Official Assistance, Economic Freedom, and Policy Change: Is Foreign Aid Like Champagne?

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Foreign aid has had, and continues to have, a multiplicity of goals. Five decades of development assistance have provided an adequate historical record by which to judge to what extent aid successfully meets those goals and whether it has lived up to the aspirations of its architects or the expectations of its critics. The record also allows us to compare how aid is used and disbursed in practice with its use and disbursal in theory, something which has forced proponents, if not practitioners, to be more realistic about what aid can accomplish. Moreover, a broad consensus has emerged in recent years about the kind of policy environment necessary for economic growth, namely, the need for market-oriented policies.

In light of foreign aid's record, the traditional rationales for providing official development assistance have weakened, leading to the rise of new, plausible-sounding missions. An evaluation of aid's effectiveness in the past and of its likely effectiveness in achieving goals now emphasized by its proponents—the promotion of market reforms in developing countries and of self-sustaining growth in countries that do reform—will help in determining how much hope should be placed in continuing aid flows. Such an evaluation will also help determine whether we can expect the case for aid to be made almost regardless of its record, as Peter Bauer (1981: 91) observed when he stated, "Aid is thus like champagne: in success you deserve it, in failure you need it." Bauer noted that proponents of foreign assistance will claim the need for aid irrespective of a country's performance. Now that the market-liberal revolution has included developing countries

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around the world, aid advocates seem to be saying that the world needs development assistance more than ever. But there is little reason to prematurely celebrate the latest promises of foreign aid and every reason to believe that the world would be better off if we put away the champagne.

Aid Effectiveness

A number of recent reports have looked at the effectiveness of official development assistance, which the OECD defines as concessional aid flows from official bilateral or multilateral agencies that aim to promote economic development and welfare in poor countries and that contain at least a 25 percent grant component. Those studies have reported discouraging economic results among countries that have received development aid for decades. The United Nations *Human Development Report* (UNDP 1996: 1), for example, found that over the past 15 years economic decline and stagnation in 100 countries has reduced the income of 1.6 billion people. "In 70 of these countries," the report states, "average incomes are less than they were in 1980—and in 43 countries less than they were in 1970." Peter Boone (1994a: 24) looked at aid flows to 97 countries from 1971 to 1990 and found that "aid does not create, nor correlate with, those underlying factors which cause growth." Those findings are roughly in line with Paul Mosley (1987) and the Congressional Budget Office (1997: xi), which stated that "foreign aid overall appears to have only a marginal effect" on development and may even hinder it.

Using a sample of 73 countries from 1971 to 1995, I also looked at the correlation between aid flows from virtually all official sources and economic growth. The findings are consistent with those of Boone and Mosley. Neither aid per capita nor aid as a percentage of GDP was positively correlated with economic growth. (In fact, aid as a percentage of GDP has a slightly *negative* correlation with economic growth.) When broken down by the various aid sources, the lack of any positive correlation with growth holds despite the fact that the various bilateral and multilateral agencies have emphasized different approaches to lending (the World Bank, for example, only lends to governments, while the U.S. Agency for International Development can provide credit directly to nongovernmental organizations and other private groups) even though a common principle objective has been the promotion of growth.

Of course, growth is not the only goal of foreign aid. Political objectives like purchasing security or promoting democracy and human rights have often been part of foreign assistance. But those goals are not directly aimed at improving economic welfare as is official development assistance (which can admittedly be indirectly affected by such noneconomic objectives). The main economic rationales have steadily lost force.

One major rationale for aid in the early post-World War II era was to substitute for the lack of developed private capital markets that could benefit poor countries. The scarcity of investment capital, both at the international level and within developing countries, was said to have hindered growth prospects of poor countries and even condemned them to perpetual misery. However dubious those assumptions were (see Lal 1996, Bauer 1972), abundant private capital flows to developing nations, which now dwarf official development assistance, undermine the need for aid agencies to fill that role. Does aid at least stimulate additional private capital flows? Boone (1994a: 20), Dani Rodrik (1996: 190), and James Burnham (1996) suggest there is little or no evidence for this.

