Peter Bauer and the Failure of Foreign Aid

Peter Bauer and the Failure of Foreign Aid[1].
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1. The foreign aid debacle.

Peter Bauer was one of the greatest development economists in history. He was an advocate of property rights protection and free trade before these ideas became commonplace. He appreciated before others did the crucial roles of entrepreneurship and trade in development. He was also one of the earliest opponents of the overpopulation thesis, recognizing that the poor like the rich should have the right to choose the number of children they have, that many developing countries are under-populated, and that population growth will anyhow slow down once they become richer. Bauer's writings are remarkable for their deep humanity and commitment to the welfare of the people in the developing world, but without the fake sanctimony that characterizes much of the modern rhetoric.

Bauer is perhaps best known as a persistent and articulate critic of foreign aid. At least since 1972, he saw it as not only failing to speed up, but actually hurting economic development. He started his criticism when foreign aid to the developing world was only getting underway, and never wavered. He defined foreign aid as "a transfer of resources from the *taxpayer* of a donor country to the *government* of a recipient country (1975, p. 396)." Needless to say, this did not endear him to the aid establishment.

Indeed, thirty years ago, just as today, a critic of foreign aid was ridiculed for being inhumane and insensitive to the plight of the poor. Bauer's 1972 book was savaged by the surly (now Sir) Nicholas Stern, who wrote that "*Dissent on Development* is not a

[1] This paper is a summary of remarks made at a conference in memory of Peter Bauer at the London School of Economics in 2006. It is not intended as a summary of Bauer's work. For recent summaries and interpretations, see, for example, Dorn (2002) and Vasquez (2007).

valuable contribution to the study of development (1974, p. 209)." Stern's case for aid was simple: people in the rich countries are much richer than people in the poor ones, and therefore foreign aid is their moral obligation. This observation was supplemented with a sprinkling of success stories, and a criticism of Bauer for excessive reliance on examples. Little has changed in 30 years. In retrospect, Bauer looks both prescient and courageous.

And prescient he was. Countless empirical studies have failed to find beneficial effects of official foreign aid. The consensus that aid has failed is nearly universal among those who look at the data. Perhaps the most important recent statement of this conclusion is William Easterly's account of both the history and the evidence on foreign aid (Easterly 2003, 2006, 2009).

The failure of foreign aid is all the more remarkable once we remember that, in the last quarter century, the world has experienced an enormous spurt of economic growth and social development. I have elsewhere (Shleifer 2009) called this period "The Age of Milton Friedman" and documented its enormous accomplishments. Starting from East Asia, and concluding most recently with India and China, nearly all the countries in Asia (where much of the world's population lives) have experienced rapid economic and social progress. The collapse of communism started the period of economic transition in Eastern Europe and the former Soviet Union which, while difficult at the start, within a few years has brought rapid economic growth in the whole region. Even the current economic crisis will slow down, but is highly unlikely to reverse, these achievements. Economic success has not been as conspicuous in Latin America and Africa. Even those regions, however, judging by many indicators of human development, such as health, education, and poverty reduction, have seen substantial progress.

Economic growth has been accompanied by improvements in the quality of life for billions of people. Extreme poverty is declining at staggering rates. Life expectancy has grown tremendously around the world. Literacy and education have improved rapidly. Starting in the mid 1970s, when Bauer began to criticize foreign aid, the world has experienced unbelievable growth in democracy and human rights.

The sources of economic progress are becoming increasingly apparent. Over the last quarter century, the world has embraced capitalism and free trade. Indicators of property rights protection around the world have improved dramatically. Tariffs and other impediments to foreign trade are down. Tax rates have often fallen, especially on corporate income. Interventions in capital and foreign exchange markets have been greatly reduced. Fewer governments just print money to cover their deficits. Large parts of the world undertook massive waves of privatization and other reductions of the state's role in the economy. The list goes on. Against this background of economic development and the rise of free markets, the inability to find any benefits of foreign aid is even more remarkable. One might have thought that foreign aid would have done better when the world is growing and democratizing, as it did in the last thirty years, than under less propitious circumstances. But there is no evidence of its contribution, despite a substantial effort to find it (Easterly 2009).

Bauer and subsequent writers have advanced several reasons for this dismal performance of foreign aid. The ostensible purpose of aid, at least in the post World War II era, was to stimulate economic growth. The intellectual support for many of the policy recommendations for how to allocate aid in order to stimulate economic growth was based on the big push model (Rosenstein-Rodan 1943). According to that model, what keeps countries behind is insufficient investment across sectors of the economy and in infrastructure. To the extent that foreign aid supplies investment capital, it jump starts economic growth, and initiates a virtuous cycle whereby investment generates income and thus raises the economic return to further investment.

