

Background

No. 2523
March 1, 2011



Published by The Heritage Foundation

Not All Foreign Aid Is Equal

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Abstract: *The record of development assistance as a catalyst for long-term sustainable economic growth is abysmal. Perhaps the only exception is the Millennium Challenge Corporation (MCC), which requires countries to demonstrate foremost a commitment to good governance, sound economic policies, and the well-being of their citizens. As Congress considers ways to reduce the federal budget deficit, instead of targeting the MCC—the most market-oriented of America’s foreign aid programs—Members should focus on the traditional USAID model that has repeatedly failed to deliver sustained economic growth and development.*

Congress faces many tough choices as it responds to the national security threat posed by out-of-control federal spending. However, the decision is easy in one area: foreign aid. Traditional development assistance does not work, at least not if the goal is to foster sustainable development in poor countries. Traditional efforts, such as those administered by the U.S. Agency for International Development (USAID), dole out billions of dollars each year despite evidence that these policies virtually ensure that economic growth will be minimal or unsustainable. Other types of U.S. foreign assistance—including security assistance, humanitarian assistance, and highly focused programs such as the President’s Emergency Plan for AIDS Relief (PEPFAR)—are capable of achieving specific or short-term goals.

The record of development assistance as a catalyst for long-term sustainable economic growth is

Talking Points

- As Congress responds to the national security threat posed by out-of-control federal spending, deciding what to cut is easy in one area: foreign aid.
- Traditional development assistance by the U.S. Agency for International Development has failed.
- Innovative, market-oriented foreign aid approaches by the Millennium Challenge Corporation have shown more promise.
- MCC holds developing country governments accountable for results, and MCC aid recipients must commit to good governance and sound economic policies and make serious, sustained efforts to combat corruption.
- The MCC model encourages private-sector-led economic growth, strong protection of property rights, and the rule of law.
- Congress should focus its development assistance cuts on the traditional USAID model that has repeatedly failed to deliver sustained economic growth and development.
- Specifically, Congress should eliminate USAID’s entire \$2.6 billion Development Assistance Program and make an additional \$1.4 billion in cuts in USAID’s budget.

This paper, in its entirety, can be found at:
<http://report.heritage.org/bg2523>

Produced by the Center for International Trade and Economics (CITE)

Published by The Heritage Foundation
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Washington, DC 20002-4999
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abysmal. Perhaps the only exception to this poor track record is the Millennium Challenge Corporation (MCC), which requires countries to demonstrate foremost a commitment to good governance, sound economic policies, and the well-being of their citizens.

The MCC model holds recipient governments accountable for results and requires them to make serious, sustained efforts to combat corruption. MCC programs also encourage private-sector-led economic growth, strong protection of property rights, and the rule of law. All of these set the table for domestically driven economic growth and development, which can never be replaced by foreign assistance, no matter how well intentioned.

As a part of its foreign aid approval process, the MCC uses the trade freedom indicator in the *Index of Economic Freedom*,¹ published annually by The Heritage Foundation and *The Wall Street Journal*. The entire MCC approach is consistent with the core values of the *Index*.

As Congress considers ways to reduce the federal budget deficit, cuts to USAID and its traditional aid programs should be near the top of the list. Other types of assistance—such as military assistance, humanitarian assistance, and MCC grants requiring policy reform—merit close scrutiny, but their past performance should justify continuing congressional support.

Military Aid Enhances U.S. National Security

The value of U.S. international security assistance was illustrated most recently during the crisis in Egypt. The U.S. and Egyptian militaries have worked together closely for more than 30 years through such programs as the Foreign Military Sales (FMS) and International Military Education and Training (IMET) programs. When rioters on Tahrir Square demanded the overthrow of the Mubarak government last month, it was Egypt's military—and only the military—that succeeded in holding the line against virulently anti-U.S. elements.

