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Exploring the failure of foreign aid: The role of incentives and information

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Abstract The stated purpose of foreign aid is to promote economic and human development. Recently, the ability of foreign aid to achieve its goals is called into question. Widespread conceptual and empirical literature suggests that foreign aid is ineffective. This paper explores the failure of foreign aid relying on the role of both incentives and information. The success of aid depends on incentives faced by all parties in donor and recipient countries. In addition, both donors and recipients must obtain the necessary information to actually target and achieve desired goals. This analysis provides a double-edged sword to explain why foreign aid fails to achieve development goals.

Keywords Foreign aid · Development · Incentives · Information

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1 Introduction

In 2006, $103.6 billion dollars of foreign aid flowed to developing countries. Over the past 50 years, the amount of foreign aid dispersed totals over $2.3 trillion 2006 dollars (Easterly 2006a, p. 4). However, despite a large amount of time and resources devoted to development assistance, a lack of theoretical consensus surrounding the effectiveness of foreign aid remains. Two competing theories have emerged. The public interest theory argues that foreign aid is necessary to fill a financing or investment gap, and this will in turn lift countries out of a so-called poverty trap (for example, Sachs 2005). This remains the core argument for the use of foreign aid over the last 50 years. A contrasting theory, a public choice perspective, contends

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that foreign aid is ineffective and possibly damaging to recipient countries (Bauer 2000; Easterly 2001).

Upon recent examination, a large empirical literature illustrates that foreign aid exhibits a zero effect on growth or any other indicators of poverty, supporting the public choice theory (Boone 1996; Svensson 1999, 2000; Knack 2001; Brumm 2003; Ovaska 2003; Easterly et al. 2004; Djankov et al. 2006a; Easterly 2006a; Powell and Ryan 2006; Williamson 2008). Svensson (1999) and Burnside and Dollar (2000) do find a positive effect of aid on growth when combined with the right conditions, specifically the right policy and institutional environments. However, Leeson (2008) offers an alternative explanation. Most developing countries have weak institutions and bad policies, contributing to why they are poor. Thus, where aid is needed, it will be unhelpful because the necessary institutions are lacking. Where it can do some good, in those countries with good policies and institutions, it is not needed.

For example, Easterly (2007b, p. 4) states that "$568 billion in today's dollars flowed into Africa over the past 42 years, yet per capita growth of the median African nation has been close to zero. The top quarter of aid recipients…received 17 percent of their GDP in aid over those 42 years, yet also had near-zero per capita growth. Successful cases of development happening due to a large inflow of aid and technical assistance have been hard to find..." Also, Easterly notes that the recent success stories of China, India, and Vietnam received a small percentage of aid relative to their GDP (Easterly 2007b).

The stated goal of foreign aid is a rather large one: to end extreme world poverty and achieve development in poor countries (United Nations Millennium Project 2005). Jeffrey Sachs supports this broad goal and argues that extreme poverty can be ended in our lifetime (2005). Comparing these goals with the strong empirical findings, suggesting that development aid does not actually achieve development, is leading many economists to call foreign aid a failure. It should be noted that small successes such as increasing adult literacy in Africa have been achieved with the use of foreign aid. However, proponents of aid argue that it can deliver widespread prosperity, not marginal successes. Therefore, when foreign aid's goals are compared with its achievements, the results are extremely disappointing.

This paper explores potential explanations as to why foreign aid does not deliver economic success. Not only will this insight shed light on why foreign aid aimed at economic development failed in the past but this analysis can be extended to explain why we should not expect foreign aid to achieve economic development in the present or the new human development goals, as outlined by the Millennium Development Goals. With the recent resurgence surrounding the capabilities of foreign aid, an examination of why foreign aid fails is called to order.

This paper explores the failure of foreign aid with a twofold approach. My framework includes arguments that rely on the role of incentives and information. Foreign aid alters incentives for both governments and citizens within these countries. I explore in depth how incentives in donor countries, aid agencies, and recipient countries shape the ultimate outcome of foreign aid. Secondly, the paper demonstrates the role of information, or knowledge, in effecting aid outcomes. I show how both donors and recipients may not have the information or knowledge to actually target and achieve the desired effects. These conjectures are mainly conceptual and are supported largely by case studies, examples, and anecdotal evidence available in the current literature.

Several studies highlight how foreign aid fails and give possible conjectures as to why (Prokopijevic 2006; Leeson 2008; Coyne and Ryan 2009). My work can be viewed as an extension of these studies. While previous research illustrates the importance of either incentives or a lack of information, they do not fully bring these arguments to bear nor do they rely on both powerful arguments simultaneously. For example, some proponents of aid argue that the incentive problems can be overcome (for example, Sachs 2005). In these debates, how to overcome the lack of information or knowledge is often overlooked. On the flip side, some argue that tapping into the knowledge of how to achieve development is possible (for example, Easterly 2006a). However, overcoming the incentive issues is usually not addressed.

