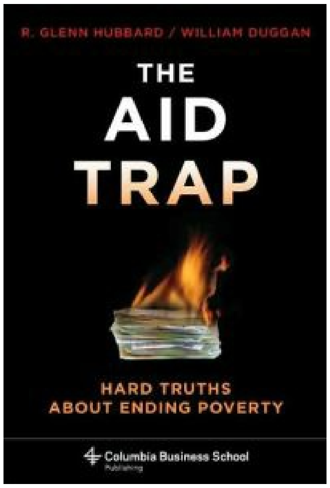

Book The Aid Trap

Hard Truths About Ending Poverty

R. Glenn Hubbard and William Duggan
Columbia UP, 2009
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Recommendation

Prosperous nations today spend more than $100 billion annually on aid to developing countries. Still, according to the World Bank "1.4 billion people live on less than $1.25 per day." Columbia University Business School academics R. Glenn Hubbard and William Duggan warn against funneling more money to corrupt governments and tinpot dictators for development projects that never materialize. Instead, they propose "a new Marshall Plan for the world's poorest nations." Like the original Marshall Plan that helped European countries rebuild their economies after World War II, the new program would focus on loans to help local businesses get off the ground. The authors thoroughly discuss where alternative plans have failed and are not shy about presenting the foreseeable obstacles and obvious downsides of their own plan. They explain in detail how to launch it, what institutions would be in charge and how they'd have to function. The authors even particularize the financing scheme by providing a detailed budget in the appendix. *BooksInShort* recommends this vital, thoughtful, interesting proposal on how rich nations can help poor nations lift their people out of poverty.

Take-Aways

- People fall into the "charity trap" if they believe that donations will eliminate poverty.
- Giving poor nations money destroys initiative, corrupts their leaders and makes their people dependent.
- Developed nations donate more than $100 billion to impoverished countries annually, but this financial aid has not made a significant difference.
- In fact, such aid keeps poor people down because it retards business development.
- The best way to lift people in poor countries out of poverty is to invest in the private sectors of their local economies.
- Throughout history entrenched interests have tried to thwart business development in undeveloped nations.
- The Marshall Plan was the most effective business development program in history.
- Industrialized nations should institute a new Marshall Plan to build up the business sectors of developing countries.
- Such countries would get economic aid only if they reform their business sectors.
- One single institution would be responsible in administering the aid of donor nations and supporting the developing countries' business development.

Summary

The "Charity Trap"

Churches, organizations and good-hearted people worldwide, including such high-profile celebrities as rock star Bono and actress Angelina Jolie, contribute time, money and prayers to help eliminate poverty and improve conditions in developing nations. But these well-meaning benefactors fall into the "charity trap" when they assume that donations alone can solve the undeveloped world's problems. They ignore the fact that their riches stem from business, not aid. Unfortunately, when poor countries and their citizens become dependent on charity and foreign aid, their local business sectors cannot thrive. If you are a poor person in such a country today, your best bet is to get appointed to a governmental position (funded by foreign aid) or to secure a job through a nongovernmental organization (funded by charity). This beats working for yourself as a farmer or artisan, but then your government has no need to develop a business sector.

"The Roots of Prosperity in the Modern World"

Throughout worldwide history, the business sector always has been the main driver in eliminating poverty. But it has never developed without obstacles. Competing fiscal forces and antibusiness conditions have slowed its growth and continue to do so in developing countries. To estimate a country's openness to business, the World Bank evaluates 10 "Doing Business" factors: What barriers restrict "starting a business, dealing with licenses, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts [and] closing a business"? Rich nations do well on the World Bank's list; poor nations do not. For example, Singapore topped the 2008 list; Congo-Kinshasa was last. History supplies further examples of the connection between the doing-business factors and a nation's wealth: In ancient, prosperous Rome, employing people (slaves) was too easy, investors did not really exist and property was not protected. Otherwise, it would have scored well on the World Bank's list.

> "The market has not worked in poor countries because it never had the chance."

