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Ideas for a More Prosperous Nation

ECONOMIC NOTE

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International Aid: How to Encourage Development in Poor Countries?

The poverty that is so widespread in developing countries, especially in sub-Saharan Africa, is one of our era's greatest challenges. A billion people continue to survive on less than a dollar a day and 30,000 children die each day of diseases or malnutrition[1]. Colonialism and slavery clearly left their mark, but how can they be held responsible for the extreme poverty of sub-Saharan Africa when places such as Hong Kong and Singapore prove that it is possible to achieve real economic miracles despite a colonial past?

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And even if slavery constitutes an undeniably dark period in history, it cannot explain everything. Ivory Coast, for instance, was one of tropical Africa's most prosperous countries after independence in 1960. Only later, long after slavery ended, did this country fall into a serious slump, leading its population into misery.

The ineffectiveness of current international assistance

In the last half-century, developed countries have poured more than $2.3 trillion into international assistance.[2] Africa, the region of the world that receives the most money, was given $813 billion.[3] However, it remains the poorest part of the planet, despite its enormous economic potential and its substantial oil reserves and mineral resources. By way of comparison, in 1960, South Korea was as poor as Ghana or Zambia. Today it is among the rich countries and devotes a portion of its GDP to development assistance.

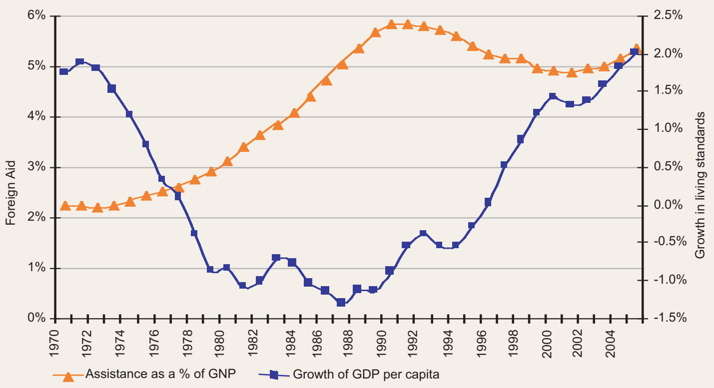
International assistance enjoys popular favour, since extreme poverty can leave nobody indifferent. However, not only has it not fulfilled its goals, but most countries in sub-Saharan Africa have seen their living standards drop in the last several decades. For example, from 1975 to 2000, GDP per capita in sub-Saharan Africa fell at an average annual rate of 0.6%.[4] These countries lost ground in the 1990s despite annual assistance equal on average to 12% of their GDPs[5]. Sierra Leone saw its standard of living fall 5.8% a year from 1980 to 2002, even though it received aid equivalent to 15% of its GDP. Over the same period, Zambia became poorer at an annual pace of 1.8% of GDP, despite assistance equal to 20% of its economy.[6] Empirical research shows that there is no link between international aid and economic growth. One researcher,[7] for example, found that international assistance provides neither for investment growth nor for rises in human development indicators. He observed, however, that it has led to growth in the size of government.

Figure 1 shows that rich countries displayed growing generosity toward Africa but that their efforts to overcome poverty were in vain. Several points explain the ineffectiveness of international aid. First, aid is based

1. See Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time*, Penguin Books, 2005.
2. William, Easterly, *How Will Greater Foreign Aid Help The Poor This Time?*, Heritage Foundation, July 2006.
3. Sarath Rajapatirana and Deepak Lal, *The Triumph of Hope Over Experience*, American Enterprise Institute, August 2007.
4. Thompson Ayodele, Franklin Cudjoe, Temba A. Nolutshungu and Charles K. Sunwabe, *African Perspectives on Aid: Foreign Assistance Will Not Pull Africa Out of Poverty*, Cato Institute, September 2005.
5. Nancy Birdsall, Dani Rodrik and Arvind Subramanian, "How to Help Poor Countries," *Foreign Affairs*, July/August 2005.
6. William Easterly, *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good*, Penguin Press, 2006, p. 347.
7. Peter Boone, "Politics and the Effectiveness of Foreign Aid," *European Economic Review*, Vol. 40, No. 2 (February 1996), pp. 289–329.

FIGURE 1

International aid and changes in living standards in sub-Saharan Africa



Source: World Bank, *World Development Indicators 2007.*

on the hypothesis that African countries suffer from poverty because they lack financial resources. But economic success depends above all on individual abilities and on the institutional context in which citizens live.[8]

Moreover, international assistance often leads to unintended consequences, such as causing internal struggles for the control of funds and kindling greed among groups with little interest in the collective well-being. In the last several decades, merely 20% of the amounts sent to African countries went directly to populations in need and were used to relieve misery.[9] The difference often goes toward buying weapons or is diverted by corrupt leaders and transferred to Western bank accounts. Sums remaining in the country contribute to patronage and to the politicization of economic activity, feeding corruption and sustaining governance problems.

