



No. 79

September 17, 2003

The New Approach to Foreign Aid Is the Enthusiasm Warranted?

by Ian Vásquez

Executive Summary

The failure of past foreign aid programs has given rise to a new consensus on how to make foreign aid effective. According to the new approach, aid that goes into poor countries that have good policies and institutions is highly effective at promoting growth and reducing poverty. Disbursing aid to countries that have good policies contrasts with the traditional practice of providing aid to countries irrespective of the quality of their policies or providing aid to promote policy reforms. President George Bush's proposed foreign aid initiative, the Millennium Challenge Account, is based on the selective approach to foreign assistance, as are, in large part, the World Bank's calls to double foreign aid flows worldwide.

Yet enthusiasm about the promise of selective aid is unfounded. Bold empirical claims about the positive effects of "selectivity" are based entirely on World Bank research, most of which is difficult or impossible to reproduce by outside researchers. Though the

World Bank's research has had an enormous influence on the debate, the few attempts to reproduce the Bank's findings using its own data and methodology have contravened the Bank's findings.

Providing development assistance to countries with decent policies and institutions is a dubious undertaking. Good policies will reap the rewards of growth. "Overrewarding" those countries with foreign aid, by contrast, may have effects similar to those of traditional foreign aid programs: slowing the pace of reform and development.

Even if selectivity could somehow be made effective, the practical impediments to making it work are formidable. Delivery of MCA funds, for example, will surely suffer from politicization, bureaucratic self-interest, and congressional micromanagement. The prevalence of traditional foreign aid programs throughout the developing world will also undermine the intended impact of more narrowly focused selective aid programs.

Massive transfers of wealth have not led to corresponding increases in prosperity.

Introduction

In the past 18 months the U.S. administration and the World Bank have advocated substantial increases in foreign aid.¹ James Wolfensohn, president of the World Bank, has called for a doubling of aid worldwide from the current level of about \$50 billion per year.² The increase would ostensibly enable countries to achieve an array of ambitious goals by 2015 including cutting world poverty in half, promoting gender equality, providing universal primary education, and ensuring sustainable development. President George Bush has proposed raising bilateral U.S. aid by 50 percent from the current level of roughly \$10 billion by 2006. The additional U.S. funds would be used to set up the Millennium Challenge Account. The MCA would disburse grants only to poor countries that were “ruling justly, investing in their people, and encouraging economic freedom.”³

This initiative is based largely on the argument that aid agencies have learned from the failure of past aid programs and that foreign assistance can now be highly effective, especially if channeled to a select group of poor countries that have generally sound policies. Indeed, the World Bank claims that its lending has already become highly selective and therefore highly effective at promoting growth, poverty reduction, and investment. In the United States, conservatives and liberals alike have supported the MCA.⁴

The new enthusiasm over aid is, however, unfounded. The current thinking on aid effectiveness is informed almost entirely by World Bank research of questionable empirical strength.⁵ The practical problems of implementing selectivity in the disbursement of aid are significant, if not insurmountable. Moreover, countries with reasonably sound policies will experience economic growth without foreign aid. Providing development assistance to such countries may improve the apparent performance of foreign aid, but it may also help to create dependence and delay

further reform, problems that have long plagued official development assistance.

The Path to Selectivity

The shift away from what foreign assistance advocates derided as “aid pessimism” began in the late 1990s after decades of disappointing experience. The failure of past aid programs is well documented. Massive transfers of wealth have not led to corresponding increases in prosperity. Studies have found no relationship between aid and economic growth or between aid and basic human development indicators.⁶ Even development agencies have acknowledged that aid has caused dependency among recipient nations and often caused more harm than good. The World Bank, for example, admits that aid has been, “at times, an unmitigated failure.”⁷

Other points around which a consensus has formed include the unsurprising finding that aid delivered into poor policy environments will not spur growth, can be inimical to development, and has characterized the way much, if not most, foreign aid has been disbursed.⁸ “Conditionality,” or aid conditioned on policy reform in recipient nations, has also been ineffective. The World Bank has found that there is “no systematic effect of aid on policy”⁹ and that “almost all adjustment loans disburse fully, even if policy conditions are not met.”¹⁰ By sustaining governments that maintain poor policies, aid thus appears to have had the effect of slowing reform.¹¹ Indeed, according to the Bank, “reform is more likely to be preceded by a decline in aid than an increase in aid.”¹² That finding is consistent with the general consensus that economic reality (often in the form of fiscal policy crises) and domestic political economy conditions are the main determinants of policy change.

