation that the central-planning model is a big part of the problem. Rather than looking for bottom-up solutions to problems—the way the market would, the way that “searchers” do—international aid imposes its solutions from the top down. And therein lies the fatal flaw.

In *The White Man’s Burden*, William Easterly has brought together knowledge and courage to speak about what he saw first-hand, what he knows as an economist, and what no one who looks at the result of the past sixty years can deny. This is why he so deserves the 2008 Hayek Prize.

HAYEK VS. THE DEVELOPMENT EXPERTS

BY WILLIAM EASTERLY

Tonight we find ourselves in a moment similar to that in which Hayek wrote *The Road to Serfdom* in 1943. Then, as now, a great financial crash was seen as a failure of freedom. Actually, things were even worse then for Hayek's point of view. In the aftermath of the Depression, many pointed out the apparent success of centrally planned industrialization in the Soviet Union in outperforming markets. As Hayek wrote in 1943, democracy barely existed outside of a few English-speaking societies. Even in the U.S., people noted the apparent success of government top-down planning for wartime production of arms. Under these circumstances, Hayek knew he would be caricatured as a right-wing ideologue, even though his ideas did not fit into the stale partisan debate about markets versus government. He argued that the best system in the long run relied upon the creativity of individuals at the bottom who had both political and economic freedom. In a way I will describe below, Hayek saw *both* government and markets as functioning better the more they were the outcome of spontaneous development from the bottom up, with nobody in charge. It took courage to criticize top-down control after the scary calamities of the Depression, yet Hayek's vision would be vindicated by subsequent events. How many of us will show similar intellectual courage in the midst of today's financial crash?

Hayek did not talk about it at the time, but his warnings about the drift toward top-down planning were perhaps most relevant of all in the so-called Third World. It is the misfortune of the field called development economics that it was born at the moment of maximum doubt about individual liberty. As a result, economists conceived of development from the beginning—and to a frightening extent still do today—as a top-down process run by development experts operating on a blank slate.

The top-down experts would prove wrong time and time again, yet the top-down view in development would prove curiously impervious to failure, for reasons that I will also attempt to describe.

In the beginning was the Big Push. Third World nations in the 1940s and 1950s were thought to be in a "poverty trap" in which poverty fed a vicious circle of excessive population growth, poor health, illiteracy, lousy infrastructure, and low savings. The answer, according to development economists, such as Sir Arthur Lewis, was a huge injection of foreign aid—the "big push"—to pay for critical investments in all these areas at once. Some countries were thought to be harder to develop than others. In the early 1960s, the World Bank ridiculed one resource-scarce country as unlikely to attain even modest success in exports. Development expert Gunnar Myrdal also raised the alarm at the same time about another country, saying population growth was an "explosive problem." The name of the first country was South Korea. The second was Singapore. Not that development experts were always pessimistic: The World Bank said of another country in 1958 that its "potential compares favorably with those of other countries in Southeast Asia." That country was Burma.

Development experts did not do any better with overall predictions than it did with those for particular countries. Sir Arthur Lewis and others had a very particular model of how aid raises growth that allows us to be precise about how much growth they expected for a given amount of aid. For the one-fourth of countries that received the most aid over the last forty-five years, the prediction was that per capita income would increase from about \$500 per capita in 1960 to over \$5,000 per capita today. This tenfold increase was more than achieved by a few low-aid countries that were just as poor as the aid-receiving countries in 1960, such as South Korea, which took advantage of market opportunities created by the global boom in international trade after World War II. So much for the poverty trap. Meanwhile, the high-aid countries fell a little short of \$5,000 per capita; their income is still \$500 today. So much for the Big Push. When a theory's predictions fail, the theory is disproved. What a tragedy that such failed ideas condemned so many people to continuing poverty.

Hayek did not write much about development, but his defense of markets and criticism of central planning was very relevant to these debates. In a classic article in 1945, Hayek pointed out that no top-down central planner can possibly have enough information to allocate resources and make factories work. A decentralized, bottom-up system allowed each individual to use his or her own knowledge of hundreds of tiny local factors and unexpected problems to make his or her own project work, their actions coordinated with others by market prices that signal to everyone which commodities are abundant and which are scarce.