After the fall of Rome (A.D. 500), the Arab Caliphate and Byzantine Empire became prominent. Their tyrannical rulers monopolized trade and seized their people's wealth. After them came Charlemagne and the feudal Holy Roman Empire. This model prevailed in Europe from 800 to 1800 AD and business did poorly in the face of nearly constant warfare. The Catholic Church forbade loans with interest, which kept Catholics out of commerce. At this time, business did well in Southeast Asia until it succumbed to the antibusiness, despotic models of China and India.

> "Business will never touch the heart the way charity does."

Venice, a great trading entity, revived the business system that had prevailed in Europe during the Roman era. "Fraternities," which began as family monopolies, developed into companies that moved beyond family ties. Big firms with similar histories evolved in northern Italy and later throughout Europe. In 1602, probusiness Holland formed the Dutch East India Company, "the world's first company financed completely by public shares." Other European cities and countries, particularly England, slowly adopted the Dutch economic system. Moving across the Atlantic, this Anglo-Dutch system became the *de facto* business model in the new American colonies. Over time, publicly held companies became the core of the Euro-American system.

> "If the charity system is bigger than the business system, prosperity will never come."

In the 19th century, Karl Marx and Friedrich Engels promoted antibusiness ideas. Russia adopted a socialist system, as did China. After the 20th century's Great Depression and World War I, Japan, Italy and Germany adopted National Socialism, based economically on government control of private business. World War II brought it to an end. With the fall of Communism, Russia and Eastern Europe became probusiness, but the Euro-American business-oriented system did not gain traction in developing nations.

"The Roots of Failure in Poverty Aid"

Russia won more gold medals than any other nation during Rome's 1960 Summer Olympics. Worldwide, people regarded its triumph as a validation of the communist economic system, which had helped turn Russia from a poor, backward country into a mighty power. Many newly independent nations in Asia, Africa and Latin America regarded Russia as a development role model. They adopted enough of its socialist system to "cripple their local business sectors." Ironically, these same nations accepted financial aid from "liberal business countries" in Europe, as well as the U.S. and Japan. Financial aid was supposed to buy nation's loyalties in the United Nations and to prevent some countries from trading only with communist-bloc nations. France, the U.K. and some other Western democracies were inclined toward moderate socialism themselves. Many poor nations followed the old Soviet model and established five-year plans, a structure that made giving them aid less complex. Emerging nations developed antibusiness economic systems due to:

- **"National socialism"** – Poor countries preferred to nationalize their industries to favor their own citizens instead of benefiting former colonial powers.
- **"Technology"** – In 1957, Sputnik lent credence to the belief that the Soviet Union had more advanced technology than the Western nations. Third World nations wanted to industrialize and develop technologically like the U.S.S.R.
- **"Tribalism"** – Tribal cultures dominate in Africa and bind the loyalties of tribe members. This breeds corruption, which is antithetical to business.
- **"Geography"** – Business depends, in part, on three geographic advantages: "farming, minerals and water transport." Africa is deficient in all three.
- **"Despotism" –** Tyranny is the "oldest enemy of business and the hardest to defeat." Despots depend on brutal force to remain in power. History proves that developing a strong business class is the ideal way to limit despotism.

> "A local well-digging company cannot compete with a foreign charity that digs wells for free."

Financial aid spurs the growth of developing nation's governments, which quickly form ministries to handle every concern: agriculture, mines, commerce, defense, justice, transport, trade, health, fisheries, labor, energy, foreign affairs, forestry, you name it. Why not? Financial aid foots the bill. In such nations, nearly all of the omnipresent civil servants expect bribes.

> "In Mozambique, it takes 12 steps to start a business. That means you go to 12 different government offices to fill out a form. That gives a job to 12 Mozambiquans behind the desks. They get their small salary plus the bribe you give them to get their stamp on your document."

During the Cold War, aid helped secure allies. Then, prosperous nations began asking what happened to the development their financial aid was supposed to be buying. Representatives of the financial-aid system came up with three reasons development remained invisible:

1) **Infrastructure development** – Aid helped poor nations improve their roads, ports and education and health care systems. Prosperity will follow, but not in the

short term. 2) **Corruption** – The system needs to control corruption, which siphons off aid money. 3) **Democracy** – Once governments become democratic, corruption will vanish. Until then, NGOs, not individual governments, should administer aid.