I attempt to establish a more general framework relying on *both* incentives and information in order to understand why foreign aid fails to deliver. When combined, the incentives/information argument is a double-edged sword that deflates the optimism surrounding proponents of foreign aid. Although I separate out the arguments into either incentive or information based, these issues are intertwined and connected to one another. Incentives and information go hand in hand. For example, it may be the case that the incentives are not in place to gather critical knowledge. It is also a possibility that once an intervention takes place without the sufficient knowledge, individuals operate with a different set of incentives than they previously faced. Many of the examples that follow do not fall neatly into one category and may illuminate both an incentive and information failure. Therefore, relying on both incentives and information provides a deeper insight into the key problems with foreign aid.

The remainder of the paper proceeds as follows. Section 2 discusses incentives faced by both donors and recipients. This section first outlines the theoretical framework for the analysis using insights from public choice. A subsection for both donors and recipients is provided to give specific illustrations of the various stakeholders' incentives that must be overcome. Section 3 discusses the role of information in designing and implementing foreign aid policy. A theoretical framework is also provided in this section, drawing largely from Hayek, with following subsections to describe the knowledge problems for both donor and recipients. Section 4 concludes.

2 Incentives: a public choice analysis

In the analyses of the effectiveness of aid, the motivations and incentives faced by all involved are often overlooked or assumed to be benevolent. In many cases, it is presumed that the individuals involved put aside their own interests and act in the best interests of the developing countries.[1] This implies that agencies involved with dispersing and receiving foreign aid take the most effective means of achieving the stated ends. This line of reasoning takes for granted that donor countries or aid agencies are unbiased in their initial decision to donate to a specific country, as well

[1] Sachs (2005) supports this view.

as continual decisions to donate.[2] Further, this line of thought also presumes that recipient governments allocate foreign aid in an effective manner in order to accomplish the required tasks. However, public choice insights call these assumptions into question. The decision-making process surrounding aid disbursement is burdened with different stakeholders, special interests, and rent-seeking activities. The aid process entails various layers of self-interested actors that include donor and recipient governments, donor agencies, producers, and citizen interest groups.

Public choice applies the same logic of private actors to public actors where individuals act based on their own desires and concerns. Voter behavior and special interests groups will influence the actions of both donor and recipient governments and aid agencies. Meanwhile, bureaucrats in positions to disperse aid will attempt to influence the process by maximizing their budgets and attempting to create a demand for their services. Politicians in both countries may seek to pursue their own agenda in the disbursement and allocation of foreign aid.

The main result from the public choice model applied to foreign aid is that those involved in the process may fail to facilitate coordination and cooperation that is necessary to achieve development. Instead, these various groups may actually contribute to the persistence of low growth as they pursue their own narrow interests. There is little reason to believe that the best policies and practices will actually be adopted and implemented. To further highlight and understand the role of incentives in shaping the outcome of foreign aid, a subsection on both donors and recipients is provided.

2.1 Donor incentives

Donor countries and aid agencies face their own incentives when developing foreign aid policy that ranges from special interest groups, bureaucrats, and government strategic interests. This section explores how the incentives faced by these groups shape the effectiveness of foreign aid.

Politicians within donor governments are constrained to some extent by public opinion and by a larger extent, special interests. Individual voters do not have the incentive to become informed about foreign aid policy and remain rationally ignorant. However, special interests groups within the donor countries do have the incentive to become informed in order to secure large benefits while dispersing the costs among the larger population. It follows that we should not expect politicians in donor countries to actually form foreign aid policies that will promote development due to special interests influence.

To illustrate this point, consider the following example. Producers in the donor countries are interested in affecting various development supplies and projects. They are interested in securing rights to supply aid-allocated resources in recipient countries. These producers find it in their best interest to lobby the donor

[2] Foreign aid is defined as all public official development assistance received. This can be in the form of a loan or a grant. Foreign aid does not include private donations. Donor countries refer to the bilateral donations that occur from one government to another. Aid agencies refer to the multilateral donations from such groups as the World Bank, International Monetary Fund, and the United Nations.

government for projects that will benefit their specific purpose. These lobbying efforts need not align with the best aid projects being implemented or with the most efficient producer securing the rights to provide these services. In fact, if the producers are very successful, they may even be able to secure unnecessary, expensive projects. Donor governments submit to these lobbying efforts to appease politically important domestic producers. Supporting this argument, Younas (2008) provides empirical evidence indicating that aid allocation motivation stems partly from potential trade benefits that accrue to the donor country. Foreign aid is dispersed more to recipient nations who import capital goods from the donor country.