What Hayek correctly called a "marvel" was a bottom-up system that nobody has to direct or even understand in order for it to work. As Hayek said in 1945: "those who clamor for 'conscious direction' . . . cannot believe that anything which has evolved without design (and even without our understanding it) should solve problems which we should not be able to solve consciously."

There were development economists that got it right at the time about individual liberty in development, such as the South African economist Herbert Frankel and the British-Hungarian economist P. T. Bauer. Unfortunately, there are better rewards for bad ideas in development economics than for good ones. Arthur Lewis and Gunnar Myrdal got Nobel prizes. P. T. Bauer was ostracized as a heretic, and poor Herbert Frankel was ignored and then forgotten altogether. I come before you proudly aspiring to be this generation's Herbert Frankel.

This is not to say that development economists weren't a bit capable of changing with events. In the 1980s, free-market ideas finally started gaining acceptance among some development economists in response to the failure of aid and the success of the East Asian tigers. Yet, paradoxically, these same development economists did not give up the top-down planning mindset. Just reciting the words "free markets" does not give you a free pass to be a top-down planner. As the quote from Hayek just pointed out, markets evolve from the bottom up without conscious design. IMF and World Bank bureaucrats with little knowledge of local policies, politics, or institutions imposed their own transitional design as to how to jump to a free market in Africa, Latin America, and the Middle East in the 1980s and 1990s.

These attempts became even more ludicrous with the fall of the Berlin Wall and the imposition of "shock therapy" on Eastern Europe and the former Soviet Union, a comprehensive attempt by these same IMF/World Bank bureaucrats to take a Communist economy to a capitalist one in one leap. Jeffrey Sachs was the intellectual godfather of shock therapy. Again, critics were a minority. Peter Murrell at the University of Maryland and John McMillan at Stanford pointed to the shocking hubris of the shock therapists. As McMillan summarized, "if we could have planned the reforms, then we could have planned the economy."

GDP per capita growth was zero in Africa, Latin America, and the Middle East in the 1980s and 1990s, and the republics of the former Soviet Union experienced one of the worst depressions in economic history. The backlash after the failure of these so-called "free market reforms", imposed by foreigners, paved the way for the xenophobic, anti-liberty figures like Chavez, Evo Morales, Mugabe, and Putin.

Yet once again, being right got little reward: Murrell and McMillan were ignored, while Jeffrey Sachs became a celebrity economist despite the failure of shock therapy. Jeffrey Sachs got even more fame for his top-down planning approach when he re-discovered the fifty-year-old failed ideas of the poverty trap and the Big Push from foreign aid in the new millennium. These views resonated with many, as individual freedom fell back into disfavor in development; Sachs even gained the support of movie stars. Sachs cited Hayek's support for his ideas, but unfortunately his support came not from Friedrich Hayek but from Salma Hayek.

How come the top-down expert approach still dominates development economics despite fifty years of failed predictions from development experts? There are many reasons, but one that I think is particularly interesting is that our brains are hard-wired to believe in top-down planning. We see intentional behavior by someone at the top even in a bottom-up spontaneous order in which the outcomes are not the conscious goals of anyone. Philosopher Daniel Dennett argues that human evolution favored the "intentionality" way of thinking. There was evolutionary payoff in seeing intentional behavior in all living animals. When you saw a lion move, you could get away if you understood that it intended to eat you. When you saw a group of cavemen from the next cave over approaching you with torches and clubs, you could defend yourself more readily if you saw this as a group with a specific agenda, such as killing your men and stealing your women. Cavemen that saw intentional action everywhere survived. Those who didn't perished.

So now perhaps we can understand statements from those that attribute evil intent to spontaneous processes, such as anti-globalization protesters who said in 2002 that corporate leaders meet at "posh gatherings" in order to "chart the course of corporate globalization in the name of private profits." Where there is inequality in market economies, people too often believe that somebody intended to make the poorest people poor. Where there is spontaneous entrepreneurship that both creates new jobs and destroys old jobs, the newly unemployed too often believe that somebody conspired to take their job away. With our caveman hard-wiring, it is difficult to understand that nobody intends either the good outcomes or the bad outcomes. Another Nobel laureate, Kenneth Arrow (someone who, unlike Hayek, is not seen as a right-wing ideologue), said: "[T]he notion that through the workings of an entire system effects may be very different from, and even opposed to, intentions is surely the most important intellectual contribution that economic thought has made to the general understanding of social processes."