The reasons for aid’s failure are various, many of which have been discussed by development economist Peter Bauer, long foreign aid’s most eloquent critic.¹³ Though ignored during most of the post-World War II period, many of Bauer’s critiques have now attained validity

among development experts. The new approach to disbursing development money on the basis of selectivity aims to avoid committing the errors identified by Bauer and others and appeals to market advocates and development practitioners alike. Thus, for example, in 2000 the bipartisan Meltzer Commission of the U.S. Congress advocated that multilateral development banks provide grants based on some degree of selectivity.¹⁴

Yet the idea of selectivity is not new. Some 20 years ago, Bauer himself recommended it as a way of mitigating “the worst effects of aid.” According to him, aid grants would have to be made “deliberately discriminating.”

Aid would have to be concentrated carefully on governments whose domestic and external policies were most likely to promote the general welfare of their people, notably their economic progress. Aid would have to go to governments which tried to achieve this end by effective administration, the performance of the essential tasks of government, and the pursuit of liberal economic policies. . . . Selective allocation of aid along these lines would reduce its propensity to politicize life, and thereby reduce the extent and intensity of political conflict.¹⁵

As far back as the 1960s, others, including President John F. Kennedy and U.S. AID official Charles Lindblom, emphasized the importance of selectivity.¹⁶ But it is only in recent years that calls to expand aid are being based on strong claims about the promise and accomplishments of selectivity.

Selectivity in Focus

Empirical claims about the positive effect of selective aid rest entirely on World Bank research conducted since the second half of the 1990s. A handful of studies has exerted an enormous influence on the debate.¹⁷

Of those studies, only Burnside and Dollar is replicable by outside researchers since it relies on widely available data. The other studies are based on internal Bank measures compiled in an index known as the Country Policy and Institutional Assessment. The CPIA data set, which now covers 20 policy components for the period 1974 to the present, is not available to outside researchers.

Burnside and Dollar look at the fiscal, monetary, and trade policies of 56 developing countries from 1970 to 1993 and relate the policy environment to aid flows. They find that the impact of aid on growth is positive in good policy environments. The Bank explains that in good-policy countries a 1 percent of GDP increase in aid produces a sustained increased growth rate of 0.5 percent. Burnside and Dollar also find that better allocation of aid to poor countries that have good policy environments “would have a large, positive effect on developing countries’ growth rates.” According to them, good policy countries that received small amounts of aid grew by 2.2 percent per capita compared to good policy countries that received large amounts of aid, whose growth rates were 3.7 percent.¹⁸

But Burnside and Dollar’s results have been contravened by a recent study by William Easterly et al.¹⁹ Easterly and his colleagues replicate the Burnside and Dollar methodology but they update the data by extending the original 1970–1993 period to 1970–1997. They also include missing data from the original 1970–1993 period. By adding the new data, the authors report that they “no longer find that aid promotes growth in good policy environments” and they caution economists and policymakers to be less sanguine about embracing the conventional wisdom on selectivity.²⁰

Easterly and his colleagues do not explain why they obtained such different results. But a number of explanations are possible. The period that Burnside and Dollar used included the late 1980s and early 1990s, a time in which many developing countries such as Peru or Argentina had implemented far-reaching reforms that initially produced high growth. However, those countries did not continue

By adding the new data, the authors report that they “no longer find that aid promotes growth in good policy environments.”

When viewed over a longer time period, selectivity may impose negative effects on reform and growth.

implementing reforms after the mid-1990s and so experienced diminishing returns in terms of growth. Ironically, both high initial growth and the provision of aid to such countries may have discouraged governments from pursuing further reform. That explanation is especially plausible if the general consensus is right that reform results when governments feel economically constrained. Thus, when viewed over a longer time period, selectivity may impose negative effects on reform and growth.

