Escaping Poverty: Foreign Aid, Private Property, and Economic Development

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Abstract

P. T. Bauer boldly conjectured two hypotheses about the process of escaping poverty. First, he argued that foreign aid not only fails to promote economic progress but may actually retard this process. Second, Bauer argued that private property rights are necessary and sufficient for economic development. This paper evaluates both of Bauer's controversial claims. First, I consider the theoretical mechanisms through which aid might depress recipient-country development and examine the empirical evidence that addresses this hypothesis. Second, I theoretically investigate the role of private property in economic development and examine the evidence for Bauer's claim regarding the primacy of private property. My analysis finds support for both of Bauer's provocative hypotheses and suggests that his work anticipated the most important results in the contemporary field of economic development.

I. Introduction

Investigating the causes of the wealth and poverty of nations is perhaps the most important task of economics. While a sizeable percentage of the world prospers, an even larger part stagnates in relative poverty. According to the World Bank (2007), "low" or "lower-middle" income countries make up more than half the world's economies. Average income is $875 or less in the former group and between $876 and $3,465 in the latter. The depth poverty reaches in these countries is even more striking. More than 20 percent of the developing world – 1.1 billion people – subsists on less than $1 a day (World Bank, 2005). In some developing countries, such as those of Sub-Saharan Africa, more than 70 percent of the population lives in

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"extreme poverty" (World Bank, 2005).[1]

More than 230 years ago, Adam Smith proposed a startlingly simple recipe for economic development. As he put it, "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things" (Smith [1776] 1904, p.I.56).[2] Two centuries later, the late development economist P. T. Bauer echoed Smith's sentiment. According to him, "Emergence from poverty requires effort, firmly established private property rights, and productive investment." Bauer's (2000) work explains how firmly established private property rights are the lynchpin of this prescription. Where private property is secure, effort and investment follow. Where it is absent, so too are these supporting factors of development.

In the years preceding WWII, economic development as a field of economic study did not exist in any meaningful sense.[3] Neither a World Bank nor an International Monetary Fund (IMF) yet existed, and there was no coherent development community.[4] On the contrary, from the classical political economists, such as Smith (1776) and J. S. Mill (1848), to their intellectual successors, such as Ludwig von Mises (1949) and F. A. Hayek (1960), the causes and consequences of the wealth and poverty of nations were simply part of the unified social science of political economy. Apart from the importance economists attributed to questions about economic development, they did not treat them any differently than other questions in political economy. Indeed, it would be fair to say that before WWII, political economy was development economics. Researchers developed the tools of economic reasoning to discuss and understand the sources of economic progress and decline.

In the postwar period, however, things changed. On the policy side, a burgeoning development community began to assemble to investigate methods of improving the economic state of the Third World. On the academic side, economic development began to

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[1] The World Bank defines "extreme poverty" as living on less than $2/day.

[2] This quote is originally attributed to Smith in 1755 by Stewart (1793).

[3] There was some discussion of reconstruction efforts post-WWI. However, this was primarily concerned with "nation building" rather than economic development generally.

[4] The World Bank Group was first established in 1944. The IMF was founded in 1945.

emerge as a separate and specialized field in the discipline of economics. By the 1970s the interaction between these two arenas was in full swing, as was the idea that questions of economic development were somehow at least partly different from other economic areas of inquiry. One of the most striking developments along these lines was the strong emphasis on active "do good-ing" among those interested in questions of development. To improve the plight of underdeveloped countries, the development community deployed the most cutting-edge (then largely Keynesian) economic thinking in poverty-stricken nations.[5] The financial backing for their efforts came from foreign aid.

William Easterly's excellent work (2001, 2006) documents these misadventures in detail.[6] Depending upon the current fashion in growth theory, the development community supplied foreign aid for different purposes. At one time, donors designed foreign aid to transfer resources from taxpayers in rich countries to governments in poor countries with the goal of filling the "investment gap" – the difference between the level of investment ostensibly needed to propel economic growth in the recipient country and the level of savings it had domestically to devote to this purpose. The later focus was on the human capital gap instead. Here, donors devoted aid to education in recipient nation. Still later, the development community used aid to finance prophylactics for citizens in developing countries on the grounds that poverty resulted from overpopulation, and individuals in poor countries were either unaware of condoms or too poor to purchase them.

In the age of galloping aid, few voices could be heard questioning aid's efficacy or the efficacy of the economic models that served as the basis for aid's distribution. Undoubtedly, the most important

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[5] On the distinction between the economist as a student of society in the context of development policy vs. the view of the economist as the savior of society in this context, see Boettke and Coyne (2006). What is interesting to note for my purposes, however, is that the student role is consistent with "development economics" as it existed when it was simply political economy, as it was for Smith, the other classical economists, and later the Austrian economists. After WWII, however, the idea of the economist as a savior, which came directly out of the academic work in the newly-created field of development economics and the Keynesian way of viewing economic policy more generally, which dominated at this time, replaced the older notion of economist as student.