Bauer relentlessly criticized the big push model. He argued that foreign aid providers do not know which investments are appropriate for a developing economy, so aid money is poured into bad projects (also known as white elephants), which not only fail to encourage economic growth, but divert scarce human and other resources away from productive uses. The limited institutional and human capabilities of a country are wasted on unproductive rather than productive activities. Aid destroys economic incentives, leads to misallocation of scarce resources, and so not only fails to jump start, but actually undermines growth. Easterly (2006) discusses these arguments in detail, and supplies considerable evidence supporting Bauer's skepticism about the big push.

Easterly (2009) surveys the many reasons for the poor performance of foreign aid, but the basic ideas go back to Bauer. One approach is to follow the long and intricate road that a dollar of a Western taxpayer's money must follow before it reaches a needing recipient in a developing country. Think about what happens to that dollar. First, it must be allocated by the donor country's government. That government has its national political, military, and economic objectives, such as supporting friendly states, selling its food and weapons, promoting its own consultants, intervening in international conflicts, and so on. Traditionally, much of bilateral foreign aid has been tied to purchases from donor countries, although apparently this phenomenon has seen some decline (Easterly

2009). Many of these objectives have little to do with development. A large chunk of the U.S. development assistance, for example, is military support for Egypt and Israel.

Even for the part of the Western taxpayer's dollar intended for development, the donor country's government can have incorrect or even bizarre ideas for how to spend it. Think of the Swedish government's support of socialist policies in Tanzania, which most observers believe have failed. Or the French government's support of petty Francophile dictators in its ex colonies in West Africa, designed to expand the French sphere of influence. In a similar vein, countries may choose to spend "development" money on their own firms and contractors undertaking projects abroad. Much of the money of course stays at home. The role of kickbacks, bribes, and campaign contributions in shaping decisions on foreign aid by *donor* countries is only beginning to be understood.

But suppose that some fraction of that initial dollar actually reaches a bilateral or multilateral development agency with the intention that it be spent on actual development as opposed to arms procurement or transfers to Western firms and farms. In addition to having significant staffs of their own, these institutions often have ideas of their own, as well as constraints on how to spend the money dictated by donor priorities. For example, coordinated investment spending a la big push was the prevailing development wisdom for much of the 1970s, which may have resulted in a significant misallocation of resources. Furthermore, development institutions have a strong incentive to spend – push the money out (this is the true big push). This means that countries willing to accept the most money, as grants or as loans, and to spend it on the biggest projects, become the most attractive candidates for aid. There is not much evidence that aid is allocated to countries that spend it more wisely (Easterly 2006).

But let us keep following whatever is left of the Western taxpayer's dollar. Suppose that some fraction of that original dollar is now lent or given as a grant to a government in a developing country for some purpose that may contribute to development. As has been extensively documented, in many instances the first instinct of the officials receiving the funds is to steal them. Many a developing country leader has become a billionaire courtesy of foreign aid. When the money is not stolen by the leader, there are the various ministers, officials, and other bureaucrats who all want a cut.

This problem is particularly severe in the case of foreign loans, which is how the World Bank and the IMF deliver most foreign aid. Because loans are sovereign obligations of the receiving country, it is difficult for the donors to control how they are spent: conditionality is typically a failure (Svensson 2003, Easterly 2009). Because loans come in the form of cash, they are particularly vulnerable to diversion. And of course, unlike aid grants, loans become the obligation of the borrowing country, and therefore are supposed to be eventually repaid – a tax on future resources.

The consequences of this structure have been dramatic. The loans to developing countries have come to be known as "odious debt" because the proceeds are stolen by the governments and the citizens are taxed to repay. The debt has been largely rescheduled and rarely repaid. Indeed, donor countries came under severe criticism for even asking for repayment. In many countries, especially in Latin America, borrowing from the IMF and the World Bank was condemned by the left as the attempt by capitalist West to destabilize the developing economies. Far from being seen as an exercise in benevolence that promoted development, foreign aid in the form of loans has energized the left in its support of economic and social policies most antithetical to development.

The diversion of foreign aid by officials in recipient countries is not, unfortunately, just a lump sum tax. To begin, when diversion of aid money is a significant issue, recipient governments begin to seek assistance for projects from which it is easier to steal and where spending is harder to monitor. The composition of aid spending is then distorted. And just as donor countries want to allocate aid money for national priorities, recipient governments want to spend it for their national priorities which may, but need not, coincide with development needs. The recipient governments want to allocate money to their friends, families, and political supporters, to pursue military and foreign policy goals, etc. Like the donor governments, the recipient governments often, perhaps even more often, have bizarre ideas about development. And so another fraction of that Western taxpayer's dollar is wasted.