Other possible explanations for the Easterly results include the fact that the Burnside and Dollar methodology does not adequately measure the determinants of a good policy environment or that other factors that are more difficult to measure, such as institutions (e.g., rule of law, secure property rights), play a significant role in development. If so, the Easterly findings are not hard to understand. But they underline the practical difficulties of devising set criteria by which to evaluate whether the domestic conditions for growth are present.

World Bank research subsequent to Burnside and Dollar relies on the fuller set of measures and dates included in the CPIA. Using the CPIA, Collier and Dollar²¹ corroborate the earlier finding that selectivity substantially increases growth. They also find that selective allocation of aid significantly reduces poverty. Collier et al.²² and Collier and Dollar²³ expand on that research. They find that in the 1990s official development assistance worldwide has shifted from a disbursement practice that did not favor good policy environments to disbursements that were selective, and therefore much more effective. Through its concessional lending arm (the International Development Association) the World Bank during the 1990s went from being fairly selective to being highly selective. According to these studies, each dollar of IDA aid to good policy countries raises gross investment by two dollars and the increased selectivity of overall aid in the 1990s means that an additional \$1 billion in aid would now lift 284,000 people out of poverty. The

Bank concludes that given the now highly effective character of aid and given the general improvement in policies in developing countries, a substantial increase in aid is urgently needed.

Unfortunately, because the CPIA data is not available to outside researchers, it is impossible to fully assess the quality of the Bank's findings. There are, however, reasons to be skeptical. Using the same data, former World Bank economist William Easterly was unable to reproduce the Bank's finding that there has been an overall increase in selectivity.²⁴ He also found "no evidence of a significant positive association between good policies . . . and aid flows in the 1990s or at any other time."²⁵ Easterly notes, moreover, that if the Bank's claims about poverty reduction effectiveness were true, each person pushed above the income poverty threshold of \$365 would cost \$3,521 in aid spending.²⁶

The Bank also appears to have engaged in questionable manipulation of data. According to Easterly, the World Bank obtained its results on IDA's increased selectivity by excluding India and Indonesia from its sample and by defining poor policy countries as those that ranked in the bottom third of the CPIA among countries eligible to borrow from IDA.²⁷ Given that IDA countries tend to have the world's poorest policy environments, deeming only one third of those nations as having poor policies is an especially charitable way for the Bank to categorize them.

Another problem is that the CPIA ratings are themselves largely subjective measures of the policy environment.²⁸ Perhaps that explains why, out of a total of 114 poor countries rated in the CPIA in 1998, a surprising 55 countries—almost half of those rated—were deemed to have good or very good policy environments.²⁹ That number contrasts sharply with the 20 or so countries that would likely participate in the first few years of the MCA's operation. Among the countries the CPIA rated as "good" were India and Senegal, and among those rated "very good" were Argentina and Brazil. Yet India and Senegal rank low in terms of other measures of the

policy environment; both countries have consistently ranked in the bottom half of the list of 123 countries annually rated by the Fraser Institute according to their level of economic freedom.³⁰ Both Brazil and Argentina, moreover, subsequently suffered policy deterioration and economic crises. (Brazil received an IMF bailout in 1998—the same year the above CPIA rated it very good—in a failed attempt to prevent its currency from falling).

The last two examples again call into question the selectivity approach. Both Argentina and Brazil suffered from a buildup of excessive debt in the late 1990s. If selectivity crowded in more investment in a country mismanaging debt, disinclined to pursue further reforms, or inclined to backtrack on policy, the aid could indeed prove harmful.³¹

I stress the shortcomings of the Bank's empirical studies and performance on selectivity for two reasons. First, the Bank's research has exerted an enormous influence on the aid debate by making such strong claims. That influence has extended to the creation of the Bush administration's MCA, an aid program that admittedly is better designed than World Bank selectivity appears to be.³² Second, problems with the Bank's selectivity approach are not just ones of design. Even the most thoughtfully crafted selectivity approach could hinder development.

Indeed, in the policy debate surrounding the MCA, much discussion has focused on technical factors that would make the delivery of that aid effective. Those include relying on selectivity criteria that are transparent, clearly measurable, and to the extent possible, objective; providing grants rather than loans; relying on results rather than inputs as a measure of success and eligibility for further grants; and ensuring that the performance of MCA aid is evaluated by an independent body. Such mechanisms will surely make the MCA work better than World Bank selectivity.

