

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 regional multilateral development banks;
- not use foreign aid to encourage or reward market reforms in the developing world;
- eliminate programs 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; and
- not counter the increase in China's foreign aid with more U.S. foreign aid.

Foreign aid has risen notably since the turn of this century. The United States spends \$40 billion in overseas development assistance, and total aid from rich countries is now around \$168 billion per year (see Figure 1).

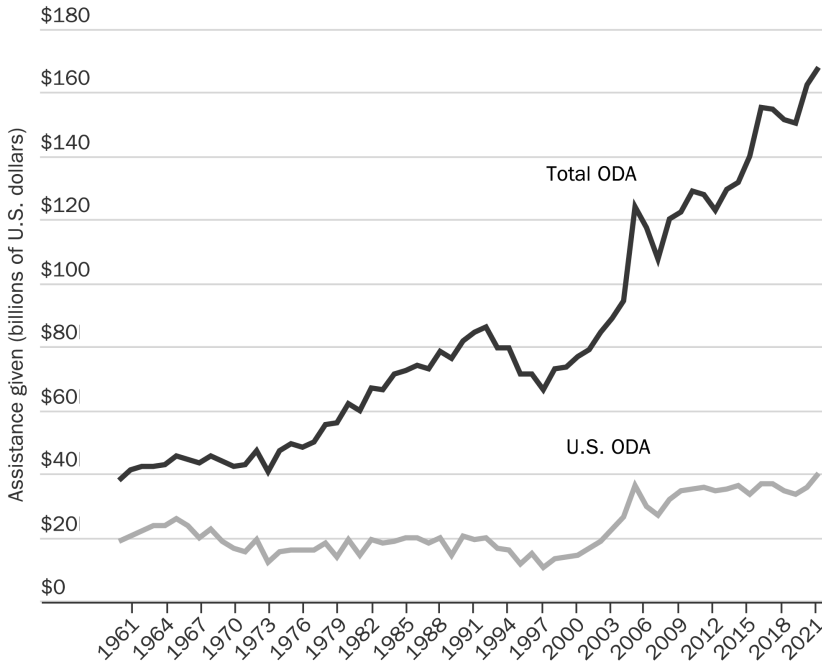
Despite that increase in foreign aid, what we know about aid and development provides little reason for enthusiasm:

- There is no correlation between aid and growth.
- Aid that goes into a poor policy environment does not 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. The

Figure 1

Official development assistance (ODA), 1960–2021



Source: “Net ODA,” Organisation for Economic Co-operation and Development.

increase in aid reflects a gap between the scholarly consensus on the limits of development assistance and the political push that has made more spending happen.

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 regional development banks that have subsequently been created on the World Bank's model and to which the United States contributes: the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, and the European Bank for Reconstruction and Development. The International Monetary Fund (IMF), 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, the multilateral development banks have not achieved any more success at promoting economic growth than has the U.S. Agency for International Development (USAID). 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 congressional Meltzer Commission 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." There is scarce evidence that the record of aid has improved in more recent years.

Massive transfers from the developed to the developing world have not led to a corresponding transfer of prosperity for several reasons. 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. Moreover, much aid goes to autocratic 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, but 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.

Precisely because aid operates within the (usually deficient) political and institutional environments of recipient countries—even when it goes to countries that don't rely on development planning—it can have detrimental effects. That is all the more true with higher levels of foreign assistance, as has been the case with sub-Saharan African countries, most of which have received 10 percent or more of their national income in foreign aid for at least three decades. As Nobel laureate in economics Angus Deaton notes: “Large inflows of foreign aid change local politics for the worse and undercut the institutions needed to foster long-run growth. Aid also undermines democracy and civic participation, a direct loss over and above the losses that come from undermining economic development.”

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. Indeed, a comprehensive study by the IMF found no relationship between aid and growth. Moreover, economic growth in poor countries does not depend on official transfers from outside sources. 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 but 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. For instance, Ernest Preeg, former chief economist at USAID, saw 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.”

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.”

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 for regimes that are uninterested in reform, it should reject schemes that call for funding countries based on their records of reform. That includes the Millennium Challenge Corporation, a U.S. aid agency created in 2004 to direct funds to poor countries with sound policy environments. 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 receive aid. In practice, the effectiveness of such selective aid was questioned by an 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 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 creation of the Millennium Challenge Corporation was not an attempt to reform U.S. foreign aid. Rather, the aid funds it administers are in addition to the much larger traditional aid programs that continue to be run by USAID—in many cases in the very same countries.

Help for the Private Sector

Similar efforts to promote market economies include the underwriting of private entrepreneurs by the World Bank (through its program to guarantee private-sector investment) and 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 the 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 of the need to create 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 one of the world's largest exporters because of agencies like the Export-Import Bank, which finances less than 0.5 percent of U.S. exports.