But remember that money, of what is left of it, is still in the recipient country's capital. The small piece of it designated for some activity that resembles economic or social development is yet to be spent for that purpose. That piece still needs to pass through the treasury, the spending ministry, the regional offices, and the actual spenders in the developing country. At each turn, some fraction is diverted, misspent, or wasted. According to Reinikka and Svensson (2004), 13 cents out of each dollar of the Ugandan government's expenditure on schools actually reached those schools. Not all of that waste is malevolent. Western governments have a lot of trouble spending money efficiently; the human and administrative capabilities of developing country governments are considerably lower, as is the efficiency of their spending.

Last but not least, when the money reaches a designated recipient – a bridge builder, a teacher, or a farmer – that recipient must spend it wisely. The bridge builder must build the bridge, the teacher must show up at school, the farmer must use his fertilizer. None of these can be taken for granted. Indeed, the lesson of development economics of the last decade is that there is tremendous corruption, waste and resource misallocation at every stage. Bridges are not built (or collapse soon after if built), teachers stay at home, and farmers retain old production techniques.

The bottom line is that perhaps a few pennies of the original Western taxpayer's dollar are actually spent as might be designed and implemented by a benevolent and effective social planner. The rest is wasted or diverted. Easterly suggests that a trillion dollars has been spent on foreign aid since World War II. But how much has actually been delivered wisely to the intended recipients of that aid? Viewed from the perspective of a dollar traveling from the Western taxpayer's pocket to the intended ultimate recipient, the failure of foreign aid is not all that puzzling.

As important, the diversion of most of the dollar before a few pennies reach an intended recipient is not development neutral—this diversion may actually undermine development because it interferes with the political and institutional processes that might actually be beneficial to a country. For example, many social scientists believe in the idea going back to the Magna Carta (and which has some empirical support as well), that governments should have to raise taxes to finance their spending, so that they are forced to seek the consent of the governed. By breaking the link between government resources and its ability to tax, foreign aid might undermine the basic contract between the government and the governed. And to the extent that the evolution of indigenous political institutions is a central element of economic and social development, these adverse effects of foreign aid might be as significant as the meager benefits it provides.

Another way to make this point is to focus on economic policy. Pro-market economic policies have been as important as anything we know of in fostering economic development. Yet foreign aid, by relaxing the budget constraint of the government, in many instances has the effect of delaying the introduction of such good policies. In the 1980s and 1990s, the donors tried to address this problem by linking aid to policy reform. The donors often failed, because the client governments resisted, because they failed to deliver policy reform even when they accepted conditionality, and because conditionality was severely criticized in the West for interfering with the sovereignty of developing countries (Svensson 2003). Today, the promotion of good policies through conditionality is at best a half-hearted foreign aid priority.

The bottom line is that Bauer was correct about foreign aid. Foreign aid has failed to meet its principal objective: to spur economic growth. The reasons for its failure are probably multiple and more complex – and more numerous -- than just a failed model of development. But the evidence has broadly corroborated Bauer's view: an important instance of economic analysis making a correct prediction about reality in advance.

2. Foreign Welfare.

The foreign aid community did not disregard this evidence of failure that has accumulated since the 1970s. But it did not conclude that foreign aid is a bad idea, either. Instead, the conceptual framework for foreign aid has adjusted to the failure. There are three parts to the new view. First, the answer to the failure to identify the benefits of foreign aid is to spend more, not less. It is the insufficiency of spending that explains our inability to find its benefits. Second, growth has lost its dominance as the goal of foreign aid. The goal should be poverty alleviation, which has the distinct advantage of lower accountability for the donors. Foreign aid should become a massive welfare program for the developing world. Third, what must support continued and increasing foreign aid expenditures is not proof of effectiveness, but sympathy of the Western taxpayers. Buildup of that sympathy through public relations has increasingly become the cornerstone of foreign aid.

The change of objectives of foreign aid from growth to welfare is easy to defend. Investments in health and education are truly worthy humanitarian goals even when they do not lead to economic growth. Although an argument has been made that investment in health, as opposed to physical capital, will ultimately promote growth, the evidence for this proposition is weak at best. There is no evidence that health improvements have a causal benefit for growth. There is not even evidence that the AIDS epidemic has had adverse consequences for growth in Africa, or, conversely, that progress against AIDS will accelerate growth (see the discussion in Easterly 2009). Given the evidence, the current strategies of the world development community are unlikely to accelerate growth.

In other ways, however, this change of approach is depressing, since it is entirely obvious that the world has seen only one way out of poverty, namely economic growth (see Besley and Burgess 2003). India and China are only the most recent, as well as the most obvious, examples. Developing country welfare, including health spending, may bring many desirable results if it actually works. Saving and improving lives is important even with no growth effects. The trouble is, without growth, welfare is permanent. As the world moves to a foreign aid regime that looks so much like a welfare program, it needs to be prepared to spend money forever, or alternatively hope that other economic mechanisms totally unrelated to foreign aid, such as globalization, take care of growth.

