CBO TESTIMONY

Statement of
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on
The Role of Foreign Aid in Economic Development

before the
Subcommittee on African Affairs
Committee on Foreign Relations
United States Senate

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NOTICE

This statement is not available for public release until it is delivered at 2:00 p.m. (EDT), Wednesday, May 1, 1996.

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Madam Chairman and Members of the Subcommittee, I am delighted to be here today. At the request of Senator Kassebaum and Congressman Hamilton, the Congressional Budget Office (CBO) has undertaken a study of the role of foreign aid in promoting economic growth and social well-being in developing countries. Our work is not complete, but we will share with you today what we have learned so far.

In the past 30 years, experts have come to recognize that the development process is complex and depends on many factors. CBO has studied that process in an effort to answer two questions: what are the most important conditions that further successful economic and social development, and what is the role of foreign aid in development? Of those, the second is the more difficult question to answer. A considerable consensus exists on the conditions that foster growth; there is much less agreement, however, on the role of foreign aid in that growth process.

CBO is now reviewing the scholarly and policy literature on the conditions that promote development and on the relationship between foreign aid and development. We are also exploring those links by making a focused comparison of pairs of developing countries. My testimony today briefly discusses the level of U.S. spending on foreign aid and then presents the themes that are emerging from our study. We will illustrate some of our points with specific references to the pair of countries in our study from Sub-Saharan Africa--Botswana and Zambia.

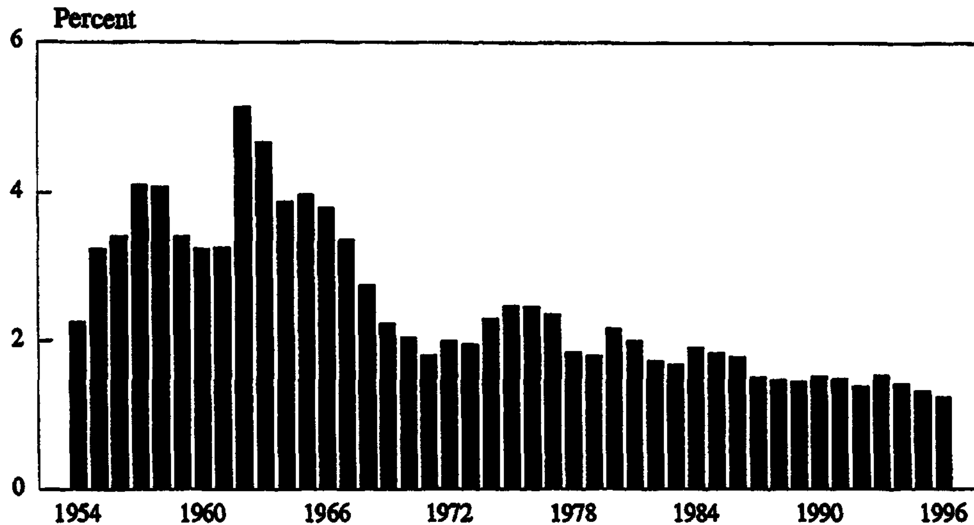
DEFINING DEVELOPMENT

First, what do we mean by *development*? CBO employs a broad definition of the word. Development in our study encompasses a long-term trend of growth in gross national product (GNP) per capita, rising education levels, improving health conditions, low to moderate population growth, sustainable use of natural resources and the environment, and food security. We use specific quantitative indicators of each of those conditions in our study to track the process of development and compare one country with another.

A BRIEF HISTORY OF U.S. FOREIGN AID

A look at historical U.S. spending on foreign aid and international affairs will put this discussion into context. Real U.S. spending on international affairs (budget function 150), a large majority of which is foreign aid spending, reached a relative peak of $29 billion (in 1996 dollars) in fiscal year 1962. It fell to around $15 billion in fiscal year 1996. As a percentage of federal outlays, U.S. spending on international affairs reached its lowest level of the post-World War II era in fiscal year 1996 (see Figure 1).

FIGURE 1. U.S. INTERNATIONAL AFFAIRS SPENDING AS A PERCENTAGE OF FEDERAL OUTLAYS



SOURCE: Congressional Budget Office based on data from the Office of Management and Budget.

NOTES: International affairs spending (budget function 150) includes funding for the conduct of foreign affairs and foreign information and exchange programs as well as foreign aid. Historically, foreign aid spending has made up approximately two-thirds or more of the function.