Easterly and Pfutze (2008) highlight three ineffective aid channels that result from special interest incentives: tied aid, food aid, and technical assistance.[3] Consider the practice of tied aid. Tied aid is one of the more obvious structures of aid that highlights the role of special interests groups in aid disbursements. Tied aid requires recipients to purchase a certain percentage of goods from the donor country. This practice tends to result in donor producers overcharging recipients due to their increased market power and prohibiting recipients from being able to purchase goods cheaper elsewhere. Domestic producers find it in their interests to try and secure a position where their products are related to the tied aid. Easterly (2006a) finds states that the United States requires about 75% of its aid to be spent on products from American companies. Other donors have similar requirements.

Food aid is another ineffective channel that is often preferred by donor special interest groups. Food aid is mainly in-kind provision of foods that typically could be purchased much cheaper in recipient local markets. It is argued that food aid is a mechanism for high-income countries to dump excessive agricultural products onto markets in developing countries. If this is the case, it is not much of a stretch to make the connection between agricultural special interests groups lobbying the donor government to disburse food aid in order to keep prices higher in the donor country.

The third ineffective aid channel is technical assistance. Technical assistance is activities that provide certain skills or technical knowledge to developing countries. This form of assistance is often tied and viewed as another mechanism reflecting donor interests. Easterly (2006a) claims that technical assistance is worse than other forms of tied aid because donors usually require these technicians to be from the donor country. What follows is recipients handing the aid back to consultants in the donor country that may or may not understand the local problems. Tied aid, food aid, and technical assistance provide three specific examples how domestic special interests groups shape donor incentives that alter the effectiveness of aid policy.

Not only do special interests influence aid policy but bureaucracy does as well. Bureaucracies face their own set of incentives. Aid agencies operate in a perverse environment that hinders their abilities to succeed. These perverse incentives stem from such problems as negligible feedback from beneficiaries, hard to observe outcomes, and low probability that bureaucratic effort will actually translate into favorable outcomes. To respond to these incentives, aid bureaucracies organized

[3] The average percentage shares for tied aid, food aid, and technical assistance are 21%, 4%, and 24%, respectively, for bilateral donors (Easterly and Pfutze 2008).

themselves "as a cartel of good intentions, suppressing critical feedback and learning from the past, suppressing competitive pressure to deliver results, and suppressing identification of the best channel of resources for different objectives" (Easterly 2003, p. 34). Rashid (2005) provides support for this argument, stating that aid agencies suffer from considerable mismanagement, and questioning their performance is equally important.

Due to multiple donor agencies, incentives to be held accountable for aid failures are weak, and thus, no one agency is held responsible. In other words, there are too many principles, and multiple principles weaken the incentives to achieve results (Easterly 2006c). For example, the World Bank, IMF, Inter-American Development Bank, United States Agency for International Development, US Drug Enforcement Administration, British Department for International Development, plus several more agencies, are all operating in Bolivia. Each of these agencies affects the outcome but no one agency is ultimately held responsible.

Bureaucrats in both government and aid agencies face their own incentives. Donors, especially aid agencies, prefer to focus on aid disbursements as the preferred measure of success. Not only are disbursements observable but they are also the agency's budget, and an agency's budget is its source of existence. Bureaucracies are budget maximizers. Bureaucrats face the incentives not only to exhaust their current budget but also to ask for increases in their budget in order to increase the size of the agency. Given the larger development goals foreign aid seeks to promote, there is no reason to assume that bureaucracies found in donor governments and aid agencies will choose to pursue the most efficient policies and strategies, given the incentives that they face.

To highlight this point, let us turn to one of the largest organizations involved in foreign aid, United Nations (UN). The United Nations is the largest sponsor of the Millennium Development Goals (MDGs), the blueprint of foreign aid today. Easterly (2006b) asserts that the United Nations not only supports the MDGs to help the poor but also as a way of helping itself. In fact, Secretary-General Kofi Annan explicitly comments on the MDGs at the UN World Summit in 2005 saying "it is also a chance to revitalize the United Nations itself".[4] At this same summit, Annan cites the many failures of foreign aid and the MDGs, yet instead of taking responsibility for the failures he calls for *more* aid as the solution. This example supports what the public choice theory predicts. The UN is acting as a budget maximizing bureaucracy calling for increases in foreign aid in order to increase its own budget and thus increase its agency.

