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63. Foreign Aid and Economic Development

Congress should

- abolish the U.S. Agency for International Development and end government-to-government aid programs;
- withdraw from the World Bank and the five regional multilateral development banks;
- not use foreign aid to encourage or reward market reforms in the developing world;
- eliminate programs, such as enterprise funds, that provide loans to the private sector in developing countries and oppose schemes that guarantee private-sector investments abroad;
- privatize or abolish the Export-Import Bank, the Overseas Private Investment Corporation, the U.S. Trade and Development Agency, and other sources of international corporate welfare;
- forgive the debts of heavily indebted countries on the condition that they receive no further foreign aid; and
- end government support of microenterprise lending and nongovernmental organizations.

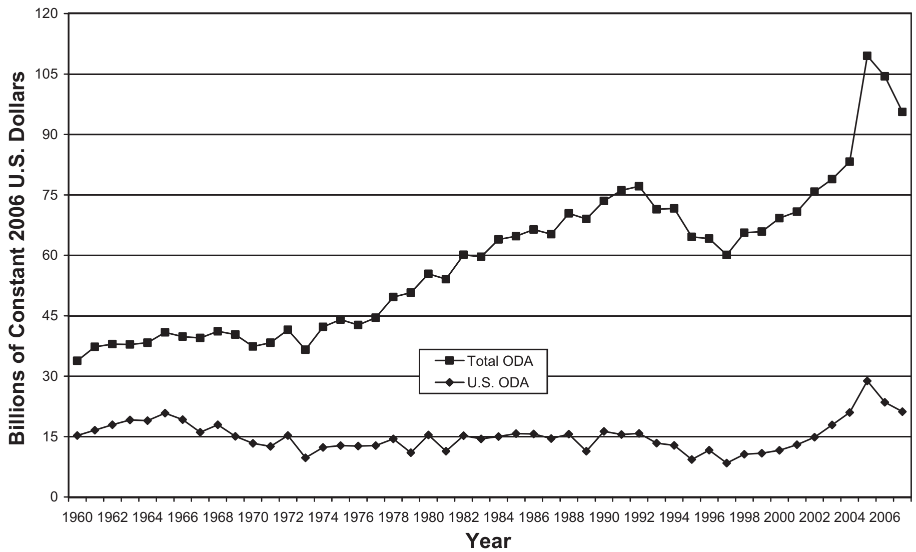
In 2002, President Bush called for increasing U.S. bilateral development assistance by about 50 percent by fiscal year 2006, gradually raising the aid above the then prevailing level of roughly $10 billion. The Millennium Challenge Account, managed by a new government agency, the Millennium Challenge Corporation, was created in 2004 to direct the additional funds to poor countries with sound policy environments. Likewise in recent years, the World Bank and the United Nations have been advocating a doubling of official development assistance worldwide to about $150 billion. Foreign aid has risen notably. The Bush administration reached its funding goal, and total aid from rich countries is now around $100 billion (see Figure 63.1).

Those calls for significant increases in foreign aid are based on the argument that aid agencies have learned from the failure of past foreign aid programs and that overseas assistance can now be generally effective in promoting growth. But what we know about aid and development provides little reason for such enthusiasm:

- There is no correlation between aid and growth.
- Aid that goes into a poor policy environment doesn't work and contributes to debt.
- Aid conditioned on market reforms has failed.
- Countries that have adopted market-oriented policies have done so because of factors unrelated to aid.
- There is a strong relationship between economic freedom and growth.

A widespread consensus has formed about those points, even among development experts who have long supported government-to-government aid. As developing countries began introducing market reforms in the late 1980s and early 1990s, the most successful reformers also experienced

Figure 63.1
Official Development Assistance, 1960–2007



Source: Organisation for Economic Co-Operation and Development, *OECD, Stat Extracts.* http//states.oecd.org.

noticeably better economic performance. As would be expected, the improvement among the successful reformers also improved the apparent performance of foreign aid in those countries—thus, the new emphasis on giving aid to countries that have already adopted good policies. The new approach to aid is dubious for many reasons, not the least of which is the fact that countries with sound policies will already be rewarded with economic growth and do not need foreign aid. In any event, much, if not most, foreign assistance will continue to be awarded without regard to the record of internal reform.