Another argument marshaled in favor of aid is that it be used to reduce poverty and address basic human needs. Here again, the record of aid in practice has strayed far from theory. Boone (1994b: 4, 21), for example, found "no significant impact of aid on improvements in infant mortality, primary schooling ratios nor life expectancy." He further concluded that "there is strong evidence that aid flows primarily benefit a wealthy political elite . . . and does not benefit the poor." Similar conclusions were reached by Mosley (1987) and by the World Bank's (1994) discovery that despite $200 billion of infrastructure investment in the developing world, most of it bypasses the poor. The Bank's finding is especially damning since so much development assistance has gone to infrastructure.

Another justification for aid is to redress inequality in developing countries, something that is often associated in the literature with economic growth and liberalization (see, for example, UNDP 1996). This argument is particularly wrongheaded since it tends to treat poverty alleviation and the reduction of wealth inequalities as though they were the same thing; it is also misleading since aid probably helps widen the gap between the elite and the poor given the way it is ultimately disbursed. Economic growth, furthermore, is positively correlated with poverty redressal, but some studies have found no correlation with reductions in income inequality (Lal and Myint 1996: 39–41). In other words, growth sometimes coincides with increases in income inequality and sometimes does not; growth does, however, increase poor people's incomes. Steve Hanke and Stephen Walters (1997: 140–42), on the other hand, found that growth promotes income equality, thus confirming Gerald Scully's (1992) earlier research.

The reasons aid has proved so disappointing are varied and many of them are well known. They include public choice reasons (aid agencies, aid officials, and recipient governments face incentives to continue or increase aid flows independent of how well those funds are used); multiple and conflicting goals within and among aid agencies; the politicization of developing economies (most aid goes to governments at the expense of the private sector and civil society); aid increases consumption (mostly by governments) but does not increase investment; and most aid is disbursed to governments that maintain policy environments inimical to economic growth. One reason aid does not improve basic human development indicators even when that is the explicit purpose of such aid is that the assistance is totally fungible (Feyzioglu, Swaroop, and Zhu 1996). Not only do goverments use balance-of-payments support to fund their preferred projects; it appears that governments behave the same way even in the case of aid-supported social expenditures and other types of project aid.

The case for foreign aid has been weakened further by research that has identified the real sources of economic growth. While aid cannot be shown to cause growth, a number of studies (Gwartney and Lawson 1997; Johnson, Holmes, and Kirkpatrick 1998; Messick 1996; and Hanke and Walters 1997) have established a strong link between economic freedom and economic prosperity. James Gwartney and Robert Lawson (1997), in the most sophisticated and comprehensive of the first three studies, tracked the level of economic freedom in more than 100 countries from 1975 to 1995, looking at 17 variables in each nation ranging from openness of the economy to inflation variability as empirical measures. They found that high levels of economic freedom and increases in economic freedom positively influence growth, and that achieving and maintaining high levels of freedom over time tends to produce high national income levels. Growth, moreover, has dramatically improved the absolute living standards of the poor as measured by human development indicators and income levels. Life expectancy, for example, will increase by about 6 percent when a nation's per capita income rises from $500 to $1000; moreover, a 10 percent increase in economic freedom tends to increase per capita GNP by 7.4 to 13.6 percent (Hanke and Walters 1997: 118, 139). Given that countries like Peru and Argentina have improved their levels of economic freedom by more than 100 percent between 1985 and 1995 (Gwartney and Lawson 1997: 32), the implications for the poor are impressive. That is particularly the case since a given increase in wealth positively affects poorer countries more than it does richer countries, and much of the pestilence that afflicts the poor is relatively inexpensive and straightforward to deal with (Taylor 1994). Where aid has failed, growth has succeeded and can continue to do so.