The UN is not the only aid agency that points out aid failures but still calls for more of it. The World Bank and International Monetary Fund do the same thing. This is not a recent phenomenon either. This bureaucracy mentality can be traced throughout the existence of foreign aid. At a UN summit in 1977, the goal of universal access to water and sanitation was set for 1990. This goal is now included in the MDGs for 2015. In 1990, at another UN summit, the goal of universal primary school enrollment was set for the year 2000. This goal is now also part of the MDGs set for 2015. No one was held accountable for these missed goals. Instead of taking

[4] http://www.un.org/summit2005/

responsibility, the agencies involved continue to call for more aid as the solution, not only retaining their agencies' role but also possibly increasing it in size.

The lack of accountability and the focus on aid disbursements rather than intended results not only lead donor agencies to not take responsibility for past failures but also to a "big plan" bias (Easterly 2006a). Donor governments, including politicians, and donor agencies prefer to set big, wide sweeping goals such as "ending extreme poverty", as opposed to marginal steps, such as provide more clean water to a specific location. This preference stems from the political incentives facing politicians and bureaucrats. Instead of choosing a few goals with the highest returns and lower costs, politicians will choose to do work on all goals in order to satisfy all parties involved. Aid agencies ignore tradeoffs and spread scarce resources over each goal, leaving the possibly attainable goals under-funded. By doing so, the benefits from specialization are lost, and ineffective policies are adopted, contributing to the failure of aid.

In addition to special interests and bureaucracy, political motivations surrounding aid disbursements also contribute to the ineffective adoption of aid policies. Previous literature indicates that donors disburse aid based on political motivation, not necessarily given to those who need it most (Mosley 1985a, b; Frey and Schneider 1986; Trumbull and Wall 1994). This research highlights another role of perverse donor incentives. Boone (1996) shows that aid reflects the relatively permanent strategic interests of donors. This argument is based on the idea that aid is given as a strategic, political move, and not necessarily based on need.

For example, Alesina and Dollar (2002) find that how much aid a recipient country gets is affected by whether the recipient is a former colony and the regularity with which a recipient country votes with the donor in the United Nations. Other evidence shows that allies in the war on terror, such as Central Asia, Pakistan, and Turkey, were rewarded with new aid from donor agencies after September 11, 2001. This political motivation shapes the form that aid policies take and can contribute to why aid is not achieving its goals.

In addition to the large-scale aid organizations, nongovernmental organizations (NGOs) may suffer from these same weak incentives cited above, including bureaucratic pitfalls. Werker and Ahmed (2008) show that support for development NGOs has risen significantly in the past 20 years. These supporters idealize NGOs, stating that these organizations do not have the same problems as other development agencies, and they possess the ability to provide real assistance. Werker and Ahmed provide evidence that NGOs suffer from weaknesses, including inefficient, multilayer decision making, low-quality service due to a lack of feedback, and agenda control stemming from pressure from national governments, their largest donors. NGOs may be able to provide humanitarian assistance, but they are not the "magic bullet" in the development process. The weaknesses found in NGOS as well as other aid agencies are primarily due to the fact they are not exposed to the competitive market process.

This section illustrates how donor agencies, both bilateral and multilateral, may have many different objectives for foreign aid besides poverty reduction, such as rewarding allies, promoting donor country exports, or maximizing budgets. Multiple objectives often work against each other and weaken each other, so that aid may end up serving none of its multiple goals especially well. The potential for donor incentives to be misaligned with general development goals is quite large, leading to the adoption of ineffective policies and contributing to the failure of foreign aid. The next section applies the same public choice analysis to the role of recipient incentives in shaping the outcome of foreign aid.

2.2 Recipient incentives

Recipients of aid face their own incentive structure. These recipients include the receiving government, individual citizens, and special interests groups within these countries. This section provides examples as to how the incentives faced by these groups shape the success or failure of foreign aid.

Foreign aid disbursements go to the ruling governments in aid receiving countries. What incentive do these governments have to actually achieve results? Most of the governments receiving large sums of aid are already corrupt, contributing to why they are poor in the first place. According to Coyne and Ryan (2009), the world's worst dictators have received $105 billion dollars under the guise of official development assistance. Instead of helping the poor, development assistance is aiding the ability of dictators to remain in power. Also, Alesina and Weder (2002) do not find any evidence that aid donors give less to corrupt governments. They actually find in some cases that donors give more.[5]

Combining the lack of accountability and enforcement from the donors with the fact that so many recipient governments are corrupt can promote poor incentives for the receiving governments to properly allocate aid resources. Essentially, recipient governments do not have any incentive to achieve results. In fact, it is possible that governments actually do not want to achieve results. Easterly (2007b) argues that these governments explicitly want to keep down the productive capability of the poor due to the potential of creating political activism that would threaten the current political regime. In addition, special interest groups currently receiving favorable windfalls created from foreign aid will resist any change that may reduce their benefits, including policies that may be wealth enhancing.