Even if we ignore this reality, international assistance in its current form is not necessarily effective for the economy. Since governments often finance undertakings in which the private sector refuses to invest, aid is channelled to projects which are not financially viable. For example, in 1979 it enabled the Nigerian government to build a steel mill costing $5 billion. Nearly 30 years later, this mill has yet to produce anything![10]

Figure 1 thus shows a vicious circle: poverty leads rich countries to assist sub-Saharan Africa, but this assistance causes perverse effects and misallocation of resources that, in turn, increase poverty, leading rich countries to raise their levels of assistance, and so on. To break this circle, donor countries will have to choose between abolishing international aid programs and radically transforming them.

The engines of growth

While countries in East Asia were as poor as those in sub-Saharan Africa not so long ago, they have achieved such enormous growth that it is worth exploring their experience. For example, Singapore's living standards rose 1,048% between 1960 and 2005, whereas Ivory Coast's were up just 2% and Zimbabwe's fell back 9%. Why has Asia succeeded where Africa failed?

In the last 50 years, East Asian countries have opened their markets, facilitated exports, kept import tariffs very low, eliminated quotas and let their currencies float. Studies show that the more a country is open, the wealthier it is (see Figure 2) and the faster its economic growth.[11] The most open countries recorded average growth of 5% during the 1990s, while closed countries grew just 1.4% a year.[12] These results can be explained by the fact that trading enhances resource allocation, providing for gains from specialization and for incentives that improve production methods and create to economies of scale.

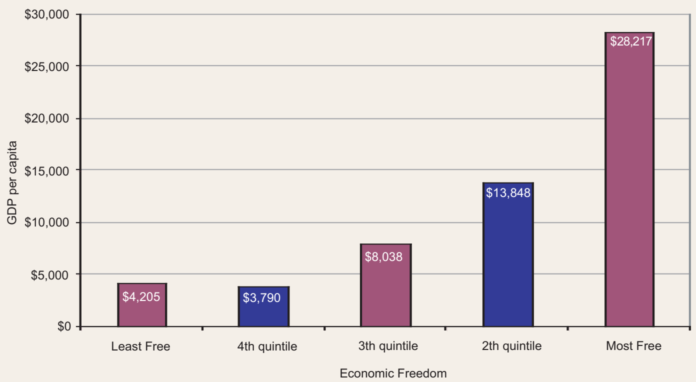
If they really wish to help, wealthy countries should first reduce their customs tariffs and stop subsidizing their farmers. Their protectionist policies hold back the development of sub-Saharan Africa: there can be no hope of aiding it without abolishing or at least substantially cutting tariffs. But sub-Saharan Africa also has a role to play in trade liberalization, for it is one of the most protectionist regions on Earth. While the rich countries cut their average tariffs by 84% between 1983 and 2003, sub-Saharan

Empirical research shows that there is no link between international aid and economic growth.

8. P.T. Bauer, *Reality and Rhetoric: Studies in the Economics of Development*, Harvard University Press, 1984, p. 43.
9. Christopher Preble and Marian L. Tupy, *Trade, Not Aid*, Cato Institute, June 2005.
10. William Easterly, *op. cit.*, Note 6, p. 51.
11. James Gwartney and Robert Lawson, *Economic Freedom of the World: 2007 Annual Report*, Fraser Institute, 2007.
12. Paul Collier and David Dollar, *Globalization, Growth, and Poverty: Building an Inclusive World Economy*, World Bank and Oxford University Press, 2002, p. 5.

Figure 2

GDP per capita based on economic freedom



Source: Heritage Foundation, *Index of Economic Freedom 2008*.

Africa reduced its own tariffs by just 20%. Moreover, sub-Saharan Africa's non-tariff barriers are four times higher than those of the rich countries.[13] Since protectionism is an obstacle to economic growth, African governments should liberalize their exchanges with the rest of the world, regardless of the policies adopted by developed countries. Hong Kong, Singapore, South Korea and Taiwan, to take only these examples, have benefited greatly from unilateral liberalization, and sub-Saharan Africa should not be afraid to do the same.

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Trade liberalization is a necessary but insufficient condition for the development of poor countries. There is also a need to create an economic context promoting private initiative and commercial exchanges and enabling everyone to show a spirit of enterprise, to benefit from the results of their success and to assume responsibility for their failures. In other words, economic freedom, without which a country cannot develop, must be implemented.