With the collapse of central planning and the empirical record speaking so clearly, it has become evident that "the great differences in the wealth of nations are mainly due to differences in the quality of [countries'] institutions and economic policies" (Olson 1996). A general consensus has arisen that those policies and institutions necessary for economic growth should be market-oriented. Indeed, in the 1980s, aid agencies were already conceding the need for market-oriented policy change in recipient countries if lending was to do any good (World Bank 1981, 1984, 1987; U.S. AID 1989). There was a recognition that aid would not do good in countries that had bad economic policies. Today there is increasing agreement with World Bank Vice President Ernest Stern's (1991: 2) observation that "a soundly designed project in a poor economic environment will not yield expected results" (see CSIS 1998, Williams 1996).

That observation, however, is not new, though it seems to have been forgotten soon after aid programs became institutionalized. In its 1948–49 annual report, for example, the World Bank itself recognized the futility of lending to countries that maintained inappropriate policies:

> Certainly no amount of external aid, technical or financial, can replace the essential will and determination on the part of the government or the country concerned to adopt the often difficult and politically unpopular economic and financial measures necessary to create a favorable environment for development [as quoted in Mason and Asher 1973: 461].

To test whether aid agencies have acted on their own observations, I looked at the 20 countries in the Gwartney-Lawson (1997) sample whose overall economic freedom declined or remained the same (excluding Hong Kong, which has maintained the same high level) from 1985 to 1990. Of those 20 nations, aid as a percentage of GDP *increased* during that period in 19 countries and in 11 of those countries per capita GDP decreased. Moreover, the greater the reduction in freedom among those countries, the greater were the aid flows they received. Aid agencies were not in fact reducing their level of funding to countries that maintained anti-growth policies; *rather they were increasing aid flows despite widespread acknowledgment that such action would not promote development and would likely inhibit it.*

The period from 1990 to 1995 showed that aid agencies continued to ignore their own advice regarding lending to countries with inappropriate policy environments. Of the 24 countries whose overall economic freedom declined or remained the same during those years (excluding Hong Kong and Singapore), 11 countries saw their aid flows as a percentage of GNP increase or decline negligibly (a less than 10 percent fall). Of those 11 countries, seven saw their economies contract during that period.

The empirical evidence on aid and the causes of economic growth have led to calls for aid to focus on promoting economic reforms and on supporting countries that introduce such reforms. Aid, in other words, should be used "as a carrot to lure countries down the path of economic freedom" (*Investor's Business Daily* 1997) and then to promote growth under those conditions. Michael O'Hanlon and Carol Graham (1997: 62, 43) thus assert, "Today's least developed countries can benefit in most cases from more aid, provided they are reforming their economies and are committed to use the resources professionally and seriously. . . . When sound economic fundamentals are in place . . . there will be little reason for donors not to work with the recipient government." Likewise, Craig Burnside and David Dollar (1997: 32) conclude, "Aid would be more effective if greater effort were made to direct it to good policy performers."

Policy Change and the Ritual Dance

Naturally, many aid proponents already claim that foreign assistance, particularly multilateral development assistance from the World Bank and the International Monetary Fund, has been largely responsible for the worldwide shift away from statism. Yet the adoption of market-oriented policies at first by a handful of developing countries and then increasingly by dozens more has had little to do with five decades of official lending. Anne Krueger (1993) and Deepak Lal (1987) suggest that the cause for reform is typically the onset of economic crisis. The failure of import-substitution policies to promote industrialization in Taiwan and Korea, for example, combined with those countries' inability to rely on a wealth of domestic natural resources, and the cut-off of massive U.S. foreign aid had the effect of concentrating the minds of the ruling elite (Krueger 1993, Lal and Myint 1996, Krauss 1983). The economic liberalization of recent years, likewise, has been "due to the 'crisis' in governability that past dirigisme had engendered" (Lal 1996: 12).

The proposal that loans from aid agencies be conditioned on policy reform is, of course, not new. The IMF has always had a component of conditionality attached to its lending, and the World Bank has done the same since 1980 in the form of structural adjustment loans (SALs). Because conditionality has been a feature mostly of multilateral lending institutions and because multilateral aid as a share of total aid flows is increasing (IMF 1998), it is useful to examine how successful that instrument has been.