This supports previous arguments from Bauer (1971) and Friedman (1958). They argue that politicians will not distribute aid in an effective manner as to achieve the stated goals of the aid programs. The political elite understand that they will benefit from aid flows by having access to more resources (aid), thus strengthening their relative positions and keeping them in power.[6] As public choice theory would predict, governments of the poor have an incentive to misappropriate foreign aid in a manner that serves their own self-interest. Fearful that development might bring about their downfall, officials in these governments have the incentive to use or misuse aid in a manner that promotes their regime maintaining power.

These governments understand that they will benefit from foreign aid, creating additional incentives to not only misallocate aid but also to seek out an environment that actually attracts it. If foreign aid disbursements are allocated based on the level

[5] Easterly (2006c) shows that countries still receive loans after failure to reform and after failure to repay the loans.

[6] Bauer (2000) argues that the structure of aid facilitates its failure. The money goes to the rulers, not the people, supporting bad policies and reinforcing a damaging government.

of poverty in a country and governments of these countries want to be attractive to donors, recipient governments might actually have the incentive to keep the country in poverty. This creates a moral hazard problem. Brautigram and Knack (2004) illustrate the existence of a moral hazard problem surrounding foreign aid. Aid allocation may encourage impoverishing policies because as the damaging policies create misery, the more likely donors are to grant more aid to try and alleviate the impoverished conditions.

In addition to the allocation of aid, debt forgiveness also creates a moral hazard problem. Supporters of debt forgiveness argue that it will free up money that governments can spend to provide relief to the poor. However, irresponsible lending and borrowing practices only promotes the same impoverishing policies these governments are pursuing (Easterly 2002). Thus, aid and debt forgiveness might make governments less likely to put in place the policy framework, institutions, resources, and necessary personnel needed for development.

Bauer (2000, p. 43, 48) provides examples of governments engaging in such corrupt behavior but continuing to receive foreign aid flows despite adopting damaging policies. Examples of such policies chosen by governments receiving aid include persecution of productive ethnic minorities, suppression of trade, restriction of foreign capital, expropriation of property, restrictions on external contracts and domestic mobility, and extensive economic controls. More specifically are the examples of Ethiopia and the Sudan in the 1980s. The destructive polices these governments adopted over this time period created massive poverty. This created an environment effective for eliciting large sums of foreign aid (Bauer 2000).

Not only do the governments of countries receiving foreign not exhibit incentives to promote efficient usage but also special interest groups and individual citizens within these countries also face incentives that can contribute to the failure of aid. For example, similar to the moral hazard situation facing government is the “Samaritan’s Dilemma” facing citizens. Buchanan (1975) not only identified that foreign aid may prop up brutal regimes but also that aid created the Samaritan’s Dilemma. By giving foreign aid, the “Samaritan”, or the donors, alters the incentives faced by those receiving it. If the recipients believe that future poverty will increase the likelihood of more foreign aid, aid could actually worsen incentives to invest. Instead of saving and investing, citizens now face an even stronger incentive to consume and become dependent on the donors; hence, the Samaritan’s Dilemma.

Boone (1996) empirically supports the existence of this dilemma. In his analysis, foreign aid has zero effect on investment. Instead, individuals chose to consume. Thus, aid finances consumption rather than investment, supporting Buchanan’s prediction. Coyne (2008) provides an example of the Samaritan’s Dilemma. Prior to the collapse of the Barre regime in Somalia, foreign aid accounted for more than 70% of Somalia’s budget. The aid actually created a dependency that has made change in recent years more difficult.

Easterly (2001) argues that prior to aid, if the incentives to invest are poor, then aid will not increase investment. A lack of investment from the poor indicates a lack of opportunities. These individuals simply do not have an incentive to invest in their future. If these individuals do not see any payoff from their investment, they engage in other behavior such as more consumption. These countries simply do not have supporting institutional arrangements that give the incentives necessary for individuals to engage in behavior that will promote growth.[7]

In addition to altering incentives to invest, aid may change incentives faced by individuals by altering the institutions, or the rules of the game. Previous research finds negative effects of foreign aid on institutional quality. Knack (2001) finds that higher levels of aid erode the quality of governance. Similarly, Heckelman and Knack (2008) show that higher aid actually slowed market-policy reforms over the period of 1980–2000. By altering the institutions, individuals now face different incentive structures. For example, Coyne and Leeson (2004) demonstrate how different institutional arrangements determine the type of entrepreneurship individual will engage in. Some institutional regimes promote wealth-enhancing activities, while other institutions promote destructive behavior. Foreign aid promotes the latter by destroying institutions and thus altering the incentives that individuals face. These incentives promote destructive behavior such as rent-seeking activities (Svensson 2000; Brautigam and Knack 2004; Harford and Klein 2005; Djankov et al. 2006b).

