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Reflections on *Doing Bad by Doing Good*

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Introduction

We appreciate the opportunity to offer some comments on Dr. Christopher Coyne's book *Doing Bad by Doing Good*. The book is interesting and unique not just because it questions the efficiency and efficacy of state-led humanitarian interventions – many others have raised similar questions – but because it does so by applying insights derived from public choice theory.

Much of Dr. Coyne's book is based on public choice perspectives regarding bureaucratic behavior – building on the seminal work of people like Niskanen (1971) and Tullock (2005). Coyne reminds us that state-led humanitarian efforts are implemented by large national and multi-lateral bureaucracies and the constellations of NGOs and consulting firms that have become financially dependent on funding from these bureaucracies. While their stated objectives may be noble (eliminating hunger and malnutrition, reducing poverty, increasing access to health care, etc.) these bureaucratic entities exhibit all of the tendencies described by public choice theory – decision-makers who are out of touch with the needs of those they are trying to serve (on this point, see also Anderson et al. 2012), lack of coordination between entities, a "bigger is better" mindset leading to mission creep and budget expansion, supply-driven rather than demand-driven programming, and generally exhibiting inefficiencies caused by the lack of competitive market discipline. Coyne lucidly describes why these problems are, in fact, exactly what we should expect and at a conceptual level, his arguments are quite compelling.

So, what are the "take away" messages from Dr. Coyne's book? We would list them as follows: 1) vulnerability is a function of poverty (wealthy societies are much more resilient to shocks); 2) humanitarian interventions, *in and of themselves*, are unable to initiate widespread economic growth and alleviate chronic poverty; 3) interventions should instead focus on encouraging the development of economic freedom and the emergence of what Coyne calls "productive entrepreneurship;" and, 4) doing number 3 well is extremely difficult even in the best situations and likely impossible in some situations. On all of these points, we generally agree with Dr. Coyne.

Having said that, we now address some areas where we are less likely to agree with Dr. Coyne. First, a theoretical concern. While the public choice perspective is valuable for understanding various drivers of bureaucratic inefficiency, we believe it to be incomplete. Throughout the world and in many different public and private contexts bureaucracies continue to serve as a primary mechanism for delivering complex social services on which households, firms, and economies rely. Given this, it seems we must consider the possibility that, at least in some contexts, bureaucracies provide organizational, informational, and/or transaction cost efficiencies that are useful in tackling complex social challenges (North 1990, Williamson 1996). Just as the existence of market inefficiencies (e.g., externalities) cannot totally discredit the important role of markets in addressing complex socio-economic challenges, the existence of bureaucratic inefficiencies is insufficient to discredit the role of governments and bureaucracies in addressing complex socio-economic challenges (such as economic stagnation and poverty).

This leads to our second point, which is that the arguments in Dr. Coyne's book are primarily theoretical. Yes, his book contains many anecdotes regarding the failures of humanitarian interventions, but one could find similar anecdotes regarding successes. We are applied economists, so for us the performance of international humanitarian organizations, or any bureaucracy for that matter, is ultimately an empirical question. Coyne references some empirical studies in the book, but these studies provide mixed findings. We recognize the difficulties inherent in empirically analyzing the effectiveness of humanitarian interventions – pre-intervention baseline information must be collected, long-time lags may exist before interventions begin to generate measurable benefits, during those time lags any number of other confounding variables may change, and results from one context may not apply to another. Though difficult, this empirical research is critical to furthering our understanding of the long-term impacts of various types of humanitarian interventions.