The idea of spontaneous order that is not designed or intended by anyone has grown much more comprehensible in our day than it was in Hayek's. We now realize that such diverse areas as the Internet, language, biological evolution, social networks, and even pedestrians walking on a sidewalk without running into each other are spontaneous orders, with nobody in charge. Seeing the absurdity of top-down planning in these situations is to illustrate just how spontaneous they are: How well do you think it would work to have a top-down planner assign us our friends and our spouses? How well would it work for a Manhattan Department of Walking to give each of us, every morning, our precise paths on the sidewalks so we wouldn't run into each other? But when you persist in the caveman mindset of seeing outcomes as intended by someone, even in bottom-up, spontaneous orders such as markets, then you will always favor top-down, intentional action by experts to try to improve the outcomes.

Hayek tried to counter this inbred bias by pointing out just how much radical uncertainty there was in economic life, which a top-down expert cannot possibly process. So you need decentralized, independent searches for many types of success by well-informed and highly motivated individuals. He can say it better than I can:

> 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. . . . [I]ts results cannot be predicted . . . . [W]e cannot know which views will assist this growth and which will not.

and

> Liberty is essential to leave room for the unforeseeable and unpredictable; we want it because we have learned to expect from it the opportunity of realizing many of our aims. . . . [W]e trust the independent and competitive efforts of many to induce the emergence of what we shall want when we see it.

The way countries succeed in development is often by finding a big hit in export markets. What will be the big hit is impossible to foresee. That's why you need Hayek's "independent and competitive efforts of many." Who would have predicted that cut flowers in Kenya would capture 40 percent of the European market for romantic men bringing flowers home to their wives? You could say the same about women's cotton suits in Fiji (42 percent of the U.S. market), or "floating docks" in Nigeria (84 percent of the Norwegian market), or electronic integrated circuits in the Philippines (71 percent of the world market), or regional jets in Brazil (Embraer now has 22 percent of the world market). Egypt's largest single manufacturing export success, accounting for 30 percent of the total, is bathroom ceramics, of which 93 percent goes to Italy. Can you picture development experts telling the Egyptians, "The secret is just export toilets to Italy!"?

Hayek correctly predicted that development would be unpredictable! This may sound contradictory, but this is a genuinely testable hypothesis, like the prediction of the efficient-markets hypothesis that nobody can, year after year, predict the stock market. Economic growth rates satisfy the unpredictability hypothesis, not only the anecdotes above, but also research conducted by me and others that finds that rapid economic growth seldom persists. China and India are fast growers now but were slow growers in the 1960s and 1970s; Brazil and Cote d'Ivoire were fast growers in the 1960s and 1970s but have had slow growth since 1980. Statistical analysis suggests rapid economic growth in the short run is determined mainly by transitory factors that cannot be predicted. Even a completely free market will randomly have high growth during periods when entrepreneurs find a lot of big hits and low growth when there is a stretch without big hits.

So the difference between successful bottom-up systems that protect individual liberty and systems that restrict liberty often *cannot* be seen that clearly in comparisons of growth rates over limited periods, even over periods as long as a decade. This difficulty is often exploited by the critics of liberty, who can easily cite a counterexample of an unfree country with rapid growth (China is the current favorite). In fact, growth rates are so volatile that experts can prove just about any theory of economic development they want with a spurious example of a country with a temporarily high-growth rate that also happens to have whatever economic policy the expert likes. These arguments are the intellectual equivalent of the Las Vegas gambler who attributes his streak of good luck to the socks he was wearing at the time, and will then keep wearing his increasingly foul socks in a futile attempt to reproduce that luck.

The difference between free and unfree systems *does* show up in long-run comparisons, such as in the *level* of per capita income. The relevant fact about China's long-run performance is that its per capita income is still today ranked only 122nd in the world, behind Albania, Ecuador, Gabon, Jamaica, and Suriname, at one-tenth of the level of free America. Levels of per capita income are strongly correlated with measures of economic and political liberty, and statistical techniques suggest this correlation is causal: liberty causes prosperity. Even North Korea has had periods of high growth, but it would be hard to miss the argument for liberty supplied by the vast differences today in per capita income, health, and nutrition between free South Koreans and enslaved North Koreans.