The record of policy-based lending has been disappointing. Rodrik (1996) has concluded that it is unclear whether conditionality has been effective in practice. Others have been more critical, stressing the aid agencies' institutional pressures to lend and referring to a "ritual dance" between donor and recipient (Callaghy 1986; Mosley, Harrigan, and Toye 1995; Ranis 1996). The World Bank's SALs, for example, are disbursed in various tranches, in an effort to improve the enforceability of the attached conditions. Mosley, Jane Harrigan, and John Toye (1995: 173) note, however, that "the recipient knows that if it makes amicable noises, plus comparisons with other countries if necessary, it can expect the release of the second tranche within a year as surely as day follows night." SALs have done little to change the policies of recipient nations and in practice have often encouraged governments to maintain poor economic policies (CSIS 1998). Burnside and Dollar (1997: 4) found that some countries, like Ghana, exhibit a positive correlation between aid and policy change, but that "For each Ghana . . . there is a Zambia, in which policy deteriorated continuously from 1970 until 1993, while aid receipts rose continuously. The general result is no systematic effect of aid on policy." Mosley, Harrigan, and Toye (1995: 172) explain why that might be so:

> In cases where there has been substantial delinquency on loan conditions, a typical sequence has been as follows: a supervision mission . . . flies out to the recipient country to inspect progress. . . . The recipient government is informed that the second tranche is being withheld. . . . The recipient government makes a conciliatory gesture. . . . What is being bargained about at this stage, therefore, is not whether the second tranche will be released, but when.

Dollar and Jakob Svensson (1998: 4) observe that "almost all adjustment loans disburse fully, even if policy conditions are not met." Gustav Ranis (1996: 6) concurs:

> While the program loan instrument may be loaded with conditionality, ultimately the need to lend will overcome the need to ensure that those conditions are indeed met.
>
> At the same time, while the additional resources are supposed to ease the pain of the adjustment, they serve to take the pressure off and permit the recipient to avoid adjustment. What usually occurs, at the risk of some exageration, therefore, is a rather time-consuming and expensive ritual dance. Few tranche releases have

> ever been cancelled—at most they are delayed. Few countries, certainly not large ones, have ever had prolonged break-downs in their relations with the World Bank.

Even if more of the developing world is moving toward economic freedom for reasons unrelated to the lending agencies' conditionality, the lending agencies may be making matters worse. The aid institutions that take the policy reform mission seriously are, after all, in the awkward position of trying to discourage bad policy and encourage policy change through loan cut-offs and, at the same time, trying to encourage policy change through the release of more aid if a country promises such change. Yet releasing that aid would once again jeopardize reforms. Not releasing that aid, on the other hand, would mean that policy change would occur without aid and thus run the risk that the agencies would be viewed as irrelevant. From an institutional perspective, lending agencies simply cannot afford to let developing countries reform on their own. Both the aid institutions and the recipient governments know this, thus further reducing the credibility of so-called conditionality.

Despite their stated goal to promote market reforms, lending of this sort tends to delay rather than accelerate liberalization. This may even be the case in countries that are already predisposed to reform, since additional funding, by relieving the pressure to reform, can make it harder for liberal-minded regimes to resist the pressures of entrenched interests. Moreover, as Miles Kahler notes, "Policy action taken prior to securing external support offers a good predictor of the likelihood that programs will be implemented, but this observation only buttresses the point that governments committed to policy reform will probably undertake them in any case and that those opposed will resist" (as quoted in Haggard and Kaufmann 1992: 17). Evidence of the effects of aid for liberalization was most recently provided when India faced western sanctions in 1998 in response to the country's nuclear tests. As the *International Herald Tribune* (1998) reported, "India approved at least 50 foreign-investment projects to compensate for the loss of aid from Japan and the United States," and that India would take additional measures to attract capital.