Even USAID has claimed 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 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

By the mid-1990s, dozens of countries suffered from inordinately high foreign debt levels. Thus, the World Bank and the IMF devised a \$75 billion debt-relief initiative benefiting 39 heavily indebted poor countries. The initiative, of course, was 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 was owed to bilateral and multilateral lending agencies. Indeed, in 2006, at about the time the debt relief initiative began taking effect, 96 percent of those countries' long-term debt was public or publicly guaranteed.

Forgiving poor nations' debt is a sound idea, on the condition that no other aid is forthcoming. Unfortunately, the multilateral debt initiative is keeping poor countries on a borrowing treadmill, since they are eligible for ongoing multilateral loans based on conditionality. There is no reason, however, to believe that conditionality will work any better now than it has in the past. Again, as a 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 began borrowing ever-larger amounts from aid agencies. Easterly notes, moreover, that private credit to the heavily indebted poor countries was virtually replaced by foreign aid and that foreign aid itself was lent on increasingly easier terms.

The debt relief initiative did in fact reduce debt, but it did not prevent countries from getting themselves back into trouble. For example, debt owed to official and private creditors has again risen significantly in African countries that made up the bulk of the heavily indebted poor countries initiative. The public debt of sub-Saharan African countries grew to 35 percent of gross domestic product by 2014, then to 55 percent by 2019, before the COVID-19 pandemic. The debt in the region reached 60 percent by 2021, with the IMF now listing dozens of developing countries in debt distress or being at risk of debt distress.

The Folly of Countering Foreign Aid from China

In the past 15 years, China has become a major aid donor. It has spent hundreds of billions of dollars on education, agriculture, and infrastructure projects, among other areas, and has done so by imposing little conditionality and less concessionary terms than those required by Western aid donors. The rise in China's aid is viewed by admirers as an effective way to promote development based on recipient countries' interests with few strings attached and to simultaneously advance Chinese diplomacy and national interests.

Many in the United States similarly view Chinese aid as particularly effective and thus a challenge to U.S. influence that must be countered in kind. According to Jim Richardson, former director of the Office of Foreign Assistance at the U.S. State Department, for example, "Washington needs to do the same—and beat Beijing at its own game." At a G-7 meeting in July 2022, President Biden announced a multiyear, \$200 billion initiative to support infrastructure in the developing world that would be complemented by hundreds of billions of dollars in additional spending from other G-7 countries.

There is, however, no reason to believe that Chinese foreign aid is immune to the problems that have long plagued other countries' aid programs. For example, although China's ambitious Belt and Road Initiative (BRI)—a massive, overseas infrastructure lending program—has often been touted as a savvy way for China to promote development and its own hegemony, evidence of the initiative's serious shortcomings keeps growing. A recent review by AidData at the College of William and Mary of more than 13,000 projects financed by China and worth \$843 billion in 165 countries found that "35% of the BRI infrastructure project portfolio has encountered major implementation problems—such as corruption scandals, labor violations, environmental hazards, and public protests." The resulting rise in negative sentiments toward China has even led some countries to cancel BRI projects. Thomas Fingar and Jean Oi at Stanford University conclude that "China's relationship with more or less all countries is more fraught today than it was before [President] Xi launched the BRI [in 2013] and China began to flex its economic and military muscles in ways neighbors found worrisome." In short, while much of China's overseas aid is difficult to assess because of its opaque nature, it is increasingly evident that its approach is misguided, and it is a mistake for the United States to counter China with yet greater aid expenditures.

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 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 Group for Alternative Policies, 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.” Maren adds, “When aid bureaucracies evaluate the work of NGOs, 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 program often favored by 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 tens of billions of dollars since the 1970s and achieved a repayment rate of about 97 percent, according to its founder. 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, Jonathan Morduch of New York University 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.” David Roodman of the Center for Global

Development found little evidence for the grand claims of the microcredit movement, including that it can noticeably reduce poverty. He advocated reducing funding for microlending and increasing its effectiveness.