The Dismal Record of Foreign Aid

By the 1990s, the failure of conventional government-to-government aid schemes had been widely recognized and brought the entire foreign assistance process under scrutiny. For example, a Clinton administration task force conceded that, ''despite decades of foreign assistance, most of Africa and parts of Latin America, Asia and the Middle East are economically worse off today than they were 20 years ago.'' As early as 1989, a bipartisan task force of the House Foreign Affairs Committee concluded that U.S. aid programs ''no longer either advance U.S. interests abroad or promote economic development.''

Multilateral aid has also played a prominent role in the post–World War II period. The World Bank, to which the United States is the major contributor, was created in 1944 to provide aid mostly for infrastructure projects in countries that could not attract private capital on their own. The World Bank has since expanded its lending functions, as have the five regional development banks that have subsequently been created on the World Bank's model: the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, and the Middle East Development Bank. The International Monetary Fund, also established in 1944, long ago abandoned its original role of maintaining exchange-rate stability around the world and has since engaged in long-term lending on concessional terms to most of the same clients as the World Bank.

Despite record levels of lending, however, the multilateral development banks have not achieved more success at promoting economic growth than has the U.S. Agency for International Development. Numerous self-evaluations of World Bank performance over the years, for example, have uncovered high failure rates of bank-financed projects. In 2000, the bipartisan Meltzer Commission of the U.S. Congress found a 55 to

60 percent failure rate of World Bank projects based on the bank's own evaluations. A 1998 World Bank report concluded that aid agencies ''saw themselves as being primarily in the business of dishing out money, so it is not surprising that much [aid] went into poorly managed economies—with little result.'' The report also said that foreign aid had often been ''an unmitigated failure.'' ''No one who has seen the evidence on aid effectiveness,'' commented Oxford University economist Paul Collier in 1997, ''can honestly say that aid is currently achieving its objective.''

Although a small group of countries in the developing world (some of which received aid at some point) has achieved self-sustaining economic growth over an extended period, most recipients of aid have not. Rather, as a 1989 USAID report suggested, aid has tended to create dependence on the part of borrower countries.

There are several reasons that massive transfers from the developed to the developing world have not led to a corresponding transfer of prosperity. Aid has traditionally been lent to governments, has supported central planning, and has been based on a fundamentally flawed vision of development.

By lending to governments, USAID and the multilateral development agencies supported by Washington have helped expand the state sector at the expense of the private sector in poor countries. U.S. aid to India from 1961 to 1989, for example, amounted to well over $2 billion, almost all of which went to the Indian state. Ghanaian-born economist George Ayittey complained that, as late as 1989, 90 percent of U.S. aid to sub-Saharan Africa went directly to governments.

Foreign aid has thus financed governments, both authoritarian and democratic, whose policies have been the principal cause of their countries' impoverishment. Trade protectionism, byzantine licensing schemes, inflationary monetary policy, price and wage controls, nationalization of industries, exchange-rate controls, state-run agricultural marketing boards, and restrictions on foreign and domestic investment, for example, have all been supported explicitly or implicitly by U.S. foreign aid programs.

Not only has lack of economic freedom kept literally billions of people in poverty, development planning has thoroughly politicized the economies of developing countries. Centralization of economic decisionmaking in the hands of political authorities has meant that a substantial amount of poor countries' otherwise useful resources has been diverted to unproductive activities, such as rent seeking by private interests or politically motivated spending by the state.

Research by economist Peter Boone of the London School of Economics confirms the dismal record of foreign aid to the developing world. After reviewing aid flows to more than 95 countries, Boone found that ‘‘virtually all aid goes to consumption’’ and that ‘‘aid does not increase investment and growth, nor benefit the poor as measured by improvements in human development indicators, but it does increase the size of government.’’ A recent comprehensive study by the IMF also found no relationship between aid and growth.

It has become abundantly clear that as long as the conditions for economic growth do not exist in developing countries, no amount of foreign aid will be able to produce economic growth. Moreover, economic growth in poor countries does not depend on official transfers from outside sources. Indeed, were that not so, no country on earth could ever have escaped from initial poverty. The long-held premise of foreign assistance—that poor countries were poor because they lacked capital—not only ignored thousands of years of economic development history, it also was contradicted by contemporary events in the developing world, which saw the accumulation of massive debt, not development.