The dynamic between lender and borrower has had further damaging consequences. Rodrik (1996) has suggested that aid agencies, to increase their credibility, should invest their resources in countries with which they have negotiated conditionality as a sort of signal that those nations are or will become good places in which to invest. Because conditionality implies a sort of official seal of approval of a country's policy environment, the aid institution's role as a rating agency for countries becomes paramount. But there are several reasons to believe that aid agencies cannot perform this function properly. The most obvious reason is that the aid agency faces a conflict of interest if it were rating countries in which it had its own money at stake. Moreover, if aid agencies are to provide proper signaling to investors, they must be less secretive about what they know and do not know of a country's economic situation and likely direction. If aid agencies are to follow the IMF's lead in trying to prevent national financial crises from erupting, however, they are likely to remain secretive. Indeed, if the IMF and other official lenders did perceive a potential crisis in a country, they would precipitate a crisis by announcing their concerns. Not sounding the alarms, however, would undermine their role as credible rating agencies. This appears to have occurred recently with the IMF in the Asian crisis (Vásquez 1998). Only by not lending could the IMF increase its integrity. At that point, however, it would merely be duplicating a function already available in the private sector.

The signaling function of conditional lending can be harmful in other ways. Paul Collier (1997: 60) has observed that the ritual dance between donors and borrowers has made it especially difficult for genuine reformers to signal their intentions because so much conditionality has not been honored and in Africa has come to represent the wishes of the donor as against the wishes of the recipient. "Conditionality has thus had the inadvertent outcome of enabling African governments only to signal their policy incompetence. Failures are clearly attributable to governments; successes are not." Collier furthermore notes that aid for reform is likely to be highly volatile as African nations increasingly contest elections and thus enter into "political business cycles." As they do so, policy-based lending is likely to be highly cyclical and so contribute to instability, thereby becoming a source of economic crisis. That observation is consistent with Rodrik's (1996: 184–86) that there is no evidence that multilateral aid stimulates additional capital flows and that it may even deter them; it appears, moreover, that such aid has followed, rather than led private capital flows, suggesting "the possibility that multilateral institutions end up bailing out private investors."

Given the problems with conditionality, some aid advocates (Burnside and Dollar 1997, Collier 1997) have suggested that aid be disbursed only to countries with good policy environments where it can achieve desirable results. This approach, known as selectivity—providing foreign assistance only to countries that can show a level of achievement—is also not new. Aid agencies have long struggled to differentiate between the two approaches (conditionality and selectivity) and to determine which works best. In 1966, for instance, former U.S. AID official Charles Lindblom explained, "The distinction between trying to buy, with aid, the policies we like and coming more generously to the assistance of policies that promise growth is a fine one; but it is a genuine one" (as quoted in Mason and Asher 1973: 442). And, in their review of the World Bank's lending history, Edward Mason and Robert Asher (1973: 442) noted, "The Bank has governed its lending operations by judgments both of the significance of development indicators and of the effect of particular policies; and with respect to policies it has on occasion rewarded and on other occasions attempted to induce their adoption."

Alas, reliance on the selectivity approach is also questionable. Aid institutions would be in charge of determining what constitutes sufficient achievement for aid disbursal; proponents of the selectivity mission have been especially vague about the necessary criteria. At what level of economic freedom or after how much policy reform would a country qualify for selective aid? Obviously, this is a judgment call. But given the aid agencies' demonstrated institutional incentives to lend, which have so plagued conditional aid, there is little reason to believe that such pressure will not also undermine selective lending. Countries that reformed after a certain point might slow or stop their reform processes in the knowledge that they would now qualify for continuing aid. Indeed, if the aid did flow and reforms stopped, what would be the response of the aid agencies? Aid agencies could cut off recipients to induce further reforms, but then they would merely be resuming the pattern of conditional lending again. It is not at all clear why selectivity would be more successful at promoting reforms than would be an international environment of market forces with no such aid. Although Burnside and Dollar, for instance, do not list the countries they selected as good policy environments, they did mention Ghana as one example; it is worth noting that policy slippage there has increased since the release of their study.

A world without development aid (whether conditional, selective, or otherwise) is likely to be a world in which private selectivity and conditionality would have more credibility and thus lead to real conditionality and real reform.[1] It would reduce, if not end, the dizzying spectacle of "ritual dances" based on too much champagne.

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[1]Alberto Alesina and Dollar (1998) find that "While foreign aid flows respond more to political variables, foreign direct investments are more sensitive to economic incentives, particularly 'good policies' and the protection of property rights in the receiving countries."

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