Our third point (which we develop at some length) is related to long-term economic development efforts (rather than short-term emergency response). Coyne argues that this is where interventions are likely to be the least effective. But if one agrees with the earlier statement that short-term vulnerabilities are largely a function of poverty, then facilitating economic growth must surely be a primary focus of humanitarian interventions. The question is whether outside interventions can effectively facilitate economic growth. Dr. Coyne seems to believe not, while we tend to disagree, though it seems likely that even on this issue we could find some common ground with Dr. Coyne. For example, Dr. Coyne seems to essentially be calling for humility and pragmatism on the part of donors and development practitioners – he is asking that they avoid the temptation to engage in grand schemes of social and economic engineering which he characterizes as " . . . micromanaging the world according to the desires of 'experts'" (p. 180). Anecdotes abound of development practitioners who naïvely stumble into complex social and economic realities which they do not, and cannot, fully understand, and, as a result, create all manner of unintended side effects. Furthermore, due to pressure from donors and domestic political realities within the recipient country, incentives exist to engage in interventions that generate a quick burst of economic growth that is not sustainable over the long term.

While there is truth to these assertions, they don't necessarily imply that all economic development efforts are bound to fail. Dr. Coyne would likely agree with us that economic development efforts should be targeted primarily on creating an enabling environment for economic growth. Rather than trying to "kick-start" economic growth by supporting specific sectors of the economy (a strategy of "picking winners"), the focus should instead be on developing the political, legal, and economic institutions that can facilitate endogenous growth in economic opportunities.

Where we may disagree is that we would also add a role for donor investments in context-specific research and knowledge generation. In particular we are thinking about knowledge generation related to determinants of economic growth such as resource availability, locally appropriate production technologies, and risk management mechanisms. Much of this research has "public goods" characteristics and is not likely to be provided by the private sector. Given the overwhelming demands for public services, this research is also unlikely to be sufficiently funded by governments in lower income countries. This we believe creates an opportunity for limited, pragmatic, investments that over the long-term can contribute significantly to sustainable economic growth.

Providing an Environment for Growth: The Peruvian Case

Consider, as an example, the paradox of capital flows. Standard economic theory indicates that there are diminishing marginal returns to capital. This implies that areas with relatively little capital (such as lower income countries) should provide opportunities for relatively higher rates of return on capital investments. Thus, capital should flow naturally from capital-rich, developed countries to capital-poor, lower income countries. Those in developed economies with funds to invest benefit from the higher rates of return offered in lower income countries while those in lower income countries benefit from increased access to capital that can be used to improve the quantity and/or quality of productive assets. So why does capital not flow naturally from capital-rich areas to capital-poor areas in search of higher rates of return? There are a number of reasons but scholars generally agree that a major inhibitor of capital flows is risk and the high transaction costs required to reduce risk (Besley 1995, Armendáriz and Morduch 2010). Certainly, political risk and/or macroeconomic risk inhibit capital flows but we have argued elsewhere (Barnett, Barrett, and Skees 2008, Collier, Skees, and Barnett 2009) that in many lower income countries the lack of efficient (low transaction cost) mechanisms for transferring catastrophic weather risk contributes to low levels of capital investment and thus, limited economic growth.

In northern Peru for instance, severe El Niño events slow growth and perpetuate poverty. The most recent severe El Niño, in 1998, caused torrential rains that were 40 times normal rainfall, injuring and killing many, inundating crops, washing out roads and bridges, stifling local markets, and isolating communities for months. The risk of these events reduces local investment. For example, following the 1998 El Niño, many banks stopped lending to agriculture, one of the largest economic sectors in the region, reducing access to productivity-enhancing inputs and lowering the earnings potential of hundreds of thousands of households.

Bottom-up entrepreneurship is insufficient for addressing risks like severe El Niño. Physical mitigation requires major investments in public infrastructure such as roads, bridges, reservoirs, and water and sanitation systems. Even financial mechanisms require top-down organization. Local lenders cannot effectively diversify against spatially correlated risks such as disasters that affect many of their borrowers at once. Similarly, local insurers cannot absorb such huge potential losses.

New financial instruments are required that can efficiently transfer these risks into international markets; however, a host of free-rider problems complicate the development of these instruments. First moving insurance companies must create and price a product, obtain regulatory approval of the contract language, and invest in market development through consumer education and capacity building. In the case of successes, first mover advantages do not warrant these investments because financial products are so easily replicated by competitors. Thus, market failures prevent what would be economically important and seemingly viable financial services from developing.