The transformation of foreign aid objective from economic growth to income support would not have been possible without a massive publicity campaign. After all, welfare is unpopular in the wealthy Western countries, even with respect to taxpayers' own compatriots. Today, the Irish rock singer Bono, who has done more than anyone to support development spending, is probably the world's most important development professional. The World Bank in the 1990s has used a 400-person-strong public relations department to support the growth of aid. More recently, the United Nations, which has joined the foreign aid business is earnest with its Millennium Development goals, has played a tremendous role in popularizing the cause of foreign aid.

If one thinks that foreign aid is effective, and that in the rich world today one needs publicity to get approval of any expenditure, then these publicity campaigns are all for the good. But, as always, the matter is more complex. When publicity drives foreign aid spending, another crucial distortion enters the equation, namely that the public might want to see the money spent on causes of dubious value to human welfare.

One area where the influence of public campaigns is seen most clearly is the fight against AIDS. For several years, economists and public health experts have understood and stated clearly that the effective way of controlling AIDS is to spend money on prevention, not treatment. Many prevention strategies, such as dissemination of condoms or even the use of antibiotics to treat venereal disease (and thus reduce the likelihood of AIDS transmission), are cheap and effective (Canning 2006). In contrast, treatment of AIDS patients is vastly more expensive and less effective. The economic and moral case for spending money on prevention rather than treatment is powerful.

Yet that case does not make for good public relations. The sympathy of the Western publics is with those already afflicted and suffering, not with those at risk of being so by engaging in unsafe sex. The drug companies, likewise, have little commercial interest in prevention. So the money followed the Western demand. The response of foreign aid bureaucracy, particularly the UN bureaucracy, to the evidence on the relative effectiveness of prevention has been to accuse those advocating prevention of murder. Treating the suffering AIDS victims makes for great TV, as well as helps extract money from Western governments, presumably to be channeled through the UN. The effect, of course, is exactly the opposite: it is the neglect of prevention that kills people. Only recently, under the leadership of the Gates Foundation, has the development community acknowledged the vastly greater effectiveness of prevention. It has not been calculated how many additional people were infected, and lives lost, due to the UN's publicity-focused strategies.

3. The Future of Foreign Aid.

As this piece is being written, foreign aid is expanding rapidly. The foreign aid establishment has won the battle for the hearts, minds, and wallets, of western taxpayers. Peter Bauer's prescient warnings and fifty years of evidence notwithstanding, the West is about to spend another trillion dollars on foreign aid in the next couple of decades. Should a person concerned with economic development be despondent?

The answer, I think, is no. First, the humanitarian case remains strong. Even if only a nickel or a dime of the Western taxpayer's dollar is actually spent on the needy recipients in the developing world, the relative benchmark of comparison is how that dollar would be spent alternatively. Since it is unlikely to be retuned to the taxpayer, it would probably be spent on government projects that are almost comparably wasteful, and where the ultimate recipients of cash are not nearly as needy of assistance. The main question about humanitarian assistance is whether it actually hurts development.

But it seems to me that there is an even better reason not to be despondent, namely that foreign aid is a sideshow. As I have already noted, recent decades have been a spectacular period for economic and social development in most of the world. The financial crisis has slowed things down, and has allowed a new voice to bad ideas, but it is unlikely to reverse the basic trends. The reason for the extraordinary economic is social progress is simple: the world has increasingly embraced capitalism. The name of the game has been better policy, not foreign aid. More secure property rights, freer trade, lower taxes, better – if still far from perfect – government accountability, and more prudent public finance have all contributed to economic growth. Today, the world is a radically more pro-market place than it was thirty years ago, and it is growing rapidly.

There is reason for continued optimism. The many rumblings from the left, and a few setbacks in places like Argentina and Venezuela notwithstanding, the evidence seems to indicate that this embrace of capitalism is durable. The crisis is a setback, but not a reversal. And if developing countries continue to embrace market policies and institutions, then growth is likely to continue as well. The intellectual consensus around pro-market policies is far more important than the billions of dollars of foreign aid.

Indeed, let me end this paper with a conjecture. The number of people living in absolute poverty has been shrinking rapidly, largely due to the incorporation of developing countries into the world's economy. Since 1970, the number of people living on less than $1 a day has shrunk from 26% to 18% of the world's population (which grew enormously), thanks largely to market policies and rapid growth in Asia (see Shleifer 2009). The percentage is continuing to fall rapidly as more countries join the global economy. As long as globalization continues, poverty will indeed be reduced substantially over the next decade or two. I suspect that the advocates of foreign aid will take credit, even though such aid will have little to do with the reductions of poverty. But, fundamentally, who cares?

Peter Bauer may have lost his battle against foreign aid. But he has won the war for capitalism, and it is for that victory that he must be remembered.

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