Promotion of Market Reforms

Even aid intended to advance market liberalization can produce undesirable results. Such aid takes the pressure off recipient governments and allows them to postpone, rather than promote, necessary but politically difficult reforms. Ernest Preeg, former chief economist at USAID, for instance, noted that problem in the Philippines after the collapse of the Marcos dictatorship: ‘‘As large amounts of aid flowed to the Aquino government from the United States and other donors, the urgency for reform dissipated. Economic aid became a cushion for postponing difficult internal decisions on reform. A central policy focus of the Aquino government became that of obtaining more and more aid rather than prompt implementation of the reform program.’’

A similar outcome is evident in the Middle East, which receives about one-fifth to one-quarter of U.S. economic aid, most of which has historically been received by the governments of Egypt and Israel and, more recently, Iraq. It should not be surprising, then, that the region is notable for its low levels of economic freedom and little economic reform. In 1996, the Institute for Advanced Strategic and Political Studies, an Israeli think tank, complained: ‘‘Almost one-seventh of the [gross domestic product] comes to Israel as charity. This has proven to be economically disastrous. It prevents reform, causes inflation, fosters waste, ruins our competitiveness and efficiency, and increases the future tax burden on our children who will have to repay the part of the aid that comes as loans.'' In 2001, the institute again complained that foreign aid has ''allowed Israel to avoid a very necessary liberalization of its state-controlled economy.''

Far more effective at promoting market reforms is the suspension or elimination of aid. Although USAID lists South Korea and Taiwan as success stories of U.S. economic assistance, those countries began to take off economically only after massive U.S. aid was cut off. As even the World Bank has conceded, ''Reform is more likely to be preceded by a decline in aid than an increase in aid.'' When India faced Western sanctions in 1998 in response to nuclear tests there, the *International Herald Tribune* reported that ''India approved at least 50 foreign-investment projects to compensate for the loss of aid from Japan and the United States'' and that it would take additional measures to attract capital. In the end, the countries that have done the most to reform economically have made changes despite foreign aid, not because of it.

Still, much aid is delivered on the condition that recipient countries implement market-oriented economic policies. Such conditionality is the basis for the World Bank's structural adjustment lending, which it began in the early 1980s after it realized that pouring money into unsound economies would not lead to self-sustaining growth. But aid conditioned on reform has been ineffective at inducing reform. One 1997 World Bank study noted that there ''is no systematic effect of aid on policy.'' A 2002 World Bank study admitted that ''too often, governments receiving aid were not truly committed to reforms'' and that ''the Bank has often been overly optimistic about the prospects for reform, thereby contributing to misallocation of aid.'' Oxford's Paul Collier explains: ''Some governments have chosen to reform, others to regress, but these choices appear to have been largely independent of the aid relationship. The microevidence of this result has been accumulating for some years. It has been suppressed by an unholy alliance of the donors and their critics. Obviously, the donors did not wish to admit that their conditionality was a charade.''

Lending agencies have an institutional bias toward continued lending even if market reforms are not adequately introduced. Yale University economist Gustav Ranis explains that within some lending agencies, ''ultimately the need to lend will overcome the need to ensure that those [loan] conditions are indeed met.'' In the worst cases, of course, lending agencies do suspend loans in an effort to encourage reforms. When those reforms begin or are promised, however, the agencies predictably respond by resuming the loans—a process Ranis has referred to as a ‘‘time-consuming and expensive ritual dance.’’

In sum, aiding reforming nations, however superficially appealing, does not produce rapid and widespread liberalization. Just as Congress should reject funding regimes that are uninterested in reform, it should reject schemes that call for funding countries on the basis of their records of reform. This includes the Bush administration’s Millennium Challenge Corporation. The most obvious problem with that program is that it is based on a conceptual flaw: countries that are implementing the right policies for growth, and therefore do not need foreign aid, will be receiving aid. In practice, the effectiveness of such selective aid has been questioned by a recent IMF review that found ‘‘no evidence that aid works better in better policy or geographical environments, or that certain forms of aid work better than others.’’