Through the support of various donors (including some government donors), we have for several years participated in a team led by Dr. Jerry Skees of GlobalAgRisk, Inc. to address these market failures in Peru. Rather than trying to pick winners, we worked to develop a market foundation from which myriad financial mechanisms covering a variety of risks and serving a diverse set of users could emerge, as we illustrate here through four areas in which our projects invested: product development, legal and regulatory framework, market supply, and market demand.

Product development. These projects used a parametric mechanism to transfer El Niño risk. Parametric insurance and derivatives are written on an objective index of a disaster rather than the realized losses of the end user. Our projects incurred the development costs of studying the risk, identifying a suitable index, and structuring a recommended contract. For example, the best measure of severe El Niño in Peru is increasing ocean temperatures off its coast, which creates convection leading to torrential rains. These ocean temperatures are used as the basis of payments for El Niño coverage. Because many stakeholders are vulnerable to the same disaster risk, the same mechanism can potentially be used by households, institutions, and firms in many economic sectors.

Legal and regulatory framework. Because parametric risk transfer for disasters is a relatively recent innovation, legal and regulatory frameworks to strengthen these markets are still being established. Through close collaboration with the insurance regulator, our team identified the benefits of classifying the parametric mechanism for El Niño as insurance. As compared to a derivative classification, insurance provides more consumer and market protections. Additionally, El Niño insurance is the first parametric mechanism in the world with regulatory approval as "contingent insurance." This designation reduces the burden on insurers and the insured to demonstrate a strong relationship between losses and the measure of the event, ultimately lowering the cost of the insurance. This legal and regulatory framework can conceivably be used for any parametric insurance product to be developed in Peru or other jurisdictions.

Market supply. Market competition creates advantages for insurance users by lowering prices and increasing choice. To facilitate competition, we showcased the significant market potential of El Niño insurance to local insurers and international reinsurers and have collaborated with those interested in entering the market. Based on this effort, three of the four major insurers in Peru are developing El Niño insurance products. Furthermore, increased competition among reinsurers has lowered the price of the insurance by about one third.

Market demand. Insurance tends to be poorly understood and so these markets benefit from economic research demonstrating its potential. Our work in Peru developed products for firms and institutions, targeting those that provide important services to the vulnerable poor such as microfinance institutions and agribusinesses to serve as example cases. We worked directly with these firms to assess their risk and develop education materials for their economic sectors. Based on this research a large, highly regarded microfinance institution, Caja Nuestra Gente, has been insuring against El Niño the past two years and using this protection to increase lending in underserved rural markets.

In sum, donor support of public good investments created an innovative and active market where none previously existed. This financial market for natural disaster risks in Peru is in a nascent stage, and its development, shape, and growth are now the responsibility of the people of Peru.

Conclusion

Coyne's book is a useful caution regarding the efficiency and efficacy of bilateral or multilateral humanitarian interventions, but we believe that it overstates its case. While public choice theory provides many insights that can better align bureaucratic incentives with public interests and reduce waste, it does not provide *prima facie* evidence that state-led humanitarian interventions necessarily "do bad" in their efforts to "do good." We contend that donors can foster economic growth by addressing a variety of market failures, including contributing to the establishment and maintenance of market institutional requisites and investing in context-specific research and knowledge generation.

As a specific example of the former we describe how innovative risk-transfer mechanisms hold the potential for increasing capital flows and spurring economic growth in countries that are highly exposed to natural disaster risk, but also note that these mechanisms are unlikely to emerge without donor investments to facilitate market development. An example of the latter is the donor investments that catalyzed the "green revolution" during the last century. Many other examples exist of investments in market requisites or local knowledge generation that, though unlikely to be provided by the private-sector (due to public goods characteristics) or the public-sector (due to budget constraints) could, if provided, dramatically increase economic growth. This, we believe, cautions against a generalized renunciation of state-led humanitarian interventions.

Notes

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