

# MYTH CONCEPTION: FOREIGN AID is the **KEY** to WELL-BEING

Foreign aid might well harm rather than help development. For countries to prosper, they need to be economically free and have good systems of governance in place. The “do no harm” principle is a good start in development economics.

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**B**ased on the high standards of living enjoyed by their citizens, one might think that the governments of first-world countries know how to create development. They do not. The reality is that development is not created by anyone – not even by well-intentioned policymakers and development “experts.”

Instead the ongoing process of improved well-being can only take place in an environment of economic freedom which encourages constant innovation and experimentation so that scarce resources can be used in new and better ways to provide people with things that make their lives better.

Unfortunately, the now global state-led development complex not only neglects the realities of development, but often pursues policies that actively undermine it.

As far as the governments of rich countries are concerned, development for poorer countries should not mean allowing them to go through the same messy process that they went through.

Instead, development entails top-down planning and state-led initiatives with grandiose promises that this time

these plans will, once and for all, end poverty and suffering.

Post-earthquake Haiti provides a recent example of this top-down approach in action. More than \$9 billion in aid was pledged to Haiti by governments and international organisations following the 2010 earthquake. In addition, thousands of experts and relief workers swarmed the country under the guise of helping Haitians. However, only a small portion of that assistance has actually been delivered, and even that has been largely ineffective, leading Haiti’s President Michel Martelly to conclude that the aid isn’t “showing results.”

## Why does aid not work?

There are two reasons why state-provided aid cannot create society-wide prosperity. Firstly, policymakers do not have access to the necessary knowledge to allocate scarce resources to their highest valued uses.

In their critique of socialism as a means of economic organisation in the 1930s and 1940s, Ludwig von Mises and Nobel Laureate F.A. Hayek made this exact point, noting that even the most qualified and benevolent planners lack the knowledge to

produce even the most basic items in a cost-effective manner.

As Mises and Hayek emphasised, the necessary knowledge for advanced material production is not given to economic actors ex ante. Instead, this knowledge must be continually discovered as conditions constantly change. The adaptability of markets, combined with the alertness of entrepreneurs acting within those markets, is ultimately the driver of economic well-being and prosperity.

Inventor Thomas Thwaites recently embarked on a fascinating endeavour called the “Toaster Project,” which illustrates the Mises-Hayek point.

Thwaites attempted to build a simple toaster from scratch. He quickly found that the task was extremely complicated, involving hundreds of parts and materials from various geographical locations. After much travel and effort to extract and process the necessary materials, he constructed his (extremely ugly) toaster that burned out seconds after being plugged into an electric socket.

The Toaster Project is a good example of the Mises-Hayek point, as indicated by Thwaites’s realisation that “the scale of industry involved in

making a toaster is ridiculous but at the same time the chain of discoveries and small technological developments that occurred along the way make it entirely reasonable.”<sup>1</sup>

No central planner determines the process through which a toaster is made, yet toasters are readily available in the UK and the US cheaply. This is the process of economic development. It is the process of discovering new and better ways to use scarce resources to improve the lives of citizens. But these discoveries are not made by government planning.

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The perverse incentives associated with aid are a second reason why governments cannot create development. These incentives exist both amongst the recipient and donor governments. On the recipient side, the injection of aid creates the incentive for already dysfunctional governments to remain ineffective.

A cross-country study by Stephen Knack of The World Bank found that foreign assistance undermines the quality of political institutions in the recipient country through weakened accountability of political actors, more corruption, greater chances of conflict and a weakening of the incentive to reform inefficient institutions and policies.<sup>2</sup>

### Aid, economic development and corruption

To further illustrate this point, consider *Table 1* which shows the top ten recipients of financing for financial year 2012 from the International

Development Association (IDA), which is the World Bank’s fund for the poorest countries in the world. The support provided by the IDA is used for a variety of initiatives including: health, education, infrastructure, and economic and institutional development.

Also shown in *Table 1* is the most recent rank of these same countries from the annual “Economic Freedom of the World Report” (EF Rank), which ranks economic freedom in 185 countries and Transparency International’s annual “Corruption

Perception Index” (Corruption Rank), which ranks corruption in 176 countries.