The practical problems are indeed formidable. The Millennium Challenge Corporation and other programs of its kind will require government officials and aid agencies—all of which have a poor record in determining when and where to disburse foreign aid—to make complex judgment calls on which countries deserve the aid and when. Moreover, it is difficult to believe that bureaucratic self-interest, micromanagement by Congress, and other political or geostrategic considerations will not continue to play a role in the disbursement of this kind of foreign aid. It is important to remember that the new aid funds administered by the Millennium Challenge Corporation do not actually reform U.S. aid. Rather, they are *in addition to* the much larger traditional aid programs that will continue to be run by USAID—in many cases in the very same countries.

Help for the Private Sector

Enterprise funds are another initiative intended to help market economies. Under this approach, USAID and the Overseas Private Investment Corporation have established and financed venture funds throughout the developing world. Their purpose is to promote economic progress and ‘‘jump-start’’ the market by investing in the private sector.

It was always unclear exactly how such government-supported funds find profitable private ventures in which the private sector is unwilling to invest. Numerous evaluations have now found that most enterprise funds are losing money, and many have simply displaced private investment that otherwise would have occurred. Moreover, there is no evidence that the funds have generated additional private investment, had a positive effect on development, or helped create a better investment environment in poor countries.

Similar efforts to underwrite private entrepreneurs are evident at the World Bank (through its expanding program to guarantee private-sector investment) and at U.S. agencies such as the Export-Import Bank, Overseas Private Investment Corporation, and the Trade and Development Agency, which provide comparable services.

U.S. officials justify those programs on the grounds that they help promote development and benefit the U.S. economy. Yet providing loan guarantees and subsidized insurance to the private sector relieves the governments of underdeveloped countries from creating an investment environment that would attract foreign capital on its own. To attract much-needed investment, countries should establish secure property rights and sound economic policies, rather than rely on Washington-backed schemes that allow avoidance of those reforms.

Moreover, while some corporations clearly benefit from the array of foreign assistance schemes, the U.S. economy and American taxpayers do not. Subsidized loans and insurance programs amount to corporate welfare. Macroeconomic policies and conditions, not corporate welfare programs, affect factors such as the unemployment rate and the size of the trade deficit. Programs that benefit specific interest groups manage only to rearrange resources within the U.S. economy and do so in a very wasteful manner. Indeed, the United States did not achieve and does not maintain its status as the world's largest exporter because of agencies like the Export-Import Bank, which finances less than 2 percent of U.S. exports.

Even USAID claims that the main beneficiary of its lending is the United States because close to 80 percent of its contracts and grants go to American firms. That argument is also fallacious. ''To argue that aid helps the domestic economy,'' renowned economist Peter Bauer explained, ''is like saying that a shop-keeper benefits from having his cash register burgled so long as the burglar spends part of the proceeds in his shop.''

Debt Relief

Some 41 poor countries today suffer from inordinately high foreign debt levels. Thus, the World Bank and the IMF have devised a $68 billion debt-relief initiative for the world's heavily indebted poor countries. To fund this program, the aid agencies are requesting about half the money from the United States and other donors. The initiative, of course, is an implicit recognition of the failure of past lending to produce self-sustaining growth, especially since an overwhelming percentage of eligible countries' public foreign debt is owed to bilateral and multilateral lending agencies. Indeed, 96 percent of those countries' long-term debt is public or publicly guaranteed (See Table 63.1).

Forgiving poor nations' debt is a sound idea, on the condition that no other aid is forthcoming. Unfortunately, the multilateral debt initiative promises to keep poor countries on a borrowing treadmill, since they will be eligible for future multilateral loans based on conditionality. There is no reason, however, to believe that conditionality will work any better in the future than it has in the past. Again, as a recent World Bank study emphasized, ''A conditioned loan is no guarantee that reforms will be carried out—or last once they are.''