[6] For an overview of the various stages of government-led development policy during this period, see, Boettke et al. (2005).

exception to this was foreign aid's most vocal critic, Peter Bauer (1972, 1984, 1991, 2000). Like Smith, Bauer understood the process of economic development as one rooted in particular institutions, namely private property rights.

In addition to pointing to the virtues of private property rights-led development, Bauer (1984) staunchly criticized central planning. From his perspective, the foreign aid process was simply one manifestation of this. Why, he asked, should we expect foreign-government planning of development in poor countries to be any more effective than domestic-government planning of industry in the Soviet Union?

Bauer offered a stinging critique of one of the most popular views in development economics at the time, which its advocates called the vicious cycle of poverty. Similar to the investment gap idea discussed above, the idea here was that poor countries were impoverished because they lacked capital investment. But the reason they lacked capital investment was because they were poor. Thus, developing countries needed a wealthy outsider – a foreign aid provider to break them out of this vicious cycle that kept them impoverished. This idea, Bauer (1972, 2000) argued, is erroneous. If capital investment is in fact an essential precondition of escaping poverty, and only wealthy countries have the means for this investment, how did currently wealthy countries, which were once as poor as currently developing countries, become rich?

As noted above, Bauer answered his own question by pointing to the wisdom of Smith. But he went further. Not only is aid unnecessary for development, he argued, but it may very well depress economic development in the countries it is designed to help. As Bauer put it, "Development aid, far from being necessary to rescue poor societies from a vicious circle of poverty, is far more likely to keep them in that state."

This paper has two goals. The first is to examine whether the empirical evidence supports or rejects Bauer's claim about the potentially destructive effects of foreign aid. First, I consider the primary theoretical mechanisms through which aid might depress economic development in recipient countries. Next, I consider the most up-to-date empirical results in the development literature that bear on this hypothesis. I find that these results corroborate Bauer's account. In many cases, foreign aid harms economic development in impoverished countries.

My paper's second goal is to investigate Bauer's claim that private property rights are all that is needed to get the development ball rolling. I first theoretically consider the role of private property in economic development and the problems associated with alternative institutions of property arrangement. Next, to examine Bauer's property hypothesis empirically, I investigate the results in the most important and recent research in the development literature that address the role of property in development. I find that Bauer's argument here has been vindicated as well. My analysis suggests that Bauer's pioneering work anticipated the most important results that define the current field of development economics – the potentially harmful effect of foreign aid and the primacy of private property rights for economic progress.

II. Foreign Aid's Impact on Economic Development

1. The Benign Dollars Hypothesis

There are two divergent hypotheses about the impact of foreign aid on economic development. I call the first hypothesis the "benign dollars view." This view's most-notable advocates are Jeffrey Sachs and U2's lead singer, Bono (see, for instance, Sachs, 2005). According to this hypothesis, how foreign aid works is strikingly simple. Rich countries transfer foreign aid to poor countries, which then disperse this aid to their citizens in various ways, raising the living standard of inhabitants. Several critical assumptions underlie the benign dollars view.

The first is the absence of any self-interested motives on the part of donor countries that might lead to the misallocation of foreign aid. Thus, for instance, domestic producers in the donor country do not lobby their government to gain privileged access to the aid disbursement that might negatively impact the recipient country. Domestic suppliers of the goods donor governments grant to recipient nations in the form of in-kind aid, for example, do not vie for exclusive rights to supply these goods to the donor government regardless of their (in)efficiency in supplying them.

Second, the benign dollars view assumes that recipient governments also behave out of essentially altruistic motives. They are not, for instance, interested in using foreign aid to bestow benefits on their friends or to enhance their personal wealth or power. Instead, recipient governments faithfully deliver financing and resources in the ways envisioned by aid donors. Aid safely reaches

those it is intended to assist.

A third critical assumption of the benign dollars view is that foreign aid's only effect on the recipient country is through the direct, envisaged channel of increasing the recipient country's resources. It does not have any indirect, difficult to observe, or harmful long-run consequences that the donor or recipient do not foresee.

The final crucial assumption of this view is that recipient-country political agents' interests are exogenous to aid disbursements. This assumption follows directly from assumptions two and three, which deliver benevolent political agents and direct effects of their decision making, respectively. Thus, aid does not operate to influence the marginal costs and benefits of political actor decision-making regarding aid employment or other activities. Instead, political actors exist outside the system with given altruistic motives, receive aid, and then allocate aid under the same opportunity costs they confronted pre-aid receipt.

It is easy to see how the expected effect of foreign aid on development is positive under these assumptions. There is no room for slippage at any stage of the aid disbursement or allocation processes. Donor-country citizens' interests are aligned with donor government interests, which are in turn aligned with recipient government interests that are aligned with recipient-country citizens' interests. Institutions play no role at any part of the process, and the important variables are exogenous and immutable.

2. The Destructive Dollars Hypothesis

The second hypothesis about the effects of foreign aid on economic development is far less optimistic. I call this hypothesis the "destructive dollars view." This view is perhaps best expressed by P. T. Bauer and, more recently, by the development economist William Easterly.