Each year the Heritage Foundation and *The Wall Street Journal* publish their Index of Economic Freedom, analyzing the level of economic freedom in 162 countries based on 10 representative variables such as the freedom to engage in business and the ease of investing or taking part in trade. The results (see Figure 2) show that the richest countries are also the freest. This is not a simple correlation but a cause-and-effect relationship: economic freedom leads to higher living standards[14].

This causal link can be explained by the fact that labour market rigidities, bureaucracy, voracious taxation, corruption and obstacles to trade hold back economic growth by raising the cost of all activity. The result is that entrepreneurial initiatives are stifled, and the most talented people have an incentive to pick up and go to countries offering a climate that is better suited to business.

The link between economic freedom and prosperity is observable within sub-Saharan Africa, where the least oppressive countries are also the wealthiest.[15] On a worldwide scale, it is also in the freest countries that the lowest unemployment, inflation and infant mortality rates are recorded, as well as the highest foreign investment levels, the longest life expectancy, the lowest corruption levels and the greatest environmental quality. It is also in the freest countries that individual liberties are most entrenched.[16]

In addition to being highly protectionist, countries in sub-Saharan Africa are marked by political oppression, state guidance of the economy, corruption, absence of the rule of law (notably in the area of private property) and disregard for individual freedoms. For example, it takes 233 days to start a business in Guinea-Bissau, and 119 days in Angola. In contrast, it takes just two days in Australia and three days in Canada.[17] The marginal income tax rate is at 65% in Chad, 60% in Ivory Coast and 50% in Gabon and Senegal. Business tax reaches 40% in Chad and ranges between 37% and 39% in Cameroon, Benin, Togo and Congo.

How can international assistance be improved?

Since economic freedom is essential to a country's development, assistance provided to poor countries must favour assistance that brings significant institutional reforms, such as the application of clearly defined property rights. In poor countries, individuals

13. Marian L. Tupy, *Trade Liberalization and Poverty Reduction in Sub-Saharan Africa*, Policy Analysis No. 557, Cato Institute, December 2005.
14. John Dawson, "Causality in the Freedom Growth Relationship," *European Journal of Political Economy*, Vol. 19, No. 3 (September 2003), pp. 479-495.
15. Brett D. Schaefer, *Economic Freedom: The Path to African Prosperity*, Heritage Foundation, February 2003.
16. Gwartney and Lawson, *op. cit.*, Note 11, pp. 23-27.
17. Heritage Foundation and The Wall Street Journal, *Index of Economic Freedom*, 2008.

cultivate the land and use available resources, but very few have property titles, without which nobody knows who owns what. It thus becomes impossible to sell or insure assets or to use them as collateral for loans. According to Hernando de Soto,[18] nearly 80% of the world's inhabitants live without property rights, meaning that billions of dollars in assets are unavailable instead of contributing to economic growth. In practice, this means that farmers and business people dare not invest because they have no certainty of being able to enjoy the fruit of their labour. The need to protect property rights creates the need for justice systems to apply criminal law (to punish theft and fraud) and civil law (to guarantee compliance with contractual agreements).

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Rich countries could also help sub-Saharan Africa develop microcredit to provide small loans to entrepreneurs or artisans who may appear insolvent. Microcredit promotes the realization of projects on a local scale. This favours a more effective form of development than some major government initiatives that benefit only the wealthiest. Microcredit produces superior results compared to intergovernmental assistance or debt forgiveness. It enables individuals to find ways of improving their lives on their own in addition to easing social mobility and the expansion of an entrepreneurial class.

It would also be worth encouraging societies to turn to the private sector in executing infrastructure projects, with local businesses invited to take part. This would offer a way of avoiding white elephants, of starting up projects that fit in with the local economy and meet broader constraints, and of promoting efficient work and production methods. However, there is a need to ensure that the private sector itself does not fall hostage to corrupt leaders.

The world must move beyond good intentions and a popular temptation to turn to celebrities as a substitute for international aid policies. Instead, the problems of underdevelopment must be attacked, realistically and credibly, at their roots. Too many development programs and policies are defined primarily to serve the interests of donor countries.

Finally, to enable Africa to emerge rapidly from its quagmire, wealthy countries will have to review international assistance in order to strengthen its institutions, make public spending transparent and improve legislative and judicial functions. They would also have to make sure that sub-Saharan Africa becomes more integrated in the world economy and that it strikes down obstacles to entrepreneurship, establishes the rule of law and promotes healthy governance.

18. Hernando de Soto, "The Secrets of Non-Success," *Time magazine,* April 16, 2001.

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