Nor is there reason to believe that debt relief will work better now than in the past. As former World Bank economist William Easterly has documented, donor nations have been forgiving poor countries' debts since the late 1970s, and the result has simply been more debt. From 1989 to 1997, 41 highly indebted countries saw some $33 billion of debt forgiveness, yet they still found themselves in an untenable position by the time the current round of debt forgiveness began. Indeed, they have been borrowing ever-larger amounts from aid agencies. Easterly notes, moreover, that private credit to the heavily indebted poor countries has been virtually replaced by foreign aid and that foreign aid itself has been lent on increasingly easier terms. Thus, when the World Bank and IMF call for debt forgiveness, it is the latest in a series of failed attempts by rich countries to resolve poor countries' debts.

At the same time, it has become increasingly evident that the debt-relief scheme is a financial shell game that allows the multilaterals to repay their previous loans without having to write down bad debt and thus without negatively affecting their financial status. If official donors wished to forgive debt, they could do so easily. Contributing money to the multilateral debt-relief initiative, however, will do little to promote reform or self-sustaining growth.

Other Initiatives

The inadequacy of government-to-government aid programs has prompted an increased reliance on nongovernmental organizations (NGOs). NGOs, or private voluntary organizations (PVOs), are said to be more effective at delivering aid and accomplishing development objectives

Table 63.1
Heavily Indebted Poor Countries: Amount of Debt Attributable to Official Aid and Other Government-Backed Schemes, 2006

Country	Long-Term Debt (billion US$)	Public and Publicly Guaranteed Debt (billion US$)	Public and Publicly Guaranteed Debt as a Percentage of Long-Term Debt
Afghanistan	1.76	1.76	100.00
Benin	0.78	0.78	100.00
Bolivia	5.06	3.20	63.33
Burkina Faso	1.02	1.02	100.00
Burundi	1.29	1.29	100.00
Cameroon	2.57	2.08	80.94
Central African Republic	0.86	0.86	100.00
Chad	1.69	1.69	100.00
Comoros	0.26	0.26	100.00
Côte d’Ivoire	11.68	10.83	92.75
Democratic Republic of Congo	9.85	9.85	100.00
Eritrea	0.78	0.78	100.00
Ethiopia	2.21	2.21	100.00
Gambia, The	0.69	0.69	100.00
Ghana	1.89	1.89	100.00
Guinea	2.98	2.98	100.00
Guinea-Bissau	0.69	0.69	100.00
Guyana	0.94	0.94	100.00
Haiti	1.03	1.03	100.00
Honduras	3.51	2.99	85.01
Kyrgyz Republic	2.11	1.86	88.13
Liberia	1.12	1.12	100.00
Madagascar	1.24	1.24	100.00
Malawi	0.77	0.77	100.00
Mali	1.41	1.41	100.00
Mauritania	1.40	1.40	100.00
Mozambique	2.51	2.51	100.00
Nepal	3.29	3.29	100.00
Nicaragua	3.71	3.42	92.24
Nigeria	3.80	3.80	100.00
Republic of Congo	5.33	5.33	100.00
Rwanda	0.39	0.39	100.00

Country	Long-Term Debt (billion US$)	Public and Publicly Guaranteed Debt (billion US$)	Public and Publicly Guaranteed Debt as a Percentage of Long-Term Debt
São Tomé and Principe	0.34	0.34	100.00
Senegal	1.86	1.71	91.91
Sierra Leone	1.32	1.32	100.00
Somalia	1.92	1.92	100.00
Sudan	12.10	11.61	95.90
Tanzania	2.93	2.93	99.80
Togo	1.56	1.56	100.00
Uganda	1.11	1.11	100.00
Zambia	1.83	1.00	54.82
Average	2.53	2.39	96.21
Total	103.60	n.a.	n.a.

SOURCE: World Bank, World Development Indicators Online. http://publications.worldbank.org/WDI.

NOTE: n.a. = not applicable.

because they are less bureaucratic and more in touch with the on-the-ground realities of their clients.

Although channeling official aid monies through PVOs has been referred to as a ''privatized'' form of foreign assistance, it is often difficult to make a sharp distinction between government agencies and PVOs beyond the fact that the latter are subject to less oversight and are less accountable. Michael Maren, a former employee at Catholic Relief Services and USAID, notes that most PVOs receive most of their funds from government sources.