1. Terry Miller and Kim R. Holmes, *2011 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2011).

U.S. international security assistance has made direct and short-term contributions to America's national security and should continue to be funded. This assistance includes the FMS program to subsidize sales of U.S. military equipment, services, and training to friendly developing countries; IMET grants for training foreign military professionals; and some funding of international peacekeeping operations.

PEPFAR: A Humanitarian Assistance Success Story

PEPFAR, the U.S. government's global effort to combat HIV/AIDS, is a recent example of the government's ability to respond effectively to a crisis when it wants to do so. PEPFAR has succeeded for a variety of reasons, but one of the most important was that its managers determined early on to focus on addressing one problem and to fence off its funding and management from USAID's ever-encroaching and entrepreneurial bureaucrats.

PEPFAR reflects a bipartisan political decision to apply a tangible and well-defined solution to solve a very real problem: namely, to design and implement systems to procure and deliver anti-retroviral HIV/AIDS drugs to those who are suffering from that disease around the world by using the latest generation of private business (not government) organizational techniques.

Other U.S. agencies have also led successful responses to humanitarian disasters (for example, earthquakes and tsunamis). One hallmark of these successes is that government delivery of humanitarian assistance was generally fenced off from USAID. This is powerful testimony to USAID's anachronistic ineffectiveness.

Traditional Foreign Aid Programs Do Not Work

Official development assistance (ODA) from USAID and other Western donor governments has a poor record of success in catalyzing economic growth and development. Since 1960, developed member nations of the Organisation for Economic Co-operation and Development have donated more than \$2 trillion in development

assistance,² but studies have shown that ODA failed to produce the desired results of job creation and higher living standards through economic growth.³

The evidence indicates that this failure was preordained by the nature of ODA programs. Because ODA programs focus on government-to-government transfers, they tend to promote statist approaches to development among their recipients that enhance the power and size of recipient governments and create economic distortions in recipient economies. They also promote a welfare-dependency mindset and create new opportunities for corruption.

With rare exceptions, traditional aid ultimately reinforces the problems that contribute to a lack of development. Addressing such problems as illiteracy is important, but traditional development assistance programs aimed at such problems are too small to solve them and insufficient in themselves to overcome the policy impediments to economic growth.

Some USAID programs have devolved into little more than corporate welfare schemes for U.S. universities, nongovernmental organizations, and development assistance contractors. Members of Congress have commonly earmarked development assistance funds to benefit universities and contractors in their states.

Traditional development assistance is based on a world that no longer exists. In the 21st century, private financial flows from commerce and investment dwarf ODA levels. Every day, millions of private individuals, corporations, and other groups around the world demonstrate how the market creates the

most efficient development strategies from knowledge shared through person-to-person contacts, phone calls, e-mails, and blogs—and, most important, from the technological knowledge and capital gained through trade and investment. Billions of dollars in private aid also flow annually to developing countries from faith-based and other charitable, academic, and humanitarian groups in developed countries. ODA cannot hope to compete.

The key is to facilitate these flows, not to compete with them. Private flows go where they can obtain the best return or can circumvent policy hurdles. America should focus its development efforts on encouraging developing countries to improve their policies. Development assistance allocated with this objective should require far less funding while realizing far greater returns.

The MCC's Better Approach

Private-sector trade and investment is by far the best combination to spur sustainable economic growth in developing countries, and economic growth is the bedrock of economic freedom. Only a financially healthy private sector, operating in a competitive formal economy with secure property rights and transparent rule of law, can create the businesses and long-term jobs that are essential to long-term economic growth and development.

The MCC, created by Congress in 2003, was an innovative idea intended to overcome the shortcomings of the traditional USAID model and to encourage and allocate aid to countries that embrace policies linked to economic growth. The objective indicators used by the MCC to determine which countries will receive its funding—“based on their performance in governing justly, investing in their citizens, and encouraging economic freedom”⁴—mirror those employed by The Heritage Foundation in preparing its *Index of Economic Freedom*.