The destructive dollars hypothesis challenges each of the assumptions of the benign dollars approach, and in doing so allows for considerable slippage in the foreign aid disbursement and allocation processes. In contrast to the benign dollars approach, in the destructive dollars approach the aid process is significantly more complex. The destructive dollars view recognizes, for instance, that every step of the aid decision-making process is fraught with various

stakeholders, special interests, and rent-seeking activities.[7] Although we typically think of foreign aid as a simple gift to recipient countries, in actuality the aid process is a time-intensive bargaining game played between numerous layers of self-interested actors that include the donor-country's government, producers, foreign aid agency, and taxpayers, as well as the recipient-country's government, citizen interest groups, and affected producers, among others.

Producers inside donor countries, for example, are interested in affecting the composition of, and provision rights associated with, various development supplies for recipient countries. They may be interested in securing the rights to supply aid-allocated resources or service aid-financed development projects in the recipient nation. Lobbying efforts need not be correlated with producer efficiency, meaning that the producers who win various resource supply rights or service contracts on infrastructure programs funded in aid-receiving countries may not be the most cost-effective suppliers of these goods and services. If these producers are successful enough, they may even be able to convince their governments to supply unnecessary projects to developing nations, which donor governments see as a way of using their foreign aid budgets to subsidize politically important domestic producers.

In addition to expending resources on unproductive activities in the donor country, this may also leave the recipient country with superfluous, expensive infrastructure projects it is bound to service using the donor country's privileged suppliers for many years. This is but one example of how on the donor-country side of the aid equation, decision makers can allocate aid resources inefficiently, destroying wealth in both the donor and recipient nations.

Many other political considerations will also influence the donor country's aid decisions. For example, although rarely recognized or discussed, when donors are looking to disburse foreign aid, they are often competing with other potential donor countries to "give money away" (Gibson et al., 2005). Potential recipients are thus able to shop for the best deal they can get, which often means aid with fewer strings attached. This facilitates the misuse of aid, as I discuss below. It is strange to think of competing with others to give away

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[7] For an excellent analysis of the interactions between the "players" at the various levels of the foreign aid disbursement and allocation process, see Gibson et al. (2005).

resources, but the apparent peculiarity disappears when one recognizes that aid bureaucracies are always in charge of dispensing aid, and these organizations have their own objectives, which include maximizing their budgets or preventing their budgets from being cut. Since actual success is difficult to measure in the foreign aid "business," governments often measure progress by considering the percentage of total funds available for disbursement that their aid agencies have actually disbursed. This makes aid agencies eager to get rid of funds at their disposal. Over-eagerness to dispose of aid resources can in turn lead to suboptimal aid allocation or even borderline reckless aid allocations that, like the domestic producer example considered above, stand to impose costly long-term obligations on recipients that make it more difficult for them to develop.

Similarly, the destructive dollars view sees political actors in recipient nations as self-interested agents who will use aid to benefit themselves and preserve their positions of power. Developing nations have weak institutional checks on their governments. This leads them to have rampant corruption and high levels of expropriation, and is ultimately responsible for their poverty. Disbursing aid to rulers in such an institutional environment makes it relatively easy for political actors to misappropriate aid through embezzlement and other forms of fraud. This can have two negative effects on the recipient country's ability to produce wealth.

On the one hand, it concentrates additional power and control over the nation's resources and economic activity in the hands of the recipient-country rulers, who can then use this enhanced power to further expropriate their citizens. On the other hand, if a donor provides aid to rulers with the intent of improving education, for instance, rulers have an excuse to cut domestic funding to education, diverting these funds to themselves instead. When the aid arrives, rulers may steal these resources as well, leaving education with less funding after aid than it had before foreign assistance.

According to the destructive dollars hypothesis, foreign aid may also have unforeseen, unintended, and indirect negative effects on the long-run wealth-creating capacity of recipient countries. These are potentially many, including the risk of a growing dependency on foreign aid for the recipient as well as moral hazard problems that stem from the fact that aid insures recipient governments against the costs of pursuing economically damaging policies. They also include

even more nefarious effects. Foreign aid, for example, can influence the institutional composition of the recipient country in damaging ways. By concentrating additional power in the hands of political rulers along the lines discussed above, foreign aid raises the relative benefit of being a ruler or one of his friends.

This may lead to several harmful effects. First, it promotes the growing centralization of state authority since aid increases the payoff of being at the top of the political pyramid. In addition, it may also promote political conflict that can actually break out into violence as aspiring autocrats fight one another in competition for the increased rents that accrue to being ruler. Third, foreign aid may also destroy wealth by raising citizens' relative benefit of being part of the political elite's protected class. Since incomes become more closely tied to the political elite who decide how aid will be disbursed, citizens expend more effort and resources ingratiating themselves with government officials and less effort and resources on productive activities that create wealth.