Given that relationship—PVO dependence on government hardly makes them private or voluntary—Maren and others have described how the charitable goals on which PVOs are founded have been undermined. The nonprofit organization Development GAP, for example, observed that USAID's ''overfunding of a number of groups has taxed their management capabilities, changed their institutional style, and made them more bureaucratic and unresponsive to the expressed needs of the poor overseas.''

''When aid bureaucracies evaluate the work of NGOs,'' Maren adds, ''they have no incentive to criticize them.'' For their part, NGOs naturally have an incentive to keep official funds flowing. The lack of proper impact assessments plagues the entire foreign aid establishment, prompting former USAID head Andrew Natsios to acknowledge, ''We don't get an objective analysis of what is really going on, whether the programs are working or not.'' In the final analysis, government provision of foreign assistance through PVOs instead of traditional channels does not produce dramatically different results.

Microenterprise lending, another increasingly popular program among advocates of aid, is designed to provide small amounts of credit to the world's poorest people. The poor use the loans to establish livestock, manufacturing, and trade enterprises, for example.

Many microloan programs, such as the one run by the Grameen Bank in Bangladesh, appear to be highly successful. Grameen has disbursed more than $6.5 billion since the 1970s and achieved a repayment rate of about 98 percent. Microenterprise lending institutions, moreover, are intended to be economically viable, to achieve financial self-sufficiency within three to seven years. Given those qualities, it is unclear why microlending organizations would require subsidies. Indeed, microenterprise banks typically refer to themselves as profitable enterprises. For those and other reasons, Princeton University's Jonathan Morduch concluded in a 1999 study that ''the greatest promise of microfinance is so far unmet, and the boldest claims do not withstand close scrutiny.'' He added that, according to some estimates, ''if subsidies are pulled and costs cannot be reduced, as many as 95 percent of current programs will eventually have to close shop.'' To date, a rigorous assessment of the effectiveness of microenterprise lending has not yet been done due to the lack of reliable data from the lending institutions and the scarcity of proper self-evaluations.

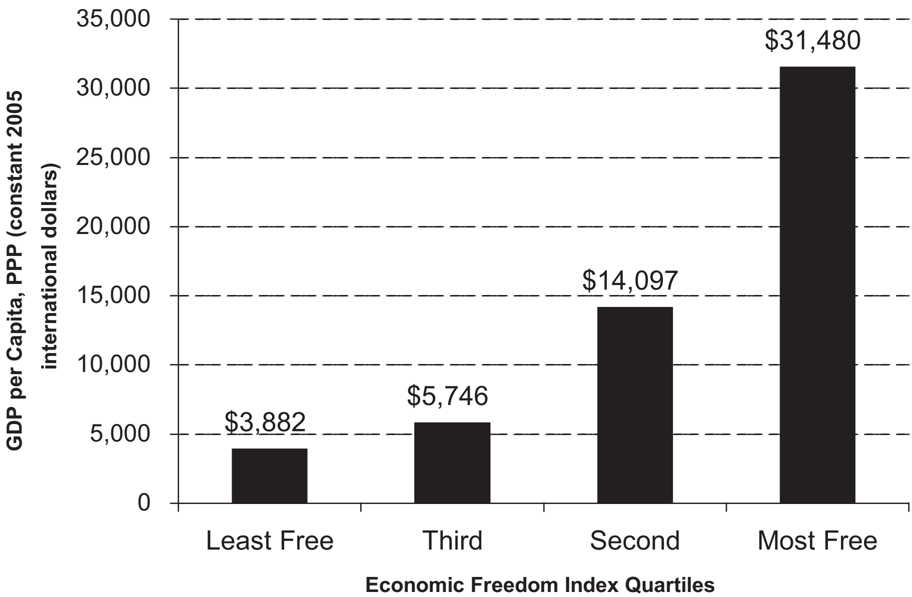
Furthermore, microenterprise programs alleviate the conditions of the poor, but they do not address the causes of the lack of credit faced by the poor. In developing countries, for example, about 90 percent of poor people's property is not recognized by the state. Without secure private property rights, most of the world's poor cannot use collateral to obtain a loan. The Institute for Liberty and Democracy, a Peruvian think tank, found that when poor people's property in Peru was registered, new businesses were created, production increased, asset values rose by 200 percent, and credit became available. Of course, the scarcity of credit is also caused by a host of other policy measures, such as financial regulation that makes it prohibitively expensive to provide banking services for the poor.