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

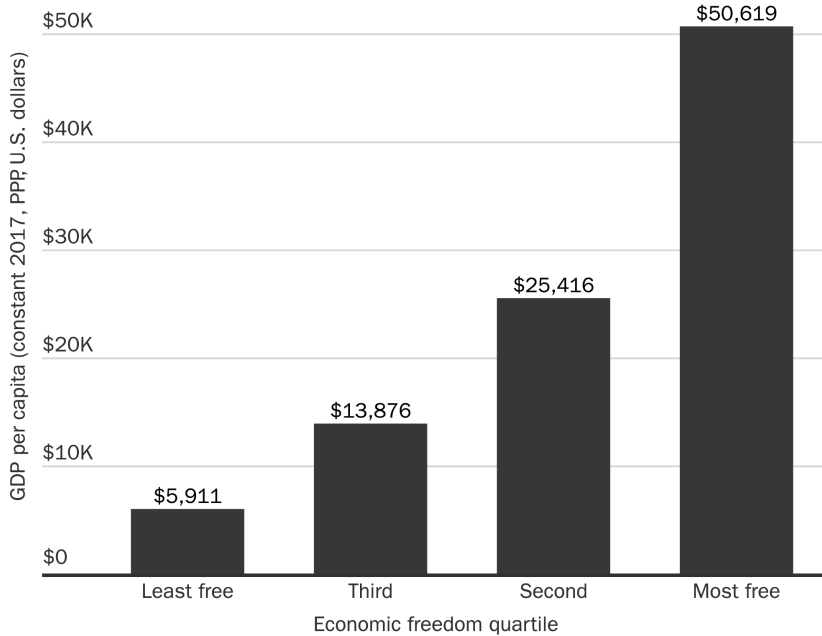
Numerous studies have found that economic growth is strongly related to the level of economic freedom. Put simply, the greater a country's economic freedom, the greater its level of prosperity over time (Figure 2). Likewise, the greater a country's economic freedom, the faster it will grow. Economic 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 just income. It is also strongly related to improvements in other development indicators, such as longevity, access to safe drinking water, less corruption, and dramatically higher incomes for the poorest members of society (Figure 3).

The developing countries that have liberalized their economies the most 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. As Deaton observes:

Even in good environments, aid compromises institutions, it contaminates local politics, and it undermines democracy. If poverty and underdevelopment are

Figure 2

Countries with greater economic freedom have substantially higher per capita incomes, 2019



Source: James Gwartney et al., *Economic Freedom of the World: 2021 Annual Report* (Vancouver: Fraser Institute, 2021), p. 18.

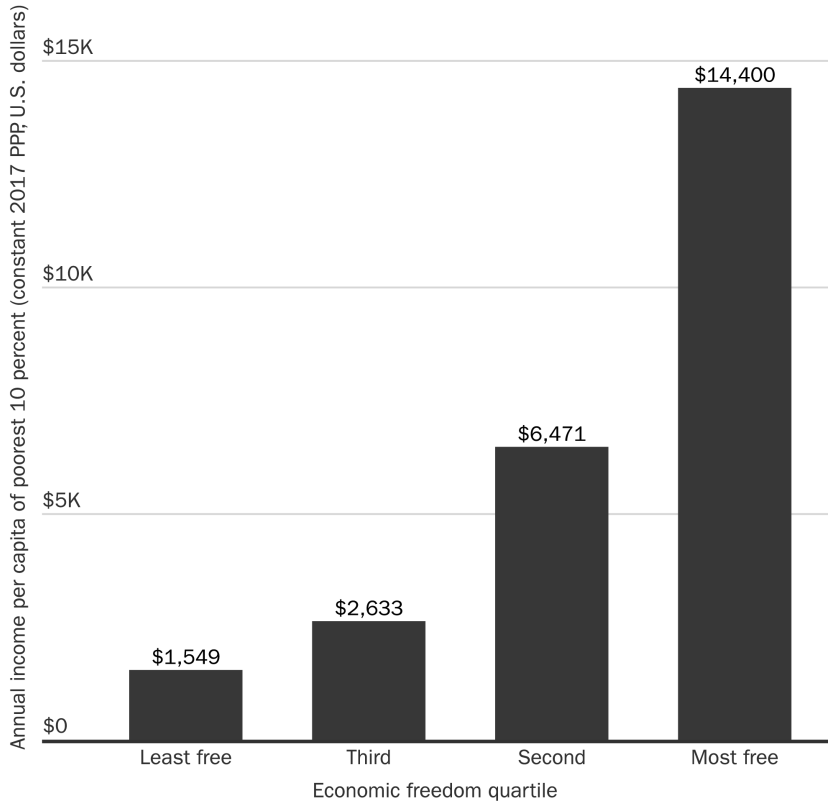
Notes: GDP = gross domestic product; PPP = purchasing power parity.

primarily consequences of poor institutions, then by weakening those institutions or stunting their development, large aid flows do exactly the opposite of what they are intended to do. It is hardly surprising then that, in spite of the direct effects of aid that are often positive, the record of aid shows no evidence of any overall beneficial effect.

In the end, a country's progress depends almost entirely on its domestic policies and institutions, not on outside factors such as foreign aid. As Easterly suggests, aid distracts from what really matters, "such as the role of political and economic freedom in achieving development." 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.

Figure 3

Economic freedom and the income earned by the poorest 10 percent, 2019



Source: James Gwartney et al., *Economic Freedom of the World: 2021 Annual Report* (Vancouver: Fraser Institute, 2021), p. 19.

Note: PPP = purchasing power parity.

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