

“A Plan Worth of Zambia”

By Luigi Zingales

The White House has set high hopes for the \$20 billion Iraq aid package it obtained from Congress last week. The administration has compared the package to the Marshall Plan, the gold standard for rehabilitating wartime foes, promoting freedom and repairing prostrate economies.

“Following World War II, we lifted up the defeated nations of Japan and Germany, and stood with them as they built representative governments. We committed years and resources to this cause. And that effort has been repaid many times over in three generations of friendship and peace,” President Bush said in his Sept. 7 televised address to the nation.

“America today accepts the challenge of helping Iraq in the same spirit for their sake, and our own..” Last Thursday when he signed the supplemental appropriations bill, Bush called it “the greatest commitment of its kind since the Marshall Plan.”

Yet Iraq looks more like traditional Third World recipients of development aid than the 1948 beneficiaries of the Marshall Plan. While invoking the Marshall Plan might have helped overcome doubts in Congress about the package of aid to Iraq, comparing Iraq to, say, Zambia might set more realistic expectations of what American money can accomplish.

It is easy to understand why the administration refers to the Marshall Plan when discussing Iraq. Despite the cost of the Marshall Plan -- almost \$100 billion in current dollars -- no one today would question the wisdom of that investment. Not only did the Marshall Plan lift up the prostrated European nations (and prop up demand for U.S. products), it promoted international cooperation and European stability. Following this plan, Western Europe has enjoyed the longest period of uninterrupted peace in its history. Even \$100 billion seems a small price to pay for such long-lasting benefit.

Not all foreign aid, however, has the same stellar record. In a recent article in the *Journal of Economic Perspective*, former World Bank official William Easterly reviews the evidence on the effect of foreign aid during the past 40 years. The conclusions are depressing. There is no evidence that on average foreign aid promotes growth. To the contrary, most aid seems wasted. If Zambia had properly used the aid it received since 1960 to build up investment and growth, by the early 1990s it should have had a per capita GDP of \$20,000. Instead Zambia is stuck with a GDP per capita of less than \$500. Where did the foreign aid go? Why was the Marshall plan so successful while most other foreign aid plans were not?

One of the important developments in the theory of economic growth in the last 20 years is the realization that growth in GDP per capita does not only depend on the amount of money invested. Economists now realize that other forms of “capital” -- human, organizational, and social -- matter as well. In other words, parachuting in money to buy modern equipment is not

sufficient to increase the standard of living of a country. The country must possess skilled workers to take advantage of that modern equipment.

In this respect, the Marshall Plan is very different from most of the foreign aid given in the past 40 years. The Marshall Plan was directed at countries that before World War II were already developed. In 1938, before the wartime destruction took place, many of the countries that later benefited from the Marshall Plan had per capita GDP of about \$5,000 in today's dollars. In other words, before the war these countries were quite developed by the standards of that time. They had accumulated not only the physical capital, such as factories, but also the worker skills, organizational strengths and social networks necessary to grow. While much of the physical capital they had was destroyed by the war, their endowment of technology, organizational ability and social networks remained intact. And in spite of heavy casualties during the war, European countries still had highly skilled and educated citizens what economists call human capital. Hence, with the benefit of the hindsight (and of the economic knowledge accumulated since), it is obvious that the Marshall Plan would have worked. If a firm has its plant destroyed by fire, it does not take much to get it started again. And certainly a loan to help pay for the new plant will speed up the recovery. Why should it be different for a country?

Getting Zambia growing, however, is a much harder challenge. It is like creating a company from scratch. Only one third of new American firms survive more than five years. Even when they receive the money and advice of venture capitalists, new businesses run a high risk of failure; roughly 40 percent don't make it. Aid does not improve their chances of success much either. A recent study shows that outside California and Massachusetts, all the money the U.S. government has invested in promoting new firms has been wasted. What is true for firms, is also true for countries. Money alone is not enough to turn a country around.

Given this distinction, where does Iraq fall? Does it look like Zambia or like Germany after the war? Before the first Gulf War, Iraqi GDP per capita was just above \$2,000, which puts it exactly between Zambia and 1938 Germany. The figure, however, is distorted by oil exports. Oil is an extremely valuable commodity that can be extracted without using a lot of local labor, companies or social networks. Foreign companies often provide the know-how. Hence, the "true" level of economic development in pre-war Iraq is probably better approximated by subtracting oil revenues from the country's GDP. That reduces Iraq's pre-Gulf War per capita GDP to little more than \$1,400. If we then use the level of literacy as a rough measure of human capital, the situation in Iraq looks even worse; in Iraq today the percentage of people age 15 years or older who can read is only 39 percent compared with 76 percent in Zambia and almost 100 percent in 1938 Germany.

On a per capita basis, the amount of foreign aid planned for Iraq swamps the Marshall Plan. If we add the \$20 billion in aid voted by Congress last week to the \$13.2 billion promised by other countries and international institutions at the recent Madrid conference, the promised aid amounts to

more than \$1,300 for every Iraqi citizen almost three times as much (in inflation-adjusted dollars) as German citizens received from the Marshall plan and other initiatives. Yet a huge amount of funds pumped into a country that lacks what economists call human, social and organizational resources to benefit from it is a recipe for disaster, giving rise to waste and corruption.

Does that mean we should cancel our aid package to Iraq and leave Iraqis to their own destiny? Certainly not. But it does suggest the size and type of financial aid must be drastically re-thought. The word “reconstruction” often used to describe the aid package for Iraq is a misnomer. Iraq’s is not a once-well-functioning economy that needs to be jump-started. It is a country that needs help finding the path for development. This is a process where we have little theoretical guidance, and even less of a track record.

But we can say with certainty that most of the money should not be used to import new oil-related equipment from the United States. The market will provide this equipment, even without any foreign aid. Where the money should be invested is in education and health. Iraqis need to be trained not only on how to maintain law and order, but also on how to make new loans, market new products, grow new crops. The future of Iraq lies in those endeavors.

Unfortunately, all these are long-term goals, well beyond the political horizon of President Bush and possibly his successor. Given the continuous U.S. casualties and pressure for disengagement from Iraq, will the United States have the same perseverance it had with the Marshall Plan? The Marshall Plan lasted four years. Developing Iraq will take longer than that.

Iraqi opposition to the U.S.-led occupation could also obstruct economic development if U.S. forces seek allies among powerful local bosses who are often the very same ones who made the previous regime possible. In return, these bosses will seek economic favors, such as government contracts and local monopolies. While this might minimize the cost of occupation, it would create powerful obstacles to economic development once foreign forces leave. Development requires free markets. But the privileged elite will oppose them, because free markets destroy the very privileges upon which their power rests. Letting that elite succeed would turn what has been promoted as the new Marshall Plan into a tragic repeat of European colonialism.