Giving Up on Foreign Aid?

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Andrei Shleifer (2009) and David Skarbek and Peter Leeson (2009) offer devastating critiques of foreign aid. Following Peter Bauer's and, more recently, William Easterly's lead, they assert that if aid has any impact at all it is most likely to do harm. The only exception, offered by Skarbek and Leeson, is that it may do some good at the micro-project level. I would like to raise what is rapidly becoming a contrarian point of view.

The Current State of Aid

At this point in time foreign aid indeed threatens to become one of the casualties of the current economic crisis. Instead of doubling the U.S. contribution, as President Obama had promised during his campaign, it appears that it will prove difficult to even maintain prior year levels. The same is true of the other OECD donors, in spite of all the agreement reached at the G8 summits at Gleneagles in 2005, Heiligendamm in 2007, and Toyako in 2008. The developing countries will just have to wait, which, according to these critics, is probably a good thing. Enhancing the resources of the International Monetary Fund, the World Bank, and the regional banks is apparently as much as can be tolerated by rich-country parliaments when there are serious budgetary constraints coupled with a growing skepticism about aid's entitlement to priority.

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The source of the earlier revival of U.S. interest in foreign aid can be located primarily in the reaction to 9/11, as reflected in the U.S. National Security Strategy Memorandum of 2002, listing foreign aid as one of the three main pillars of U.S. foreign policy. While most terrorists have been middle class, they have found havens in poor countries—or so the argument goes. Reinforcement has come from the Bono/Jeff Sachs/NGO humanitarian quarters, seized with the importance of achieving the Millennium Development Goals.

Aid Skepticism

Aid effectiveness has been subject to mounting doubts for several reasons. One, and critical, is the by now general acknowledgement—even by the World Bank and IMF—of the failure of the Structural Adjustment Lending of the 1980s and 90s, tied to conditionality enshrining the Washington Consensus, but usually deteriorating into annual ritual dances, with donors initially insisting on reforms but ultimately yielding to the need to disburse.

The Poverty Reduction Strategy Papers which followed were intended to shore up the lack of real ownership and included a reduction of the customary average 60 conditions per country to approximately 30. However, most observers, even the major donors, agree that this did not measurably improve the situation. The PRSPs are still prepared with the help of large-sized manuals produced by the international financial institutions and cannot go forward without their seal of approval. At a Kampala meeting not long ago, 15 African countries denounced the PRSPs as Structural Adjustment Lending in sheep's clothing.

A second source of the skepticism on the effectiveness of foreign aid arises from the escalating number of public and private (NGO) spigots, both within any one donor and across the donor community. A multitude of principals, working with different recipient country agents, competing for projects and giving conflicting advice, deprives recipient officials of oxygen, hugely escalating transactions costs and contributing materially to the disillusionment with a process once viewed with such optimism in the 1950s. Some developing countries have indeed asked for vacation months from the onslaught of visiting missions.

The U.S. presence on the ground is particularly confusing and chaotic. U.S. foreign aid is typically executed by a vast and bewildering array of private intermediaries, such as university scholars, NGOs, faith-based groups, private companies, contractors, UN players, and private foundations. Though most may receive their funds from a single or at least finite number of Washington agencies, in-country they each have separate identities, requiring individual agreements with a recipient government, separate sets of paperwork, varied goals and styles of work, and competing interests in relation to hiring local personnel and maintaining access to important ministers. All too often local governments find keeping track of this array of a well-intended American presence unmanageable. The aftermath of the recent Haiti earthquake makes the case most vividly. More foreign aid and more NGO projects have been going into Haiti before and since than anywhere else. Yet it has clearly been a failed state. An explosion of micro projects by itself can't do the job, in Haiti or in any of the poor Sub-Saharan countries.

But at the bottom of the critics' current skepticism is that aid is likely to contribute to two versions of the so-called Dutch Disease. The better known strand—namely, the impact of foreign aid on rendering the exchange rate too strong and thus discouraging labor-intensive exports—has been supported by several cross-country studies. But what Bauer's followers really have in mind is a second strand, admittedly potentially more harmful—namely, the impact of aid on decisionmaking, encouraging persistence with inappropriate policy regimes. Instead of facilitating reform, aid in fact takes the pressure off, leading to lower domestic savings, rent seeking, corruption, and capital flight.

It is doubtful that we are currently inclined to invest in the kind of institutional reform our overall aid program, still at an annual $20 billion level, requires if it is to make a positive difference on poverty reduction. USAID, a demoralized agency operating under a 1961 JFK-era Foreign Assistance Act that has grown from 100 to 2,000 pages of congressional earmarks and barnacles, 33 "goals," 45 "priority areas," and 247 "directives," currently handles less than 40 percent of our bilateral aid, while DoD controls a remarkable 22 percent, and there are 20-plus other "spigots." In spite of President Bush's 2006 aid harmonization effort, it is generally conceded that the U.K.'s Department for International Development has left the larger U.S. program in the dust, organizationally as well as in terms of its effectiveness and reception abroad. In spite of all the rhetoric to the contrary, while DFID really does well on poverty reduction abroad, a quarter of America's Official Development Assistance goes to Iraq and Afghanistan and AID's budget, cut by 30 percent between FY06 and FY08, has been shifted wholesale from "Development Assistance" to "Economic Support," i.e., on behalf of U.S. strategic short-term foreign policy objectives.

