64. Foreign Aid and Economic Development

Congress should

- abolish the U.S. Agency for International Development and end traditional 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 corporate welfare;
- forgive the debts of heavily indebted countries on the condition that they not receive any further foreign aid; and
- end government support of microenterprise lending and nongovernmental organizations.

Foreign aid is among the most unpopular of all government programs with the American public. Although the public continues to place the alleviation of world poverty and the promotion of development in poor countries as priorities on its list of foreign policy concerns—a view consistent with the American tradition of generosity—it has lost confidence that the U.S. government is well suited to achieve those goals.

That apprehension is not unfounded, nor is it limited to average American citizens. Today, the failure of conventional government-to-government aid schemes is widely recognized and has 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.

Despite record levels of lending, however, the multilateral development banks have not achieved more success at promoting economic growth than has U.S. AID. Numerous self-evaluations of World Bank performance over the years, for example, have uncovered high failure rates of bank-financed projects. A 1992 internal World Bank study found "a gradual but steady deterioration in portfolio performance" and deemed 37.5 percent of projects completed in 1991 "unsatisfactory." 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, most recipients of aid have not. Rather, as a 1989 U.S. AID report suggested, aid has tended to create dependence on the part of borrower countries.

There are several reasons why 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, U.S. AID 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."

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.

"New" Ideas

With the collapse of development planning and the worldwide shift toward liberalization, most advocates of foreign aid now acknowledge at least rhetorically the importance of markets and the private sector in economic development. U.S. AID, for example, emphasizes that it no longer lends mainly to governments.

Proponents of continued foreign assistance cite several noble-sounding goals to justify continued funding. They include efforts to advance market reforms, loans and guarantees to the private sector, active promotion of U.S. exports, and increased reliance on private voluntary organizations and "market-based" credit that reaches the poor.

In the post–Cold War era, appeals cloaked in market rhetoric have increased and are likely to persist. It is important, therefore, to separate fact from fiction and to examine cause and effect.

For example, a substantial amount of aid is still directed to the public sector. About one-third of U.S. economic aid goes to the Middle East; most of that aid is received by the governments of Egypt and Israel. It should not be surprising, then, that the region is notable for its low levels of economic freedom and almost complete lack of economic reform. In 1996 the Institute for Advanced Strategic and Political Studies, an Israeli think tank, complained: "Almost one-seventh of the GDP 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 1998 the institute again complained that foreign aid "is the single greatest obstacle to economic freedom in Israel."

Promoting 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 U.S. AID, 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."

Far more effective at promoting market reforms is the suspension or elimination of aid. Although U.S. AID 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 not been effective at inducing reform. One 1997 World Bank study noted that there "is no systematic effect of aid on policy." 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 micro-evidence 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. Indeed, had they received substantial foreign assistance as a reward for implementing far-reaching liberalization measures, it is unlikely that countries such as Chile or the Czech Republic would be as economically sound as they are today.

Helping the Private Sector

Enterprise funds are another initiative intended to help market economies. Under this approach, U.S. AID 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 taken place. Moreover, there is no evidence that the funds have generated additional private investment, had a positive impact 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, OPIC, 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 the provision of 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 clear 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 merely 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 about 3 percent of U.S. exports.

Even U.S. AID 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 explains, "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 $28 billion debt-relief initiative for the world's heavily indebted poor countries (HIPCs). To fund the HIPC program, the aid agencies are requesting about $14 billion 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, 97.5 percent of those countries' long-term debt is public or publically guaranteed (Table 64.1).

Forgiving poor nations' debt, of course, 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."

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 64.1
Heavily Indebted Poor Countries:
Amount of Debt Attributable to Official Aid and Other Government-Backed Schemes, 1997

	Total Long-Term Debt (billion dollars)	Total Public and Publicly Guaranteed Debt (billion dollars)	Total Public and Publicly Guaranteed Debt as a Percentage of Long-Term Debt
Angola	8.88	8.88	100.0
Benin	1.49	1.49	100.0
Bolivia	4.82	4.39	91.1
Burkina Faso	1.23	1.23	100.0
Burundi	1.05	1.05	100.0
Cameroon	7.98	7.78	97.5
Central African Rep.	0.82	0.82	100.0
Chad	1.00	1.00	100.0
Congo, Dem. Rep.	9.03	9.03	100.0
Congo, Rep.	4.31	4.31	100.0
Côte d'Ivoire	12.95	10.88	84.0
Equatorial Guinea	0.22	0.22	100.0
Ethiopia	9.52	9.52	100.0
Ghana	5.31	5.04	94.9
Guinea	3.11	3.11	100.0
Guinea-Bissau	0.85	0.85	100.0
Guyana	1.51	1.51	100.0
Honduras	4.22	3.96	93.8
Kenya	5.68	5.36	94.4
Lao PDR	2.32	2.32	100.0
Liberia	1.37	1.37	100.0
Madagascar	3.94	3.94	100.0
Mali	2.87	2.87	100.0
Malawi	2.18	2.18	100.0
Mauritania	2.15	2.15	100.0
Mozambique	5.67	5.62	99.1
Myanmar	4.64	4.64	100.0
Nicaragua	4.85	4.85	100.0
Niger	1.49	1.39	93.3
Rwanda	1.03	1.03	100.0
Sao Tome and Principe	0.23	0.23	100.0
Senegal	3.46	3.40	98.3
Sierra Leone	1.06	1.06	100.0
Somalia	2.00	2.00	100.0
Sudan	10.29	9.80	95.2