Finally, the destructive dollars approach challenges the benign dollars view that aid-related actor interests are exogenous by pointing to mechanisms through which aid affects political actors' incentives, both in the disbursement of aid and more generally, such as in the case discussed above. The principles of economic analysis, such as opportunity cost reasoning, apply equally to decision makers in the context of foreign aid as they do to decision makers in any other context. By changing the costs and benefits of alternative modes of behavior, for instance through raising the benefit of being an autocrat in an aid-receiving country, foreign aid exerts an effect on political actors' incentives that often exacerbates the already substantial difference between ruler and citizen interests in recipient countries.

3. Examining the Evidence

In one sense, the destructive dollars hypothesis associated with Peter Bauer is a simple recognition of the insights of the Public Choice revolution in economics that culminated in James Buchanan's Nobel Prize in 1986. Nevertheless, advocates of the benign dollars approach see this competing view as incorrect. Fortunately, both hypotheses are testable. Where the benign dollars approach predicts positive and significant effects of foreign aid on development, the destructive dollars approach suggests that the effect of aid is likely to be zero, or even negative.

The empirical evidence to date that bears on these competing hypotheses supports the destructive dollars view that Bauer advanced. Craig Burnside and David Dollar (2000) conducted one of the most important empirical studies to comprehensively consider the impact of foreign aid on development. This highly influential analysis has an intuitively appealing bottom line: aid can encourage economic growth in countries that pursue "good" economic policies. Elsewhere, aid is essentially wasted dollars and has no impact on economic growth.[8]

While defenders of foreign aid widely hailed this study, its punch line is substantially less sanguine about the effects of aid on development than these defenders apparently realized. Most developing countries have quite poor policy and institutional environments. This is, in fact, why they are poor. Thus, for most developing countries, aid is no benefit, as the benign dollars hypothesis would suggest. Notably, those countries that have good policy and institutional environments – the only places where Burnside and Dollar (2000) found a positive effect of aid – do not in fact require aid. Their pursuit of growth-supporting policies, such as trade openness, private property protection, and fiscal responsibility, means that they will develop without foreign financial assistance.

Thus, a more accurate interpretation of Burnside and Dollar's (2000) study is that where aid is needed, it is unhelpful, and where it is not, it can do some good. Even if one accepts the limited positive conclusion of Burnside and Dollar's (2000) study, this is a rather sobering bottom line concerning foreign aid's potential. The picture for foreign aid becomes even more sobering when one considers the fact that donors tend to allocate aid primarily to countries that have worse economic policies, or, similarly, where governments are more corrupt, as recent research by Roberto Alesina and Beatrice Weder (2002) demonstrates. Aid flows most strongly to those countries where, according to Burnside and Dollar's (2000) analysis, it is least likely to have a positive effect.

Many others have built on this research that examines the effect of aid on economic growth. Perhaps the best and most important of these follow-up studies is the one William Easterly, Ross Levine, and David Roodman (2004) conducted, which recently appeared in the

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[8] Similarly, Boone (1996) finds little evidence that aid has positively affected economic growth or measures of human development in developing countries.

American Economic Review. These authors take Burnside and Dollar's model and simply extend their dataset to include additional years. The authors find that using additional data, the Burnside and Dollar result becomes even weaker. No evidence supports the conclusion that aid promotes economic growth, even in countries with good policy environments.

While this evidence seriously undermines the prediction of the benign dollars view, it does not directly corroborate the destructive dollars approach associated with Bauer. Recall, this approach predicts not simply a zero effect of aid on development, but a likely negative effect. However, recent research by Harold Brumm (2003), inspired by Burnside and Dollar's (2000) work, corrects for measurement error in Burnside and Dollar's paper using covariance structures. It finds that aid negatively and significantly affects economic growth in developing countries, even where good policy is followed. Similarly, Tomi Ovaska's (2003) recent empirical investigation of the effect of aid on growth in 86 developing countries during the period from 1975 to 1998 also finds a significant and negative effect of foreign aid on economic growth. According to Ovaska's estimates, a one percent increase in foreign aid (as a percentage of GDP) in developing countries leads to a 3.65 percent fall in the growth rate of their GDP per capita annually.

While so far these two papers are the only ones to directly vindicate Bauer's foreign aid hypothesis in the context of economic growth, several other researchers indirectly corroborate Bauer's hypothesis by examining aid's impact on political economic variables that in turn affect growth.[9] In their paper, "The Curse of Aid," Simeon Djankov, Jose Garcia Montalvo, and Marta Reynal-Querol (2006) provide powerful evidence that aid destroys democratic institutions in recipient countries. According to their argument, foreign aid produces resource windfalls in aid-receiving countries. These windfalls have a similar effect on recipient nations that rich natural resources can have, as documented in the literature that addresses the "natural resource curse" (see, for instance, Sachs and Warner, 2001).

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[9] It should be noted that even Bauer took the slightly "softer" position that aid was *likely* in many cases to cause more harm than good, not that it necessarily would have this effect in all cases. In fact, at one point Bauer actually argues the following: "Whether [aid] is likely to promote or retard material progress cannot be conclusively shown" (1972, p.98).