In sum, microenterprise programs can be beneficial, but successful programs need not receive aid subsidies. The success of microenterprise programs, moreover, will depend on specific conditions, which vary greatly from country to country. For that reason, microenterprise projects should be financed privately by people who have their own money at stake rather than by international aid bureaucracies that appear intent on replicating such projects throughout the developing world.

Conclusion

Numerous studies have found that economic growth is strongly related to the level of economic freedom. Put simply, the greater a country's economic freedom, the greater its level of prosperity over time (Figure 63.2). Likewise, the greater a country's economic freedom, the faster it will grow. Economic freedom, which includes not only policies, such as free trade and stable money, but also institutions, such as the rule of law and the security of private property rights, increases more than income. It is also strongly related to improvements in other development indicators such as longevity, access to safe drinking water, lower corruption, and

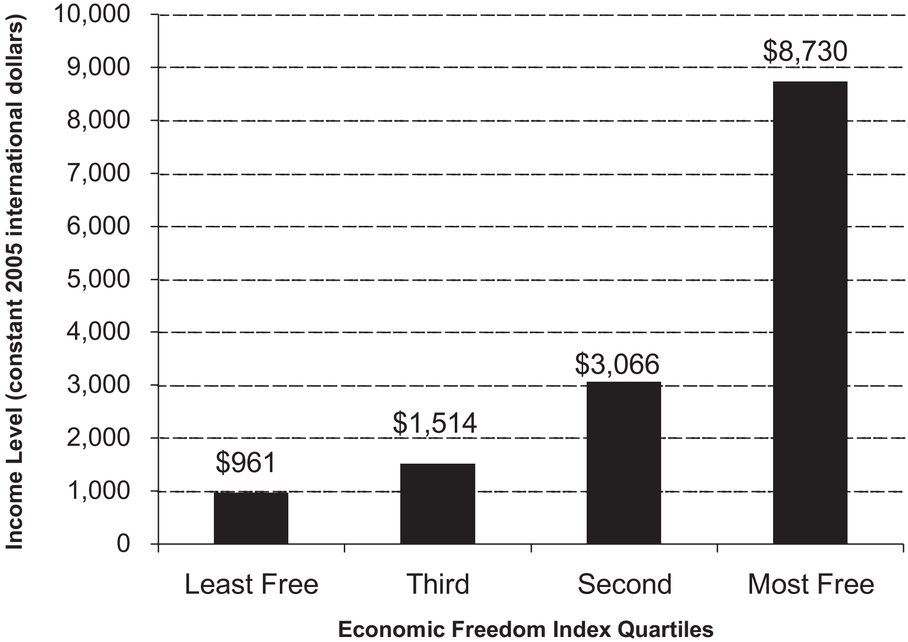
Figure 63.2
Economic Freedom and Income per Capita, 2006



SOURCE: James Gwartney and Robert Lawson, *Economic Freedom of the World: 2008 Annual Report* (Vancouver: Fraser Institute, 2008), p. 18.

NOTE: GDP = gross domestic product; PPP = purchasing power parity.

Figure 63.3
Economic Freedom and the Income Level of the Poorest 10 Percent of the Population, 1990–2006



SOURCE: James Gwartney and Robert Lawson, *Economic Freedom of the World: 2008 Annual Report* (Vancouver: Fraser Institute, 2008), p. 20.

dramatically higher incomes for the poorest members of society (Figure 63.3).

Those developing countries, such as Chile, Estonia, and Taiwan, that have most liberalized their economies and achieved high levels of growth have done far more to reduce poverty and improve their citizens' standards of living than have foreign aid programs.

In the end, a country's progress depends almost entirely on its domestic policies and institutions, not on outside factors such as foreign aid. Congress should recognize that foreign aid has not caused the worldwide shift toward the market and that appeals for more foreign aid, even when intended to promote the market, will continue to do more harm than good.

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—Prepared by Ian Vásquez