

## WHAT CAN AID DO?

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Under normal conditions, devoting more resources to X's production produces more X. This follows from the nature of the physical world, which positively relates quantities of outputs to quantities of inputs used in their production. In principles of economics classes, it is common to highlight that this relationship has nothing to do with the *economic* problem. The economic problem asks how to produce X in the least-cost way, whether to produce more or less X, and indeed, whether to produce any X at all given the alternative uses of the inputs required to produce it.

Solving the economic problem determines whether a country's economy develops. It is strange, then, that professional economists have had trouble distinguishing the positive relationship between inputs and outputs from solving the economic problem when it comes to evaluating foreign aid.<sup>1</sup> The purpose of this article is to make this distinction, and in doing so to clarify what aid can and cannot do.

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<sup>1</sup> Easterly (2009) comes close to making this distinction in his recent summary of the aid literature on Africa, where he identifies the key change between large and rapid "transformational" programs and smaller, "marginal" changes.

Foreign aid's advocates claim aid has been successful. Aid's critics claim aid has failed. We explain why both camps are correct. Aid can, and in a few cases has, increased a particular output by devoting more resources to its production. In this sense, aid has occasionally had limited success. However, aid cannot, and has not, contributed to the solution of economic problems and therefore economic growth. In this much more important sense, aid has failed.

## Flashbacks from Econ 101

Economic progress requires economic efficiency: resource allocations that maximize resources' value to society. Economic efficiency improves when economic actors move resources from less-valued uses to more-valued ones. Economic actors tend to move resources in this way when they make their decisions in an institutional environment defined by private property rights.<sup>2</sup> In this institutional environment, market prices emerge that communicate information to entrepreneurs about how to use resources in ways that enhance wealth, and entrepreneurs have incentives to act on this information (see Mises 1920, Hayek 1945, Kirzner 1978, Coyne and Leeson 2004). Central planning, which attempts to allocate resources without private property and market prices, cannot allocate resources efficiently because central planners can't learn about resource allocations that maximize resources' value (Mises 1920, Hayek 1945).<sup>3</sup>

Since central planning cannot promote economic efficiency, it cannot promote economic progress. Nevertheless, like anyone else, central planners *can* increase a given output by devoting more resources to its production. There is nothing surprising about this fact. The nature of the physical world, including the positive relationship between inputs and outputs, is as true for central planners as for anyone else. The distinction between a central planner's ability to increase a particular output by devoting more resources to its production and his ability to solve the economic problem is where most evaluations of foreign aid go awry.

<sup>2</sup> Evidence for the positive relationship between private property rights and economic progress is voluminous. For just a few recent examples, see Gwartney and Lawson (2008) and Leeson (2009).

<sup>3</sup> This is true even if central planners have incentives to allocate resources efficiently, which is highly questionable (see Boettke and Leeson 2004).

An example from the real world illustrates the relationship, or rather lack of relationship, between increasing a predetermined output by devoting more resources to its production and solving the economic problem. Before its collapse, the Soviet Union devoted substantial resources to training scientists and engineers. Because of these expenditures, during the 1980s the Soviet Union had 10–30 percent more scientists and engineers than the United States (Dezhina and Graham 1999). Occasionally, people pretend this fact illuminates the relative efficiency of these countries' contrasting economic systems.

It does no such thing. If the United States had devoted as many resources to training scientists and engineers as the Soviet Union, it could have produced as many scientists and engineers, and perhaps many more. However, the United States allowed private citizens to determine resource allocations in a way the Soviet Union did not. Under the institution of private property, U.S. citizens used market prices to direct resources to ends they valued more than additional scientists and engineers. While the United States had fewer people trained in these professions, it was richer than the Soviet Union because markets consider alternative uses when they allocate resources. Although the Soviet Union had many more scientists and engineers, it was poorer than the United States because central planners allocated resources without considering alternative uses.

## What Can Aid Do?

Before discussing what aid can do, we discuss what it cannot do. Foreign aid cannot make recipient economies grow. As Easterly (2006) points out, foreign aid is akin to central planning with externally gifted funds. Central planning cannot create economic growth because it lacks private property and market prices, which prevents it from solving economic problems. It follows that aid, therefore, cannot generate economic growth either.

For example, the influential Harrod-Domar model suggests financing the difference between the investment required to achieve some growth rate and a developing country's savings. While aid may supply additional capital to poor countries, these finances do not tell recipient planners how to invest them in economically efficient ways—that is, in ways that produce wealth.