The mechanism at work here is straightforward. Aid windfalls, like natural resource windfalls, generate a flurry of rent-seeking activity and political fighting as individuals struggle to gain access to the government-controlled funds. Existing political rulers have an incentive to solidify and concentrate their political power in a more centralized fashion since the benefits of political centralization that accrue to them increase as the value of the windfalls they control increases. Other political agents who are not atop the political pyramid stand to benefit similarly if they are able to wrest greater political power from those who currently hold it. The result is an erosion of democratic institutions of decentralized government and substitution with more autocratic institutions of centralized government. Importantly, this mechanism of institutional erosion is precisely along the lines predicted by the destructive dollars hypothesis, which sees aid as exerting potentially damaging indirect effects on developing countries that can jeopardize their ability to produce wealth in the long run.

In their panel data analysis of 108 aid-recipient countries, Djankov, Montalvo, and Reynal-Querol (2006) find that foreign aid is a "curse" to developing countries, corroborating the mechanism described above. On a ten-point democracy index, they estimate that foreign aid reduces democratic institutions by up to one full point for a country that reaches the 75th percentile of aid/GDP in their sample, a sizeable institutional deterioration. To give a better idea of the size of this negative effect, the authors compare the destructive effect of aid on political institutions (the "curse of aid") to the destructive effect of oil rents (the "natural resource curse"). They find that the curse of aid is between three and five times larger than the natural resource curse for democratic institutions.

Other important research finds similar negative effects of foreign aid on institutional quality. Steven Knack (2001), for example, finds that higher aid flows lead recipient countries to have lower bureaucratic quality, higher corruption, and a weaker rule of law. Knack's analysis provides further support for the destructive dollars hypothesis and specifically for the rent-seeking mechanism described above. In an environment of additional foreign aid flows where agents are competing for the rents that follow from these flows, it is reasonable not only to expect greater political centralization and erosion of democratic institutions of governance, but also greater political agent corruption and arbitrary government activity, which

emerge as agents battle for political control. Jakob Svensson's (2000) research finds a similar result. Consistent with the curse of aid logic, whereby aid-generated resource windfalls increase rent-seeking activity, Svensson finds evidence of foreign aid-caused rent-seeking that manifests itself in the form of increased corruption in developing countries that are home to competing social groups.

Significantly, aid's corrosive impact on effective institutions presents itself even after the political control/consolidation process it engenders finishes. Where the state has greater control over the resources that affect citizens' lives, bribery, extortion, and other violations of the law are likely to be more commonplace. The aid flows that give greater control to political actors and bureaucrats create new opportunities for them to use this control to take advantage of citizens as well as to give citizens new incentives to create illicit arrangements with political actors to improve their own access to aid-generated resources. Thus, the institution-deteriorating effects of foreign aid are felt not only during the process of the political shake up that aid engenders, but also after this shake up settles and a new distribution of political power becomes an equilibrium.

The long-run implications of the institution-deteriorating effects of aid this research documents can be difficult to measure today. The relationship between institutional changes and changes in economic performance is often long and lagged. It may therefore be difficult to estimate the destructive effect of aid on economic growth in the short run. This may help to explain why at this point only Brumm's (2003) and Ovaska's (2003) analyses find a significant, negative relationship between foreign aid and economic growth. But this fact does not ameliorate the harmful long-run effects of aid on development. If aid is damaging institutions of governance in developing countries, as the evidence suggests it is, and effective institutions of governance, such as decentralized political power, the rule of law, low corruption, and enforcement of private property rights are responsible for long-run growth – which, as I discuss below, all available evidence suggests they are – then it is virtually certain that over time the harmful impact of aid on institutions will appear for economic growth as well.

III. The Primacy of Private Property in Economic Development

1. Incentives and Information

P. T. Bauer's defense of private property rights as the key to economic development is rooted in the work of earlier defenders of private property rights, such as Adam Smith, Ludwig von Mises, and F. A. Hayek. Together, these thinkers create a two-pronged approach to understanding the primacy of private property for wealth creation.

Smith's (1776) line of argument focused on the incentives that private property rights create for individual actors. Where property is privately owned, agents are residual claimants on the uses of their property. In the context of the market, this means that private property owners' discounted future-income streams depend on how well they use their private property to satisfy the desires of others. This is a restatement of Smith's famed "invisible hand," which pointed out that in an institutional environment of private property, each agent pursuing his own self-interest is led to promote the interests of others. In this way, private property rights serve to align the interests of resource owners and resource consumers. Through this institution, the interests of the former become inextricably linked to the interests of the latter.

In contrast, where the state separates ownership rights from private individuals and holds them instead, it severs this linkage. On the one hand, since governments are coercive, they cannot go out of business. The interests of political agents who control property in a society where property is collectivized do not depend on satisfying the interests of their citizens. Political agents are thus free to use resources in ways that benefit themselves at the expense of others. On the other hand, since citizens in such a society are not residual claimants on the majority of their economic activities, their incentives to be productive vanish.