But while technical improvements may increase the effectiveness of selective aid that will typically go into growing economies, it does not follow that selectivity as a general policy will encourage reform or growth in

recipient countries. Some countries might choose to do as little as possible to continue receiving aid as long as they have met the minimum criteria of selectivity. This may be a worse outcome than one where the absence of aid compels the developing nation to introduce more far-reaching reforms in order to achieve the same level of growth that selective aid with less policy reform promises. A more probable scenario is one in which a poor country's reform performance, rather than being motivated by the pursuit of aid, is spurred by domestic and economic conditions. To the extent that selectivity increases economic growth in the short term, it may also reduce the prospects for further reform because it reduces the pressure for more policy change. In that case, growth and reform ultimately suffer. That interpretation recognizes that the political economy of many developing nations is such that growth itself can slow down reform, that the process of achieving a better policy and institutional environment in poor countries cannot be expected to be smooth, and that policymakers should avoid over-rewarding good reformers.

Evaluating the quality of a country's policies and institutions is, of course, complex. Although it is essential to rely on objective indicators such as tariff rates to make such a judgment, a large element of subjective evaluation is also necessary to determine such things as the level of political stability, or whether the rule of law is improving or deteriorating. If selectivity had the effects on growth and investment that its proponents claim, then the centralization of judgment calls, particularly in government aid agencies, would be a worrisome prospect.³³

Practical Problems

The selective approach to aid is further undermined by two large practical problems, namely the politicization of aid delivery and the continuing prevalence of traditional foreign aid. It is difficult to imagine, for example, that even the most carefully designed MCA

To the extent that selectivity increases economic growth in the short term, it may also reduce the prospects for further reform because it reduces the pressure for more policy change.

The new aid enthusiasm, though broadly shared, is not justified.

program will be immune from political pressures. Funding decisions related to MCA eligible countries such as Turkey, Pakistan, Russia or Colombia—all considered strategic to the United States—could be influenced by factors other than the desired effect of aid on development.³⁴ As with other government agencies, we can expect the Millennium Challenge Corporation, which will manage the MCA, to behave in ways that maximize its resources whether it performs well or not. Since the MCC will depend on Congress for funding, it may find itself satisfying congressional demands that weaken its mission. Indeed, other aid programs have been plagued by extensive congressional micro-management.

While the theory of selective aid implies that traditional aid is ineffective or even harmful, the old approach to development assistance is prevalent. Neither the World Bank nor the United States has significantly reduced its provision of conventional aid to poor countries. In fact, although the World Bank reports that IDA has become more selective in the 1990s, it also reports that poor policy countries are now receiving more IDA money per capita (\$2.3) than in 1990 (\$2).³⁵ The new MCA funds will likewise come on top of the ongoing \$10 billion in development assistance that Washington generally disburses. (The U.S. Agency for International Development will not be reformed, reduced or abolished.) For that reason alone, the establishment of the MCA cannot be said to be an improvement on the status quo.

The intended effect of any grants that the MCC provides, furthermore, will be undercut by the presence of official development assistance from other sources. Of the list of the probable 115 countries that will be eligible for MCA funds in the first three years, all of them receive development assistance from other agencies, some in significant amounts. More than 80 percent of those countries receive support from U.S. AID.³⁶ In the face of so much aid from traditional sources, it is hard to believe that the MCC will have the notable impact its proponents champion.

Conclusion

The new aid enthusiasm, though broadly shared, is not justified. It is based on problematic claims about aid's effectiveness and a dubious approach to development. Politicization and the prevalence of conventional foreign aid from multiple sources will undercut the U.S. effort to create a "well designed" selectivity program. Any increases in foreign aid in the name of selectivity will surely add yet another chapter to the disappointing history of foreign aid.

Notes

I thank John Welborn for his valuable research assistance. This study is based on a paper presented at the 78th annual conference of the Western Economic Association, Denver, Colorado, July 14, 2003.