Hayek (1944) pointed out that central planning “works” when it has only one will to satisfy and one goal to focus on achieving.<sup>4</sup> Under such circumstances, there is no economic problem to solve because there are no competing demands for resource uses and consequently no trade-offs for planners to negotiate. This is why central planning tends to be more effective during war. During war, there’s a more-or-less singular end—victory. For the same reason, aid is more effective when it is aimed at a singular, predetermined end, such as reducing malaria.

However, this “effectiveness” does not help aid solve the economic problem that keeps poor countries poor. There isn’t a unified, lexicographic preference for one good in developing economies. There are many different individuals with different and conflicting demands, and thus different and conflicting uses for scarce resources. Developing countries confront an economic problem—one regarding appropriate resource allocations. Foreign and domestic aid planners don’t know how to use aid in ways that generate a pattern of resource movement away from less-valued uses toward more-valued ones. Thus, as Andrei Shleifer (2009: 380) puts it, “The consensus that aid has failed is nearly universal among those who look at the data.”<sup>5</sup> Aid cannot solve economic problems.

So, what can aid do? Like other forms of central planning, aid can increase X by devoting additional resources to X’s production. Returning to our example from the Soviet Union, aid can produce more scientists and engineers. If planners pick a specific outcome, such as more immunizations, aid can provide additional resources to produce immunizations. All of the “success stories” that aid’s advocates highlight are of this nature.

In his book *The End of Poverty*, aid’s most prominent academic advocate, Jeffrey Sachs (2006), provides a list of aid “successes.” These successes include the Green Revolution in Asia, the eradication of small pox, improvements in children’s health, dispersions of vaccines, reductions in the spread of malaria, control of African river blindness, the eradication of polio, improvements in family planning, and the mobile phone revolution in Bangladesh.

<sup>4</sup> For a discussion of Hayek’s “one will” idea and its relationship to Arrow’s impossibility theorem, see Boettke and Leeson (2002).

<sup>5</sup> See Easterly 2002, 2006; Leeson 2008; and Moyo 2009.

Though Easterly is an aid critic, the aid “successes” he highlights also involve increasing a particular output by devoting more resources to its production (Easterly 2006: 175–77). These successes include programs designed to keep Bangladeshi girls in school, reduce the percentage of malnourished children in Bangladesh, control tuberculosis deaths, improve child nutrition in Tanzania, and reduce infant mortality. Easterly (2009) argues that education and health programs in Africa in particular have been successful. He notes the achievements of the “elimination of smallpox, the near-eradication of river blindness and Guinea worm, the spread of oral rehydration therapy for treating infant diarrheal diseases, DDT campaigns against malarial mosquitoes ... and the success of WHO vaccination programs against measles and other childhood diseases. The aid campaign against diseases in Africa ... is likely the single biggest success story in the history of aid to Africa” (Easterly 2009: 406–07).

In pointing out that aid can produce more of a given output by increasing expenditures on that output, we have delineated the *maximum* aid can do. In many cases aid has failed even to achieve this. Sometimes aid resources intended for a particular output do not lead to more of that output because of incentive problems and a lack of knowledge about local conditions that impede aid’s application.<sup>6</sup> Corruption is sufficient to prevent aid from increasing a particular, targeted output. If a recipient government corruptly appropriates aid resources intended for vaccinations and diverts these resources to its supporters instead, vaccinations may not increase despite the attempt to devote more resources to their production.<sup>7</sup>

## Conclusion

At least in principle, foreign aid can increase X by devoting more resources to X’s production. In some cases aid has managed to do this in practice. Aid advocates herald these cases as evidence of aid’s “success.” However, these cases are “successes” in the same sense that

<sup>6</sup> In fact, Coyne and Ryan (2009) find that a large amount of foreign aid goes to the world’s worst dictators, which suggests that some aid programs might be financing the accomplishment of a single, illiberal end.

<sup>7</sup> On the problems of government failure that can plague the foreign aid process as much as other political processes, see Tullock (2002). On these problems in the foreign aid process in particular, see Gibson et al. (2005).

the Soviet Union's army of scientists and engineers was a "success." They are successes of increasing a predetermined output by devoting more resources to its production. They are not economic successes. Aid cannot, and has not, increased economic growth. Economic growth requires a solution to the economic problem of how to allocate resources in ways that maximize their value. Like other forms of central planning, aid necessarily remains silent on this question. In this much more important sense, aid's critics are correct that aid has failed.

Aid's advocates and critics should be clearer about what they mean when they say aid can and can't "work." The distinction this article makes explains why it is possible to both acknowledge the aid "success stories" that aid's advocates highlight and consider aid a doomed approach to development. By clarifying what aid can and can't do, we hope our analysis helps economists and policymakers evaluate aid's potential more sensibly.

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