The second prong of Bauer's defense of the primacy of private property rights for economic development is rooted in the arguments of Mises (1920, 1947, 1949) and Hayek (1937, 1945), whose discussions provide the complementary argument to Smith's incentive-based defense of private property. These two thinkers emphasized the information-generating capacity of private property rights. Mises' (1921, 1947, 1949) argument here was simple but powerful. Without private ownership, no exchange can occur. Without exchange, there are no exchange ratios, i.e., market prices. Without market prices, rational economic calculation is impossible.

And without economic calculation, there is no way to ensure that resources will tend to flow to those areas where actors need them most. The institution of private property is what allows for market prices, which in turn enable the rational allocation of resources.[10]

Building on Mises' argument, Hayek (1937, 1945) describes the information-carrying capacity of market prices. Market prices, he argues, signal to producers and consumers the relative scarcity of resources. They tell producers how to combine resources in the ways that produce the most value for consumers, and tell consumers when they should expand or contract their consumption of various goods and services. Hayek pointed out that the information communicated to market participants through the price system is decentralized, localized, and often inarticulate. This knowledge, he argued, exists only in a divided, diffused form, throughout the members of society. As such, centralized decision makers have no way to access its most important elements. Because government cannot tap into this decentralized knowledge, central planning based on collective ownership is doomed to fail. In contrast, private property, which enables exchange and market prices to emerge, is able to tap into this information and deliver it to economic actors in a way they can use to coordinate their ends.

In applying the insights of the Smith-Mises-Hayek argument in his own work, Bauer hit on a number of important conclusions that strengthened the case for the primacy of private property in the context of modern development economics. What is needed for development, Bauer suggested, is for government to protect private property rights. This requires government to both protect private citizens' property claims vis-à-vis one another, and, even more importantly, for government to refrain from using its coercive power to violate the property claims of its citizens.[11] In this institutional environment, the power of the market-generated incentives described by Smith's invisible hand, and the illumination of the market-created information described by Mises and Hayek, can operate fully, maximizing the potential for economic progress.

A government that goes beyond this role not only fails to promote development, but actually retards wealth creation. This

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[10] For an application of Mises' argument to the failure of the Soviet Union, see, Boettke (1990).

[11] More recently, de Soto (1989) also has emphasized this second aspect.

occurs for two reasons. First, government interventions that attenuate the private property claims of individuals distort the incentives of market participants. They make certain avenues of economic activity, such as rent seeking, relatively more profitable, and other avenues of economic activity, such as production for consumer wants, less profitable.

Christopher Coyne and Peter Leeson's (2004) paper on the "Plight of Underdeveloped Countries" documents this effect in the context of developing nations. Their argument builds on William Baumol's (1990) distinction between productive and unproductive entrepreneurship. The basic reasoning behind this idea is simple.

The institutional environment, specifically the property rights arrangements of various countries, shapes the incentives of economic actors. Where governments are active and go beyond the mere protective state Bauer discussed, they raise the relative payoffs of unproductive entrepreneurial activity, such as rent seeking. This lowers the prospects for development, as citizens expend time and talent participating in the political process to secure the transfer of wealth rather than creating it. On the other hand, where government protects private property and stays within these bounds, the relative payoff of wealth-enhancing activities, such as production and exchange, rises. This improves the prospect for development, as citizens devote energies to enterprises that make the members of society better off.

Kevin Murphy, Andrei Shleifer, and Robert Vishny (1991) consider this phenomenon empirically by examining the differences in economic growth across countries with higher proportions of engineering college majors vs. those with higher proportions of law concentrators. The idea here is that a larger proportion of the former signifies an institutional environment that creates higher returns to productive activities, which generate wealth. In contrast, a larger proportion of individuals choosing to enter law suggests an institutional regime that creates relatively larger payoffs to rent-seeking. The authors' results confirm the discussion above. Countries with a higher proportion of engineering majors grow faster. Those with a higher proportion of legal concentrators grow slower.

To Baumol's (1990) productive and unproductive categories of entrepreneurship, Coyne and Leeson (2004) add a third dimension they call "evasive entrepreneurship." Evasive entrepreneurship involves the resources market participants must devote to navigating

the costly procedures for conducting business created by governments that extend beyond the merely protective function. It includes, for example, the bribes citizens must pay to corrupt inspectors, the resources private actors must expend to avoid government detection that would impose higher tax costs on their operations, and so forth. Like the unproductive entrepreneurial activities that a poor institutional environment creates, evasive entrepreneurial activities also constitute deadweight losses to society – squandered resources that agents could have deployed productively elsewhere to contribute to progress.[12] In a society characterized by an institutional regime that raises the payoff of evasive entrepreneurial activities, economic decay is inevitable as agents increasingly devote resources to ends that do not contribute to social wealth. Hernando de Soto's (1989, 2000) important work, for example, documents the damaging effect of institutional arrangements that promote evasive entrepreneurship in Peru.

Second, government interventions that attenuate private property rights also distort the information embodied in market prices. Some interventions, such as the wage and price controls actively pursued in many developing countries, literally destroy the market price system and with it the information-generating features of this system that ensure the efficient allocation of resources.