> "Of course you should not bribe local officials. But what if your competition does and you cannot compete if you don't do the same?"

These claims bought the aid system another decade. Unfortunately, these excuses were wrong.. A strong business sector brings prosperity and facilitates infrastructure development, not the other way around. "Anticorruption puts a band-aid on a dying patient." A thriving business sector works better than anti-corruption measures. It's true that NGOs do great work in many areas, including refugee relief. However, NGO village development projects have not translated to business development for poor nations. They never will. Yet the inefficient financial aid system endures for four reasons:

1.) **The "charity trap"** – People want to help.
2.) **The "self-interest" of those involved** – Development specialists, university academicians and other well-meaning aid givers are not business specialists. They would be out of work if financial aid became more business-oriented.
3.) **The "absence of advocates"** – Few individuals in the developed world support the idea that financial aid for poor nations should build up their business sectors.
4.) **The "lack of a strong alternative"** – Few methods currently exist to funnel large financial aid amounts into poor nations' business development projects.

> "Like most strong medicine, this new Marshall Plan will be very hard to take."

One small area of aid does work: microfinance. These small-scale loans enable poor people to decide for themselves how to use funds to build their own start-up businesses. However, microfinance can only do so much. It supports informal and nonregistered businesses that tend to "hit a ceiling" when they grow.

"The Marshall Plan as a Business Model"

The Marshall Plan, which rebuilt Europe after World War II, was the "largest probusiness aid program in history...about $20 billion per year in current dollars." The U.S. granted huge loans to private businesses to restart European economic production. These companies had to repay the money to European governments, which used the funds to restore the public infrastructure. They also instituted "probusiness policy reforms." European coordinators reported on their progress to a U.S. administrative group, the Economic Cooperation Administration (ECA). The Marshall Plan's focus was to get European business back on its feet – and it worked.

> "In the poor countries ... local business school graduates are the future foot soldiers of their own thriving business sectors."

A similar program could build up the business sectors of today's poor countries. Like the original, this new Marshall Plan would involve a single lending institution. This new ECA would lend money to businesses in impoverished nations that promised to "reform their business sectors." They would repay the funds to their governments, which then could use the money to develop infrastructure. Unlike most European countries, most African countries never had strong business sectors. The ECA would be responsible for helping them build it from scratch.

> "Foreign businesses are the best teachers for domestic business."

Prosperous nations would have to agree to funnel all of their economic aid through this new agency. Countries faced with the choice between business development or nothing would think twice about declining the offer. For the ECA to be effective, donor countries would need to grant it "bureaucratic autonomy." If all countries and interest groups insisted on controlling where the money went, they would try to mold the new system in their favor. That is what happens in the current system and it would have to stop.

> "You can never deliver enough charity to give poor people a decent life."

The poor countries of the world would "compete for funding." The ECA would award funds based on the World Bank's doing-business factors. The ECA would need a strong PR campaign to launch its program and drum up support. It could propose its plan at a conference attended by representatives of all the nations that wanted to receive financial aid. It could continue to hold client education and follow-up conferences throughout its lifespan.

> "Business cannot solve all the world's problems. It is hardly a charitable enterprise and certainly has its share of crooks."

The ECA would think out measures to assist small and medium-sized local businesses and to have a positive impact on the local economy. It would have to differentiate between programs that merely target the low-income bracket of developing and emerging countries, and those that actually have a good financial effect on local business sectors.

> "Aid should be part of the solution, not just part of the problem."

Poor countries would initially need grants, not loans, to develop their business sectors. The advantage of grants is that these countries could take time to plan their reforms carefully and strategically. The grants could come from an ECA "sister organization" – the "ECA Foundation," which would need an endowment of $10 billion. These two ECA organizations would operate for "at least another three decades." Think of the ECA proposal not as a "single coordinated plan," but rather as "an umbrella for many different parts moving in many different directions at many different times in many different places, to make a complex, diverse [business-development] ecosystem." This is how the original Marshall Plan worked. This is how business functions.

About the Authors

R. Glenn Hubbard is the dean of Columbia University's Business School. From 2001 to 2003, he headed the Council of Economic Advisers. **William Duggan**, a senior lecturer in strategy at the school, has vast foreign-aid experience.