As *Table 1* indicates, the top ten recipients all rank poorly in terms of both economic freedom and corruption. This means that in these countries individuals are not free to engage in legal, voluntary economic activity and are subject to bribery and abuses of power.

One response is that these poor rankings are precisely the reason for providing aid to the governments of these countries. This line of argument holds that funding can be used by these governments to reform and transform their political institutions to facilitate future economic development.

However, this line of reasoning ignores the incentives facing the governments of these countries. When political actors are rewarded with aid for behaving poorly, there will be a tendency to continue to behave

poorly, the implication being that aid helps sustain the situation rather than cure it.

There is a very easy way for the governments listed in *Table 1* to credibly signal their desire to reform while fostering development. They can stop taking bribes and property from their citizens. This does not require aid, but instead involves basic self-restraint from harming others. If political leaders in these countries lack such restraint, why should we think they will behave any differently when the governments of first-world countries hand them millions of dollars?

Indeed, the aid funds themselves entrench the position of the elite and provide greater resources with which the elite can behave corruptly. It is true that some countries have reformed and prospered, but, as Hong Kong, Singapore, Taiwan, and other countries have demonstrated, aid is not a necessary condition to do so.

### Aid and donors

Perverse incentives also plague the donor side of foreign aid. Government agencies tend to focus on spending money as quickly as possible on observable outputs in order to signal their importance and need for more money. In the absence of clear lines of accountability and responsibility, money is often wasted. A recent report, “Learning From Iraq” by the Special Inspector General for the Iraq Reconstruction (SIGIR) identified



<sup>1</sup>Source: [www.thetoasterproject.org/page2.htm](http://www.thetoasterproject.org/page2.htm).

<sup>2</sup>Knack, Stephen. 2001. *Aid Dependence and the Quality of Governance: Cross-Country Empirical Tests*. *Southern Economic Journal* 68: 310–329.

Country	IAD Aid (\$ millions) <sup>3</sup>	EF Rank <sup>4</sup>	Corruption Rank <sup>5</sup>
India	2,733	111	94
Nigeria	1,345	120	139
Pakistan	1,290	111	139
Vietnam	1,049	95	123
Ethiopia	920	131	113
Kenya	878	78	139
Bangladesh	866	109	144
Ghana	470	71	64
Tanzania	420	107	102
Côte d'Ivoire	390	129	130

**Table 1: Top Recipients of International Development Association Funds and Economic Freedom and Corruption Ranks**

\$8 billion in funds that were either wasted or unaccounted for<sup>6</sup>. In general, when people are not held responsible for their actions, they tend to act in a careless manner. This reality plagues aid efforts around the world, as no one is held accountable for waste and the unintended harms imposed on others.

### What policies can promote development?

Given the failure of foreign aid in creating development, what is the solution? Economic freedom, which requires general protections of person and property, avoids both of the

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problems with aid identified above. It does not fall prey to the knowledge problem of which Mises and Hayek warned because it recognises that attempting to micro-manage economic outcomes is doomed to fail.

Instead, economic freedom creates a general environment within which people can engage in the process of discovery and experimentation that is at the heart of development. Likewise, economic freedom avoids creating perverse incentives because it limits direct political interventions in voluntary transactions and other interactions between people. Economic freedom views government as a referee who enforces the general rules rather than an activist player that attempts to shape outcomes.

Given the importance of economic freedom and the inability of governments to create development, what steps can be taken? Instead of focusing outward on fixing other societies, those in developed countries should focus on their own policies

towards people living elsewhere.

As the Toaster Project illustrates, increasing the extent of the market is the best means of delivering more and cheaper goods and services. If the desired end is to help the worst off, this insight provides a benchmark for judging policies: does the policy contribute to increasing economic freedom and the extent of voluntary market interactions?

If the answer to this question is "yes," then the policy under consideration will contribute to improvements in standards of living and human well-being. We can, in this

area, lead by example.

For instance, whilst trade restrictions on agricultural products are not the main cause of poverty in poor countries, removing them will help developed countries, help poor countries at least to some extent and remove sources of tension so that poor countries find it easier to reform themselves. The "do no harm" principle is a good start in development economics.

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<sup>6</sup>"Learning From Iraq," [www.sigir.mil/learningfromiraq/index.html](http://www.sigir.mil/learningfromiraq/index.html)