Other interventions that do not directly interfere with market prices, such as subsidies or import barriers, indirectly distort price-provided information. Some avenues of production that are actually wealth-destroying for society, such as production in a domestic industry that produces inefficiently relative to foreign producers in that industry, artificially appear profitable, as though they created wealth for consumers. Other avenues of production that are wealth-creating for consumers, such as those industries that would absorb the labor and resources used in the inefficient industry receiving protection, artificially appear less profitable than they actually are, as though they created less wealth for consumers than they do. The result in both cases is an inefficient allocation of resources, leading to wealth destruction and economic decline.

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[12] The World Bank's "Cost of Doing Business Index" measures what Coyne and Leeson (2004) call "evasive entrepreneurship," allowing researchers to operationalize this idea. For a further discussion of the connection between the cost of doing business across countries and their institutions of property rights protection, see de Soto (1989).

2. Examining the Evidence

As for foreign aid, the hypothesis that private property is the key determinant of economic progress is also testable. However, investigating Bauer's hypothesis here has not been without difficulty. In an econometric framework that could examine the determinants of economic development across countries, we would like to regress some encompassing measure of national wealth, for example, GDP per capita, on some measure of private property rights protection, for example, the risk of government expropriation in these countries. Both of these measures are readily available. However, a thorny endogeneity problem emerges in a simple Ordinary Least Squares (OLS) specification.

While it is certainly plausible that, as Bauer argued, private property protection leads to greater wealth, it is also possible that wealthier countries adopt institutional regimes that better protect private property rights. Wealthier countries, for instance, may find better institutions more affordable. In other words, reverse causality may be at play. If so, we cannot causally interpret a positive coefficient on our measure of property rights protection in the simple OLS specification discussed above. The predicted relationship may be wholly or partially attributable to the endogeneity problem just raised.

Fortunately, a series of seminal articles by Daron Acemoglu, Simon Johnson, and James Robinson (2001, 2002) discovered a way around this empirical conundrum. By doing so, they provided direct evidence for Bauer's hypothesis in the context of former European colonies. The authors used a Two Stage Least Squares (2SLS) model that instrumented for private property rights protection with an exogenous variable, colonial settler mortality rates.

Their argument is interesting and compelling. Acemoglu, Johnson, and Robinson contend that the ex-colonies exhibit a variety of institutions and economic performance. Some, such as the United States, New Zealand, and Australia, exhibit strong private property rights protection. Others, such as the majority of countries in Sub-Saharan Africa, display the reverse.

They argue that the property rights institutions these countries inherited from their colonizers determined the variation in their incomes we observe today. In places like the United States, New Zealand, and Australia, the prevalence of diseases, such as malaria, was relatively low at the time of colonization. Thus, colonizers could

settle in these places for long periods of time. Since as inhabitants of these countries colonizers would be subject to the long-run effects of the property rights institutions they created, it was in their interest to establish institutions of long-run economic growth – namely, well-protected private property rights.

In contrast, in other countries, such as those in Sub-Saharan Africa, diseases like malaria were rampant and posed a serious threat to the lives of colonizers. In these places, colonizers could not settle permanently. This shaped their colonizing strategy in that it created a very short time horizon for the colonizers. They sought to get in, extract as many resources as possible, and get out. This led colonizers in these places to establish extractive institutions that poorly defined and protected citizens' private property rights.

Since ex-colonies' economic performance today cannot be responsible for the property rights institutions that colonizers created in them in the 17th, 18th, and 19th centuries, and since institutions tend to persist over time, property rights institutions at the time of colonization are a valid instrument for property rights institutions today. In other words, they allow us to overcome the reverse causality problem pointed to above. Although Acemoglu, Johnson, and Robinson do not have a direct measure of property rights institutions in the ex-colonies at the time they were colonized, they do have a useful proxy that fits with their narrative, which they can use to instrument current property rights institutions – settler mortality rates.

Needless to say, their solution to the empirical problem of estimating the effect of private property rights protection on economic development opened up the door for many subsequent analyses that could use a similar approach for related examinations. The finding of these authors' study is striking: private property rights are the key determinant of nations' levels of economic development. This is true even after controlling for other potential determinants of income, such as colonizer identity (e.g., British or French), and a slew of geographic variables like latitude, distance from a coast, and climate, which some have argued are responsible for the wealth and poverty of nations (see, for instance, Gallup, Sachs and Mellinger, 1999; Sachs, 2001; Sachs, 2003). Acemoglu, Johnson, and Robinson's (2001, 2002) research has had a profound effect on modern development economics and provides powerful empirical evidence that Bauer was correct about the primacy of private property rights

for economic development.[13]

Building on this work, Acemoglu and Johnson (2005) have gone further in corroborating Bauer's claim. In their follow-up research, these authors point to the fact that multiple types of property institutions may matter for economic development. On the one hand, there exist what they call "contracting institutions," such as government courts that enforce private agreements between citizens. These institutions are important because they aim to protect the property rights of citizens vis-à-vis one another. On the other hand there exist what they call "property rights institutions," such as constraints on government's ability to seize citizens' property arbitrarily. These institutions are important because they aim to protect the private property rights of citizens against government predation.