Providing further evidence, Moyo (2009) argues that African countries who received billions of dollars in aid are slipping further into poverty as those African countries rejected by aid donors are recording economic gains. She argues that foreign aid promotes corruption among the recipient governments, destroys the market process, and further promotes poverty. This process becomes a viscous cycle where countries receiving aid become more dysfunctional, unaccountable, and destitute, encouraging aid dependency.

As already noted in the previous section, donors have very little incentive to actually monitor how aid is allocated once it is in the hands of the recipient government. Corrupt governments are aware of this lack of accountability and do not fear any sanctions by not achieving results. These recipients are typically receiving aid from different donors, leading to multiple principles and thus weakening any incentive to achieve results.[8] In fact, recipients may actually engage in worse behavior to try and solicit more aid, creating a moral hazard problem. Individuals within recipient countries also do not have incentives to use aid efficiently. The fact that individuals did not invest before receiving any aid indicates a lack of opportunity. Foreign aid does not enhance opportunities and can actually worsen the incentives for individuals to invest in productive behavior due to the Samaritan's Dilemma and its perverse effects on the quality of institutions.

3 Information: Hayekian knowledge problems

Even if we assume that it is possible for the incentives of all parties involved to align in a manner that facilitates successful coordination surrounding foreign aid, we must address the possibility that both donors and recipients do not have adequate knowledge to achieve development goals. This section explores this possibility.

Hayek (1945) identified in his article "The Use of Knowledge in Society" the central problem to social coordination. This central problem, later known as "the

[7] For specific examples, see Easterly (2001).

[8] See Easterly (2006c) for more detailed description of principle–agent theory in foreign aid effectiveness.

knowledge problem", identifies that every society faces decentralized knowledge. Information is discontinuous, dispersed across many individuals, and often contained in inarticulate forms. Every society must find a way of tapping into this fragmented information in order for individuals and society to flourish.

Hayek applied this insight in order to successfully argue that central planning could never achieve widespread wealth because not one person or group of persons holds all of the information necessary to successfully coordinate an economy. von Mises (1922) illustrates that in a market economy, it is not necessary for one person to hold all the information. An institutional regime built on private property disperses the necessary information to economic actors. These actors engage in rational economic calculation to make efficient decisions. Economic calculation hinges on the ability to gather essential information. This information-gathering process utilizes prices that reflect relative scarcity. Without such a price mechanism, decision makers do not have a guide as how to best allocate resources. Thus, central planning could never replicate what private property and a price system provide. Unlike markets, central planning has no mechanism of gathering and integrating the fragmented information that is held across many individuals. Central planning simply cannot tap into this local knowledge. Based on this argument, Hayek contended that only private, decentralized actors operating in the market are capable of achieving social coordination. In this section, I apply Hayek's key insight to foreign aid.

We should not expect foreign aid to be any different than coordination in other economic activities. The success of foreign aid involves coordination from both the donors and the recipients. On both sides, information is dispersed, local, and decentralized. Donors are very good at specifying goals and what they hope to achieve with the aid, but they may not know where aid is required, who it is needed by, in what locations, and in what quantities. Similarly, the poor in the recipient countries know what they need and in what quantities, but they may not know who has the aid or how to get it. I argue in the following subsections that effective foreign aid, just like successful social coordination, must solve Hayek's knowledge problems for both the donors and the recipients.

3.1 Donors' knowledge problem

In order for aid to be effective, donors must be able to gather critical information, requiring the ability to tap into local knowledge. Donors must recognize that aid is needed, figure out exactly what is needed and who needs it, and evaluate whether or not what they are doing is working. This involves some form of evaluation and feedback. Donors rely on the bureaucratic process to try and solve these knowledge problems.

The main obstacle in being able to tap into this necessary information is the fact that foreign aid is managed and organized by governments and other bureaucratic agencies. Government agencies are created to oversee foreign aid disbursements. These agencies often work with or answer to other aid agencies, such as the World Bank, each with its own internal bureaucracies. These layers of bureaucracy are a necessary and inevitable outcome of government controlled activities. It is necessary because government agencies, unlike private firms that are guided by profit seeking, have no such guide (von Mises 1944). Private firms only have to tell managers to maximize profits. This system of profits and losses provides a benchmark as to how well a manager is contributing to the firm's goal.