A critical aspect of the MCC is its adherence to country ownership. Participation in MCC programs requires high-level engagement and commitment to transparency and accountability by the partner government, as well as by civil society and other domestic stakeholders. MCC programs fo-

2. William Easterly, “The Cartel of Good Intentions: The Problem of Bureaucracy in Foreign Aid,” Center for Global Development, Institute for International Economics, October 2002, p. 6, at http://williameasterly.files.wordpress.com/2010/08/36_easterly_cartelofgoodintentions_prp.pdf (February 23, 2011)

3. *Ibid.* See also Dambisa Moyo, *Dead Aid: Why Aid Is Not Working and How There Is Another Way for Africa* (New York: Farrar, Straus and Giroux, 2009), and Fredrik Segerfeldt, *Gör ingen skada! Biståndets hippokratiska ed* (First do no harm: The Hippocratic oath of foreign aid) (Stockholm: Timbro, 2009). Segerfeldt provided an informal English translation to The Heritage Foundation.

4. Millennium Challenge Corporation, “About MCC,” at <http://www.mcc.gov/about/index.php> (February 28, 2011).

cus on promoting sustainable economic growth to reduce poverty through projects in areas such as transportation, water and industrial infrastructure, agriculture, education, private-sector development, and capacity building.

MCC's selectivity and associated seal of approval creates powerful incentives for developing countries to uphold democratic and free-market principles, invest responsibly in their citizens, and transition their economies from developing to emerging markets. Development experts have approvingly labeled this the "MCC effect."⁵

Focusing future taxpayer-funded U.S. government development assistance through the MCC will sustain a development approach that is more effective than the traditional aid model typified by USAID programs. The MCC's preliminary findings from its reviews of completed ("closed out") programs have been promising. For example, in Honduras, results from an agriculture training program show that annual incomes of farmers assisted by the MCC compact have increased from approximately \$1,880 per hectare to \$3,550 per hectare after two years of assistance. This gain of 88 percent greatly exceeds the 7 percent to 11 percent growth that would have been expected without the program.⁶

What Congress Should Do

Traditional development assistance as delivered in past decades by USAID has largely failed to fulfill its stated goals. H.R. 1 (the continuing resolution) includes a 29 percent cut in fiscal year (FY) 2011 funding of MCC and a 30 percent cut for USAID.

Instead, per Heritage Foundation analyst Brian Riedl's recommendation, Congress should eliminate USAID's entire Development Assistance Program (currently \$2.6 billion). This, along with Riedl's other recommended cuts in USAID's budget, would save \$4 billion.⁷

Conclusion

The MCC was an innovative idea to overcome the shortcomings of traditional development assistance, and the evidence since it was created eight years ago is promising. Rather than targeting the MCC—the most market-oriented of America's foreign aid programs—Congress should focus its development assistance cuts on the traditional USAID model that has repeatedly failed to deliver sustained economic growth and development.

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5. Sheila Herrling, Molly Kinder, and Steve Radelet, "From Innovation to Impact: Next Steps for the Millennium Challenge Corporation," Center for Global Development *MCA Monitor Analysis*, January 16, 2009, p. 2, at <http://www.cgdev.org/doc/mca%20monitor/Innovation%20to%20Impact.pdf> (February 23, 2011).
6. Analysis of data from implementers and Honduran government statistics was provided by the Millennium Challenge Corporation to The Heritage Foundation.

7. Brian M. Riedl, "How to Cut \$343 Billion from the Federal Budget," Heritage Foundation *Background* No. 2483, October 28, 2010, at <http://www.heritage.org/Research/Reports/2010/10/How-to-Cut-343-Billion-from-the-Federal-Budget>. See also Brian M. Riedl and Emily Goff, "Additional \$47 Billion in Spending Cuts for the Continuing Resolution," Heritage Foundation *WebMemo* No. 3149, February 11, 2011, at [http://www.heritage.org/Research/Reports/2011/02/Additional-\\$47-Billion-in-Spending-Cuts-for-the-Continuing-Resolution](http://www.heritage.org/Research/Reports/2011/02/Additional-$47-Billion-in-Spending-Cuts-for-the-Continuing-Resolution).