1. In this paper, foreign aid refers to official development assistance, defined by the Organization for Economic Cooperation and Development as grants or concessional loans provided by the official sector for the principle purpose of promoting economic development and welfare.
2. James Wolfensohn, "A Partnership for Development and Peace," Speech delivered at the Woodrow Wilson International Center, Washington, March 6, 2002.
3. George W. Bush, Speech at the Inter-American Development Bank, March 14, 2002, www.whitehouse.gov/news/releases/2002/03/20020314-7.html.
4. See Adam Lerrick, "Effective Give and Take: A Business Plan for Development Aid," *Economic Directions* 13, no. 1, lecture delivered at Saint Vincent College, September 25, 2002; Brett D. Schaeffer, "The Millennium Challenge Account: An Opportunity to Advance Development in Poor Nations," Heritage Lectures, no. 753, June 27, 2002; Steven Radlet, *Challenging Foreign Aid: A Policymaker's Guide to the Millennium Challenge Account* (Washington: Center for Global Development, 2003); and Lael Brainard, Carol Graham, Nigel Purvis, Steven Radelet, and Gayle Smith, *The Other War: Global Poverty and the Millennium Challenge Account* (Washington: Brookings Institution, 2003).
5. The main findings of that research are presented in World Bank, *Assessing Aid: What Works, What Doesn't and Why* (New York: Oxford University Press, 1998) and World Bank, *A Case for Aid* (Washington: World Bank, 2002).

6. Peter Boone, "The Impact of Foreign Aid on Savings and Growth," Working Paper, London School of Economics and Center for Economic Performance, 1994; Peter Boone, "Politics and the Effectiveness of Aid," Working Paper, London School of Economics and Center for Economic Performance, 1994; and Ian Vásquez, "Official Assistance, Economic Freedom, and Policy Change: Is Foreign Aid Like Champagne?" *Cato Journal* 18, no. 2 (Fall 1998). Other sources documenting the poor performance of aid include William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (Cambridge, Mass.: MIT Press, 2001); International Financial Institution Advisory Commission (Meltzer Commission), "Report to the U.S. Congress and the Department of the Treasury," March 8, 2000; Patricia Adams, *Odious Debts* (Toronto: Earthscan, 1991); Bruce Rich, *Mortgaging the Earth* (Boston: Beacon Press, 1994); Michael Maren, *The Road to Hell: Foreign Aid and International Charity* (New York: Free Press, 1997); and *Perpetuating Poverty: The World Bank, the IMF, and the Developing World*, ed. Doug Bandow and Ian Vásquez (Washington: Cato Institute, 1994).
7. World Bank, *Assessing Aid*, p. 1. See also U.S. Agency for International Development, *Development and the National Interest* (Washington: Government Printing Office, 1989).
8. Craig Burnside and David Dollar, "Aid, Policies and Growth," World Bank Working Paper no. 1777, 1997. This paper was later published as an article by the same title in *American Economic Review* 90, no. 4 (September 2000).
9. Burnside and Dollar, p. 4.
10. David Dollar and Jakob Svensson, "What Explains the Success or Failure of Structural Adjustment Programs?" World Bank Working Paper no. 1938, 1998, p. 4. See also Paul Mosely, Jane Harrigan, and John Toye, *Aid and Power: The World Bank and Policy-Based Lending* (New York: Routledge, 1991); Gustav Ranis, "On Fast Disbursing Policy-Based Loans," background paper for the Task Force on the United States and Multilateral Development Banks, Center for Strategic and International Studies, Washington, 1996; and Paul Collier, "The Failure of Conditionality," in *Perspectives on Aid and Development*, ed. Catherine Gwin and Joan M. Nelson (Washington: Overseas Development Council, 1997).
11. See Bandow and Vásquez, "The Dismal Legacy and False Promise of Multilateral Aid," *Perpetuating Poverty*; and Dani Rodrik, "Understanding Economic Policy Reform," *Journal of Economic Literature* 34, no. 1 (March 1996).
12. World Bank, *Assessing Aid*, p. 49.
13. See Peter Bauer, *Dissent on Development* (Cambridge, Mass.: Harvard University Press, 1972), pp. 96–136; and Peter Bauer, *Equality, the Third World, and Economic Delusion* (Cambridge, Mass.: Harvard University Press, 1981), pp. 86–156.
14. Meltzer Commission, p. 12. Though there was initial resistance to this idea at the World Bank, part of the recommendation has been accepted.
15. Peter Bauer, *Reality and Rhetoric: Studies in the Economics of Development* (Cambridge, Mass.: Harvard University Press, 1984), p. 60–61.
16. For more on John F. Kennedy's support of selectivity, see William Easterly, "The Cartel of Good Intentions: Bureaucracy versus Markets in Foreign Aid," Center for Global Development Working Paper no. 4, March 2002, p. 35. For more on Lindblom, see discussion on selectivity in Edward S. Mason and Robert E. Asher, *The World Bank since Bretton Woods* (Washington: Brookings Institution, 1973), p. 442.
17. Those include Burnside and Dollar; Paul Collier and David Dollar, "Aid Allocation and Poverty Reduction," World Bank Working Paper 2041, January 1999 (this paper was later published as an article by the same title in *European Economic Review* 46, 2002); Paul Collier, Shantayanan Devarajan, and David Dollar, "Measuring IDA's Effectiveness," mimeo, World Bank, 2001; and Paul Collier and David Dollar, "Development Effectiveness: What Have We Learnt?" mimeo, World Bank, January 2001.
18. Burnside and Dollar; and World Bank, *Assessing Aid*, p. 14.
19. William Easterly, Ross Levine, and David Roodman, "New Data, New Doubts: Revisiting 'Aid, Policies, and Growth,'" Center for Global Development Working Paper no. 26, March 2003.
20. Easterly et al., p. 8.
21. Collier and Dollar, "Aid Allocation and Poverty Reduction."
22. Collier, Devarajan, and Dollar.
23. Collier and Dollar, "Development Effectiveness: What Have We Learnt?"
24. As a former economist at the World Bank, Easterly apparently had access to the CPIA data.
25. Easterly, "Cartel of Good Intentions," p. 37–38.
26. Easterly, "Cartel of Good Intentions," p. 40.
27. William Easterly, "The Cartel of Good Intentions:

The Problem of Bureaucracy in Foreign Aid," *Journal of Policy Reform* 5, no. 4 (December 2002). This article is based largely on "The Cartel of Good Intentions," Center for Global Development.

28. The World Bank acknowledges that the CPIA scores are subjective. See Collier and Dollar, p. 4.

29. The ratings for countries are available only for a few years (1998, 2001, and 2002) and they are not presented in a consistent way. I use 1998 because that is the clearest presentation of the Bank's ratings. See Collier and Dollar, "Development Effectiveness," Table 2, pp. 27-29.

30. See James Gwartney and Robert Lawson, *Economic Freedom of the World: 2003 Annual Report* (Vancouver: Fraser Institute, 2003).

31. That negative pattern would hold for IDA-eligible countries as well, though perhaps to a different degree.

32. For example, Bush cited World Bank research in his speech announcing the MCA initiative. George W. Bush, Speech at the Inter-American Development Bank.

33. It is far better to decentralize investment decisions that are based on significant subjective evaluation. Private investors in a competitive market are more likely to be sensitive to the domestic conditions of a developing country and through their collective decisions are thus more likely than selective aid programs to create a dynamic that encourages more optimal growth.

34. Radelet warns about this point in *Challenging Foreign Aid*, p. 27.

35. World Bank, *A Case for Aid*, pp. 99-100.

36. See country list prepared by Radelet in *Challenging Foreign Aid*, Box 2.1, p. 23. Aid figures are for the years 2000 and 2001.

Published by the Cato Institute, Cato Foreign Policy Briefing is a regular series evaluating government policies and offering proposals for reform. Nothing in Cato Foreign Policy Briefing should be construed as necessarily reflecting the views of the Cato Institute or as an attempt to aid or hinder the passage of any bill before Congress. Contact the Cato Institute for reprint permission. Additional copies of Cato Foreign Policy Briefing are \$2.00 each (\$1.00 in bulk). To order, or for a complete listing of available studies, write the Cato Institute, 1000 Massachusetts Ave., N.W., Washington, D.C. 20001, call toll free 1-800-767-1241 (noon - 9 p.m. eastern time), fax (202) 842-3490, or visit our website at www.cato.org.