In contrast, government agencies do not seek to make profits nor do they use a system of profits and losses to direct activities. They do not have one rule for their managers or directors to live by. It is therefore difficult to ensure that managers in government contribute to the overall goal of the agency. Hence, some other guide must be employed. This political mechanism is bureaucracy. Detailed procedures and protocols replace the profit objective to guide and check managers' behavior (Sobel and Leeson 2007).

Although bureaucracy is essential to government run activities, it does hamper the ability to gather essential information necessary to achieve results. These unavoidable bureaucratic procedures and protocols create a separation between private knowledge and political knowledge. This separation severely limits the goals that agencies can successfully achieve. Some of the separation stems from the fact that aid agencies and donor governments actually face a lack of accountability and feedback. Bureaucracies do not utilize market forces to gain vital information. In addition, aid recipients have very little opportunity to give feedback to the donor agencies, and they have no mechanism of punishing agencies if they fail. This lack of accountability and feedback ties back into the incentives these bureaucracies face. Since results such as economic growth lack immediate feedback and are mainly unobservable, donors do not have strong incentives to attempt to gather necessary knowledge in order to achieve the stated goals. Therefore, the wedge between private and political knowledge can exist due to the inability of bureaucracies to use market forces that reveal information *and* due to a lack of incentive to actually attempt to gather the necessary information.

In addition, Tullock (2005) notes that the more monumental task requires greater amounts of coordination, resulting in a lower chance that government will be able to complete the goal effectively. Ending world poverty is perhaps one of the most monumental goals that governments and other bureaucratic agencies have undertaken. The lack of coordination among donors is paramount. Easterly (2007a, p. 13) states "A maddening problem in foreign aid for all concerned is the huge administrative costs on both recipient and donor sides from the duplication of donor efforts and their failure to coordinate their efforts with each other." For example, it is estimated that a medical officer in Tanzania spends 50–70% of the time writing reports and missions. Donor agencies are calling for more coordination among donors to relieve developing countries of administrative requirements (United Nations Millennium Project 2005; Commission for Africa 2005) but Easterly (2007a) notes that there is little sign of improvement. This lack of coordination hinders the ability to gather necessary information and contributes to the failure of aid.

Consider this example of how bureaucracy works in foreign aid surrounding the Millennium Development Goals. In a 2005 report, the UN calls for plans, strategies, and frameworks in order to achieve the 54 indicators, 18 targets, and the eight goals outlined. The 451-page report gives 36 different recommendations calling for 449 separate interventions (United Nations Millennium Project 2005). All of these steps represent how bureaucratic aid agencies attempt to fill the knowledge gap between what is needed and how to meet these needs.

Filling this knowledge gap can sometimes be quite difficult and lead to failed projects that actually hurt recipients instead of helping them. Consider the following example from Easterly (2006a): In the mountains of Lesotho, an aid project was implemented to develop modern livestock management and crop production and to gain access to markets. However, those living in this area realized long ago that cash crop production was not competitive given the regions' poor conditions. Also, they were not interested in farming because they were migrants who worked in South Africa with access to markets. The project was undertaken anyway and resulted in no improvements and some losses. The newly constructed roads intended to provide local farmers with access to markets actually worked in reverse, driving out the remaining farmers as crops were brought into the region.

To further illustrate these unsuccessful attempts, Easterly (2006c) compares what he calls planners (aid agencies) versus searchers (private workers or charities, for example). Several aid agencies and bureaucrats have attempted to help prostitutes in India by taking them out of the business and placing them in shelters to be trained in other professions. However, these other professions typically pay less than sexual services so the women return back to prostitution. The increase in the spread of HIV was causing major concern for these failed attempts. To try and combat this problem, a public health clinic in India decided to take another approach. The team learned of the subculture within prostitution and found that by engaging in peer education, condom usage dramatically increased, thus reducing the spread of HIV. This example illustrates how top-down planning was incapable of tapping into the local knowledge necessary to achieve its intended results, but decentralized actors guided by market forces were successful.

Easterly (2006c) provides several more examples that illustrate this main point. A searcher in Bangladesh figured out how to reduce maternal mortality by training teenage girls to treat common problems and deliver pre- and postnatal care. A hospital was built with the help of aid, but also through charging modest fees to patients. By charging fees, the workers are accountable to the patients, and the patients provide feedback for continual improvement. Also, in Bangladesh, was another searcher who discovered the large untapped demand for credit among the rural poor. Through experimentation, this searcher figured out a scheme to help meet these demands, what is known today as microcredit.