Bauer's (2000, 1991, 1972) work clearly emphasizes the greater importance of the latter sort of private property-related institutions. Bauer sees corrupt and overactive government, rather than private individuals, as the main source of private property erosion. Furthermore, while market mechanisms, such as reputation or private arbitration, can enforce private commercial agreements between citizens, such mechanisms are powerless to prevent government expropriation in the face of the state's monopoly on force.[14] Thus, while individuals can avoid private predation without state-provided courts, they cannot avoid public predation without institutional constraints on government's ability to prey on citizens.

Acemoglu and Johnson's (2005) work aims to unbundle these two private property-related institutions to see which is more important for economic development. Alternatively, their analysis can

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[13] Although I do not consider it here, a large literature on the connection between economic freedom and economic development also provides some support for Bauer's claim about the importance of private property. See, for example, Gwartney et al. (1999), Scully (1988), and Hanke and Walters (1997), to name only a few. Besides considering private property rights protection, measures of economic freedom also consider a number of policy (as opposed to institutional) measures that are closely related to property rights. Thus, while the literature I discuss and the literature on economic freedom are connected, I focus on the latter since it provides the most direct evidence for Bauer's hypothesis.

[14] On the ability of private institutions to secure the property rights of individuals without government, see, for example, Benson (1989), Ellickson (1991), and Leeson (2007a, 2007b, 2007c). For a discussion of such institutions specifically in the context of economic development, see Leeson (2007d).

be thought of as asking which type of predation – public or private – poses the greater threat to economic development. The results of their insightful analysis overwhelmingly support Bauer's view. What the authors call property rights institutions – institutions that restrain government expropriation – are substantially more important than what they call contracting institutions – state-provided institutions to prevent private predation – for nearly all aspects of economic development. State expropriation, not predation by private individuals, is more harmful to economic progress, and thus more important to prevent. Conversely, institutional restraints that prevent government from violating the private property rights of their citizens are the dominant determinant of economic development.[15]

IV. Conclusion

P. T. Bauer proposed two bold hypotheses regarding how countries escape poverty at a time when his claims were highly unfashionable. On the one hand, he argued that foreign aid, instead of promoting the process of development, is likely to prevent it. On the other hand, Bauer claimed that firmly-protected private property rights are all that is required for economic development to occur. This paper considered both of Bauer's hypotheses and found that the most recent evidence available from the development literature supports both. This is striking when one considers that, with few exceptions, neither ardent defenders of classical liberalism nor advocates of P. T. Bauer's work conducted this research. Indeed, only a few of the researchers I discussed even viewed themselves as testing Bauer's contentions.

Bauer's hypotheses are natural complements to one another and provide the greatest insight into the process of economic development when viewed this way. If one accepts either of his major contentions, the other follows naturally from it. If one is persuaded that foreign aid is destructive to economic development for the reasons Bauer pointed to, such as its corrupting effect on recipient-country institutions, the natural question to ask is why this corrupting effect occurs. As I discussed above, it occurs largely because foreign aid changes political rulers' and citizens' incentives and information in aid-receiving nations. Recognition of this fact

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[15] On the primacy of private property rights for launching development over other potential variables, see also Johnson, McMillan, and Woodruff (2002).

implies that something must be "good" about the incentives and information generated in the absence of foreign aid (and the destructive political responses aid creates) when private property rights are well protected. Thus, one is led to a better understanding of why private property rights are the key to economic progress.

Alternatively, if one is persuaded about the primacy of private property rights in economic development, the inevitable failure of foreign aid to encourage progress and the positive harm it may do to this process also becomes more understandable. In an institutional environment in which government fails to protect private property rights and political decision makers are free to use their authority to extort the members of their population, it is easy to see why foreign aid, by providing political leaders with even greater authority and power over their citizens, would only exacerbate this institutional problem. Giving unrestrained and corrupt political agents greater resources only facilitates their ability to extort citizens; it does nothing to help restrain this.

The growing recognition of Bauer's correctness on matters of economic development, which the mounting empirical evidence to this effect in the field of development economics documents, is reason for optimism. The destructive impact of foreign aid and the importance of private property rights are on their way to becoming conventional wisdoms in the development community. This is a dramatic turnaround from the conventional wisdom regarding these issues when Bauer so poignantly criticized them only 30 years ago.

Despite this, Bauer's own insights regarding the self-interested behavior of those associated with development assistance provide good reason to at least temper this optimism with caution. Like the political actors they supply with foreign aid, the members of the development community, such as the bureaucrats who staff domestic foreign aid agencies and those involved in multilateral aid agencies, are also stakeholders who stand to benefit from continued foreign assistance. As Bauer put it, "The international aid organizations and their staffs are not disinterested" in this regard (qtd in Sowell, 1984, p.45). This suggests that growing recognition of the accuracy of Bauer's insights may not be enough to prevent foreign aid and government-led development efforts from expanding.

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