A Modified Millennium Challenge Corporation

Bauer's followers have chosen to ignore the one Bush era institutional innovation, the Millennium Challenge Corporation, which, with limited effort at reform, could prove them wrong. As is known by insiders, but generally ignored, the MCC, established six years ago, is focused, like most aid programs, on reducing poverty by promoting growth. Its instruments: use 17 transparent policy indicators to determine recipient country eligibility, negotiate compacts with these countries to fund specific projects, and ensure that these compacts reflect real country ownership. It is a miniature so-called independent agency, dwarfed by USAID, which the current budget request claims deploys "internationally best practices to maximize aid effectiveness." Yet, in spite of all that praise, the MCC allocated only $1.5 billion in FY 2008, less than $1 billion in FY2009, and has clearly been hampered by its own project focused procedures.

The MCC currently rewards countries for past performance rather than for their commitment to future policy change. Moreover, it has already made a sufficient number of exceptions to its own rules, by rewarding strategic friends, to cast doubt that it is really all that different from the customary corruption-prone aid program. I argue that there has to be real instead of simply semantic ownership by aid recipients marked by "self-conditionality" instead of old-fashioned donor conditionality.

A refurbished MCC would have to act like a bank—that is, be much more passive, letting would-be borrowers take the initiative, but ready to respond, if and when a would-be recipient indeed presents a multi-year reform package deemed politically as well as economically viable. The would-be borrowing country would present a "self-conditionality" list. Given the difficulty of any government to do too many things at once on a number of policy fronts, realism calls for restricting the number to a few critical selfdetermined bottleneck areas over any three- to five-year period. While admittedly large uncertainties attach to what is precisely the right reform package for a particular country at a particular time, such a package certainly has a better chance if genuinely cobbled together by the main domestic stakeholders. This is the only way to guarantee real as opposed to semantic "ownership."

Instead of the MCC's present grants-for-projects approach, favored by Easterly and Skarbek and Leeson, policy-based program lending or grants should be relied upon. Some of the more successful cases of foreign assistance, including Taiwan and South Korea in the 1960s and Costa Rica and Chile more recently, give ample evidence of the power of fast-flowing, policy-based lending, appreciated by recipients and enabling them to buy off domestic veto players. Project aid, including large U.S. commitments to international health in the form of PEPFAR (for AIDS) and PMI (for malaria), clearly can provide additional local capacity. But when it comes to the acknowledged aim of poverty reduction, based on macro and micro policy changes, given the well-known fungibility of resources, the country realistically has to be viewed as the only really viable "project." The critics' default position privileging physical project concreteness may appeal to congressional delegations but does not render it a rational instrument for providing aid.

If an applicant country feels it needs help in formulating its own policy reform package, it can seek outside help, but such help should come from independent third parties, not from the major donors, and should preferably be financed by foundations or other private parties. The recent IMF Policy Support Instrument endorses the importance of separating advice from financial support.

The new MCC, acting like a bank, would, of course, not simply sign on the dotted line but negotiate with respect to the contents of any proposed reform package, as well as the conditions precedent. In the final analysis, agreement may or may not be reached in every instance. Indeed, there should be absolutely no compulsion to lend, and some countries may not be interested in or able to use the new MCC window over some periods of time. Prolonged fallow years should not be viewed as a failure, but as normal, indeed healthy. Donors, domestic lobbies, and the aid establishment have their vested interests, and history exercises a heavy hand. Some inevitable "business as usual" country programs, showing the flag, would probably have to continue—if at reduced levels—by means of some of the other traditional aid "spigots."

The credibility of this new modality requires, on the quantitative side, the ability to shift funds to the MCC to enable a temporary ballooning of aid for particular successful applicants over a three- to five-year period—that is, long enough to match the political as well as economic adjustment requirements occasioned by the reforms.

The critical element of restored credibility also requires, on the qualitative side, that, if self-conditionality terms are not met, disbursements are indeed cut, so that it becomes clear to everyone that the aforementioned historical ritual dance is not about to be repeated. The music of foreign assistance needs to be radically altered.

Overcoming the Obstacles to a Reformed MCC

Admittedly, the obstacles to adopting such an initiative are formidable. It requires a change in the culture of foreign aid which has become deeply embedded over five decades. Congress must be willing to give up on some of its favorite demonstration projects; the executive branch must be willing to give up using MCC flows as an instrument to enhance short-term foreign policy objectives; and recipients must accept the notion that aid represents their opportunity to reduce the inevitable adjustment pains caused by real reforms, not to take the pressure off. But we do have an opportunity here for a realistic change in the way we do our aid business abroad.

Conclusion

Modifying the MCC initiative in these directions does not require additional resources or major executive or congressional attention—neither of which is currently available. What it does require is a willingness to try something quite different with some of the billions we know are going to continue to be allocated. The United States currently sends out $23 billion bilateral ODA annually, and in Sub-Saharan Africa, on the average, total ODA constitutes 12 percent of its GNI and 75 percent of its gross capital formation. Bauer, Easterly, Shleifer, and Skarbek and Leeson are ready to throw the baby out with the bath water. While foreign aid as presently practiced is admittedly flawed, there is no reason not to encourage at least this promising new window as a potentially valuable component of our long-term foreign policy arsenal.

References

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