Other problems resulting from a lack of sufficient information on the effect of foreign aid are the unforeseen and unintended consequences on long-run wealth, creating capabilities recently documented in the literature. This list includes, but is not limited to, creating a dependency on aid, undermining local markets, destroying institutions, increasing conflict, increasing rent-seeking activities, and altering incentives to engage in less productive activities (Maren 1997; Bauer 2000; Svensson 2000; Knack 2001; Brautigam and Knack 2004; Djankov et al. 2006b). This illustrates that intervening in an economy through aid may create its own set of problems that donors simply cannot know and plan for all of the effects caused by foreign aid.[9]

[9] von Mises (1929) outlines the dynamics of interventionism where intervention creates a new set of incentives for both public and private actors. These new incentives create a situation where political actors must choose between revoking past interventions or call for additional interventions.

This section argues that donors, even with the best intentions, may be unable to coordinate successful foreign aid policy due to a lack of information and the inability to tap into local knowledge. In the following section, I argue that recipients may also suffer from knowledge problems that prevent foreign aid from being used effectively.

3.2 Recipients' knowledge problem

In addition to the donors, recipients must possess adequate knowledge about how to achieve these specific goals outlined by foreign aid. Even if we assume benevolence on part of recipient governments, we must recognize that they may not possess the necessary information to achieve results. Just like donors, recipient governments lack the ability to tap into the knowledge that is critical for success. In addition, the individual citizens in these countries who are aware of the local knowledge and are more likely to know what is needed may not be aware that aid is available or how to get it.

Recipient governments use the same bureaucratic process that is used in developed countries' governments, the only process available to agencies operating outside the marketplace. As stated above, this process is incapable of tapping into local knowledge that is necessary for development at any level. With foreign aid in hand, these poor mismanaged governments still must figure out who is in need, what is needed, and in what quantities. This may seem like a simple task, but as the previous examples illustrate, relying on the bureaucratic process, even in rich donor countries, to gather critical information often results in failure. If rich donor countries are incapable of solving the knowledge problem, we cannot expect the governments of poor impoverished countries to possess adequate knowledge to make aid effective.

Individuals in these poor countries often possess the knowledge necessary to achieve results; However, finding the foreign aid is often more elusive. Consider the process that a poor person in Tanzania must go through to get a road repaired. The Tanzanian informs a civil society representative, who informs government officials in Tanzania. These officials ask for help from aid donors by asking for a loan. To get a loan, the government must satisfactorily complete the necessary paperwork. Next, the paperwork is handled internally by the donor agency, which involves several internal detailed steps that ultimately end with officials developing a plan that may or may not finance the road repair. If the donor agency approves aid for the road, the money must pass through the Tanzanian national government, provincial governments, and district governments at which the district government decides whether or not to repair the road (Easterly 2006a). Even when individuals know what they need, cutting through the bureaucratic red tape to relay the essential information to aid agencies involves many costly steps that may not guarantee that the information gets delivered.

This section details how the lack of essential knowledge can hinder the success of foreign aid and possibly lead to worse outcome for recipient countries. Donor agencies must figure out what is needed, where, and in what form, while recipient governments must also figure out exactly what the needs are of the poor and what can be done to meet these needs. Even with good intentions, Hayek's insight provides the theoretical explanation as to why centrally planned, top-down approaches such as foreign aid will never be able to solve economic problems due to its inability to collect the necessary knowledge. The inability of aid agencies to gather essential information helps explain why foreign aid is not successful.

4 Conclusion

When taken as a whole, it is almost impossible for the current top-down, central planning like style of foreign aid to overcome both the incentives and information problems for both donors and recipients. Combining these issues, we should not be surprised that foreign aid does not actually achieve its intended results. The framework provided in this paper helps to explain why foreign aid failed in the past and why it will continue to do so in the future. Governments and aid agencies are simply incapable of creating either the incentives or the information necessary to achieve development.

Fortunately, we do possess a different approach that achieves development through aligning the right incentives and gathering the necessary information. Instead of relying on collectivist mechanisms, we could turn to private, decentralized actors operating in the market to achieve marginal successes. These private actors spontaneously emerge, can adapt to local conditions by tapping into the decentralized knowledge, and rely on feedback mechanisms for success. For example, this market process is highlighted by Bauer's small scale trading where entrepreneurs act as middlemen facilitating economic exchange and ultimately advances in economic development. This has a radical implication for aid policy: Donor agencies should be removed from the development process. In its place, the market should be allowed to coordinate the activities that promote economic success. This does not suggest that private, non-government-supported charitable organizations operating with a bottom-up approach should be removed from developing countries; however, it may be more beneficial to the development process if large-scale, top-down government-supported aid agencies are eliminated.

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