	Total Long-Term Debt (billion dollars)	Total Public and Publicly Guaranteed Debt (billion dollars)	Total Public and Publicly Guaranteed Debt as a Percentage of Long-Term Debt
Tanzania	6.34	6.30	99.4
Togo	1.30	1.30	100.0
Uganda	3.59	3.59	100.0
Vietnam	19.29	19.29	100.0
Yemen, Rep.	3.67	3.67	100.0
Zambia	6.39	6.37	99.7

SOURCE: World Bank, *Global Development Finance* (Washington: World Bank, 1999).

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 U.S. AID, 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 U.S. AID'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. 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 loans are used by the poor 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 $1.5 billion since the 1970s and achieved a repayment rate of about 98 percent. Microenterprise lending institutions, moreover, are intended to be economically viable, able to achieve financial self-sufficiency within three to seven years. Given those qualities, it is not clear 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."

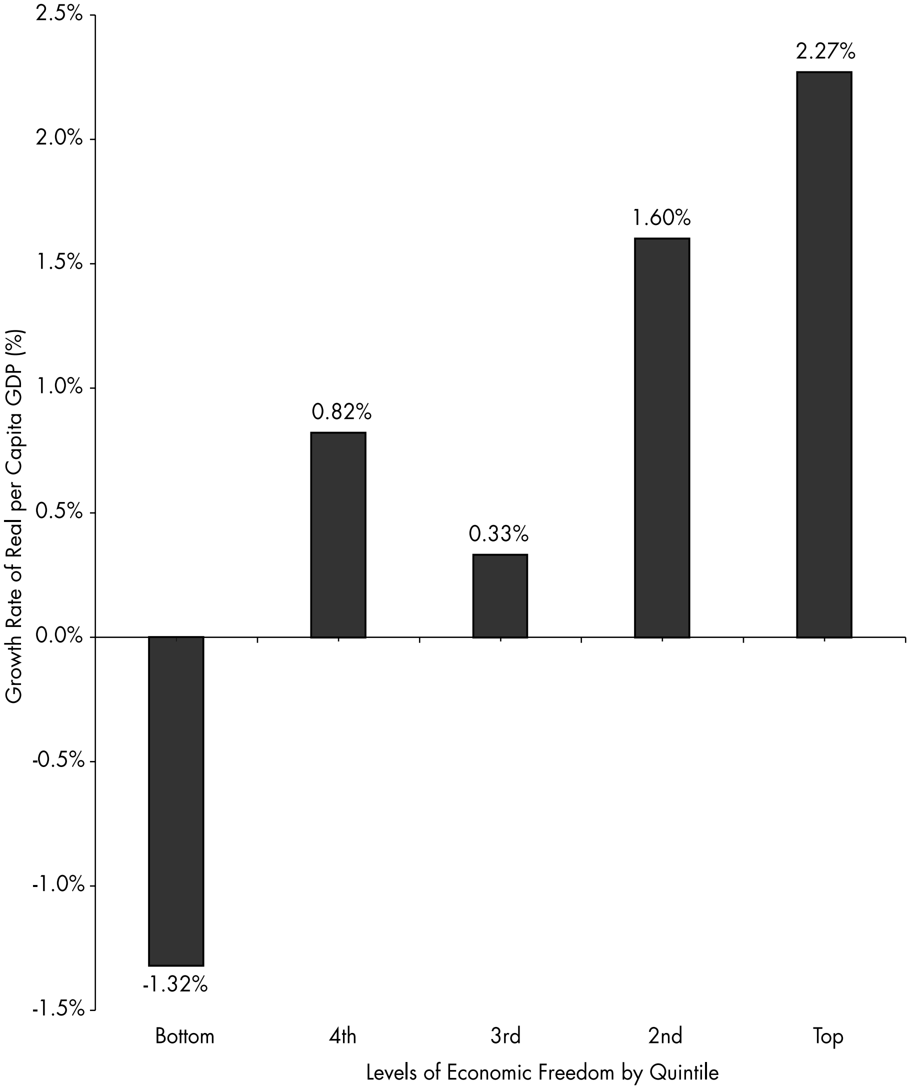
Furthermore, microenterprise programs alleviate the conditions of the poor, but they do not address the causes of the lack of credit faced by the poor. In developing countries, for example, about 70 percent of poor people's property is not recognized by the state. Without secure private property rights, 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 where 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. Likewise, the greater a country's economic freedom, the faster it will grow (Figure 64.1). Those developing countries, such as Chile and Taiwan, that have most liberalized their economies and achieved high levels of growth have

Figure 64.1
Economic Freedom and Economic Growth during the 1990s



SOURCES: World Bank, *1999 World Development Indicators* (Washington: World Bank, 1999); and James Gwartney and Robert Lawson, with Dexter Samida, *Economic Freedom of the World: 2000 Annual Report* (Vancouver: Fraser Institute, 2000).

done far more to reduce poverty and improve their citizens' standards of living than have traditional 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 to the free 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