The last stab at finding employment by us development experts is for us to concede that individual liberty is the best system, but also to say that you need us to design the government rules that make individual liberty possible. It is certainly true that liberty needs government rules to protect private property, to enforce contracts, to prevent cheating and looting, and many other rules of good behavior that make dealings between individuals possible. But it doesn't follow that experts need to design government rules from the top down. Hayek's last and possibly greatest insight was that the government rules for a market economy are *not* designed. They also evolve from the bottom up. As Hayek put it: "The value of freedom consists mainly in the opportunity for the growth of the un-designed, and the beneficial functioning of a free society rests largely on the existence of such freely grown institutions."

How do institutions freely grow? Here I think economists have gained further insights since Hayek wrote, although we still have a lot to learn. We now have game theory, which can describe a trust outcome in which each one of us agrees to respect everyone else's property rights and contracts in return for all of you to respect my property rights and contracts. Anyone who cheats or steals can be punished through social ostracism, which carries the added penalty of exclusion from profitable contracts in the future with anyone. The social norm will stabilize around respect for individual liberty that treats individuals as both deserving of the rewards of their own efforts and responsible for any costs that they impose on the rest of us. Unfortunately, there is also another equilibrium. If cheating and stealing start out being widely accepted as normal, and each individual expects to live off everybody else, then such a society can get stuck in a distrust outcome and be unable to reach the liberty norm. In fact, international differences in the answer to a World Values Survey question on whether individuals should take responsibility for themselves (about as close as this questionnaire got to individual liberty) are excellent predictors of which societies do in fact have free-market and democratic institutions. So yes, of course, you do need governments that pass laws to enforce rules, but good governments just formalize the bottom-up reality of social norms that respect liberty, which carry most of the weight in enforcing the rules.

What explains different social norms across countries? Here, frankly, neither Hayek nor today's researchers have reached a completely satisfying answer. Historical accidents probably matter: A recent study finds more distrust between individuals today in regions of Africa where more individuals were betrayed and sold into slavery during the centuries of the slave trade. But Hayek also suggested that rules and norms are themselves subject to a survival-of-the-fittest evolutionary process (perhaps a slower one than we would like). Individuals in poor societies without liberty who see the connection between liberty and prosperity are going to want liberty!

Now, here at last is a clear role for development experts. They can try to speed up the evolutionary process by persuading individuals around the world of how well a bottom-up system works in the long run when people value individual liberty.

These benefits are not abstract: As the share of nations with economic and/or political freedom has trended steadily upward since 1970, the global poverty rate has fallen by two-thirds. For the Kenyan employed exporting cut flowers to Europe and the Egyptian employed exporting toilets to Italy, free trade is not an abstraction.

We have similar examples of escaping poverty in our own history. In 1927, a baby named Nathan was born in America's own Third World, West Virginia. His father, a low-paid lumber inspector, died from tuberculosis when the boy was two years old. His mother, named Dora, was left to support two sons in West Virginia during the depths of the Great Depression. If ever there was a poverty trap, this was one. But Dora worked so hard that she was able to send Nathan to West Virginia University. Nathan himself continued to work hard at odd jobs until he could finance a return to West Virginia University to attain a Ph.D. in biology. He left West Virginia for a successful career as a professor of biology up north, so that he could give his own children a middle-class standard of living. I should know because I was one of those children; Nathan is my father. I dedicate this Hayek award tonight to my father, out of gratitude for how he realized the American dream for our family.

With such inspirational examples, we owe it to the poor everywhere to advocate the values of individual liberty that offer the world's last, best hope for ending poverty. I will close with a paraphrase of my favorite liberty-loving American politician, Abraham Lincoln:

> It is for us the living to be dedicated here to the unfinished work which they who came before us have thus far so nobly advanced. It is for us to be here dedicated to the great task remaining before us—that we here highly resolve that our world shall have a new birth of freedom—and that development of the people, by the people, and for the people, shall not perish from the earth.

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MANHATTAN INSTITUTE FOR POLICY RESEARCH
52 Vanderbilt Avenue • New York • NY 10017