Data from 1954 through 1961 are net outlays for international affairs. Data from 1962 through 1996 are discretionary outlays for international affairs.

Data for 1996 represent a Congressional Budget Office estimate.

U.S. aid spending has tended to follow U.S. strategic priorities. In the 1950s and 1960s, Asian countries--particularly South Korea, Taiwan, and South Vietnam--received the most U.S. assistance. In the late 1970s, U.S. priorities shifted to the Middle East. The United States began large security and economic assistance programs to Israel and Egypt. Since 1979, the year of the Camp David peace accords, countries in the Middle East have received about half of all U.S. direct assistance.

In contrast, Sub-Saharan Africa--the focus of this Subcommittee--has never been accorded a high priority by the U.S. foreign aid program. (Note that subsequent references to Africa in this statement mean Sub-Saharan Africa.) Between 1962 and 1989, Africa received 6.7 percent of all U.S. assistance, including the U.S. share of aid provided through multilateral organizations. In the 1990s, that figure has risen to just over 10 percent. However, only 69 percent of that amount was dedicated development assistance. The remainder was mostly food and security assistance.

Overall, Africa has received most of its development assistance from sources other than U.S. programs. Between 1990 and 1993, total U.S. development assistance to Africa--including Africa's share of U.S. contributions to multilateral organizations--represented 10 percent of total world aid to Africa. As a group, multilateral organizations contributed 35 percent of the total development assistance

made available to Africa. Other individual donors--such as Germany, France, Japan, England, and the Scandinavian countries--made up the balance.

FOUR MAIN THEMES IN DEVELOPMENT

The literature on development has tended to emphasize four broad themes.

- o The economic and trade policies that a country pursues are often the key factors determining the course of its development;
- o The quality of a country's government and institutions is a strong influence on development;
- o When countries are well governed and adopt market-oriented economic policies, foreign aid may contribute modestly to development; and
- o Economic growth and improvement in human welfare are intertwined.

I will discuss each of those points in turn.

Experts generally agree that a country's economic policies play an extremely important role in its development. In the long run, the growth of an economy depends on the growth of its physical and human capital stocks and on the growth of the productivity of those stocks. The growth of a country's population and skills largely determines the growth of a country's human capital; in turn, a country's rate of net savings determines its physical capital stock. Noninflationary monetary policies and low budget deficits provide a favorable environment for saving and the accumulation of capital, whereas large deficits, high inflation and resultant financial instability work against them. The factors determining productivity are not well understood, but other aspects of economic policy can affect the ability of an economy to deploy resources productively. Regulation, for example, generally interferes with market prices, which signal the incentives for consumption, investment, and production. Such interference typically lowers economic efficiency and the ability of an economy to reallocate resources in response to shocks. Policies that create uncertainty or that otherwise harm the incentives for saving and investment and the accumulation of physical and human capital will inhibit development and economic growth.

According to development economists, uncontrolled fiscal policies have been at the center of the economic problems of many developing countries. In most cases,

an ill-disciplined public sector has diverted resources from the private economy. Spending on large government payrolls, inefficiently run government industries, and various subsidy programs to the population as a whole, specific economic sectors, or individual industries has created large government deficits in many developing countries. Expanding the money supply has often financed the resulting government deficits. But doing so has led in turn to inflation--which, if the country has a fixed nominal exchange rate, makes its goods uncompetitive in world markets. Foreign investors may be reluctant to lend to such an economy, and the foreign exchange reserves required to maintain a fixed exchange rate may run out.

The government can inhibit the functioning of private markets in ways other than by bad fiscal and monetary policies. Price controls, the granting of exclusive monopolies, and state subsidy of particular producers are all ways in which governments have wasted resources by overriding the functioning of the market. Placing controls on interest rates and capital flows and rationing foreign exchange become necessary when a government tries to isolate its domestic economy from the powerful market forces of the world economy.

Of particular importance to development appears to be the extent of a country's openness and integration in the world economy and trading system. The discipline of world market prices makes it much harder to sustain distortionary domestic policies that might divert the economy's resources to wasteful and

inefficient uses. Substantial evidence indicates that the more a country keeps tariff and nontariff barriers low, and generally adopts an outward-looking economic policy, the more likely it is to experience sustained economic growth and improvement in social welfare. Moreover, as indicated above, uncontrolled fiscal deficits can intensify the distortions in external trade when they contribute to overvalued exchange rates.

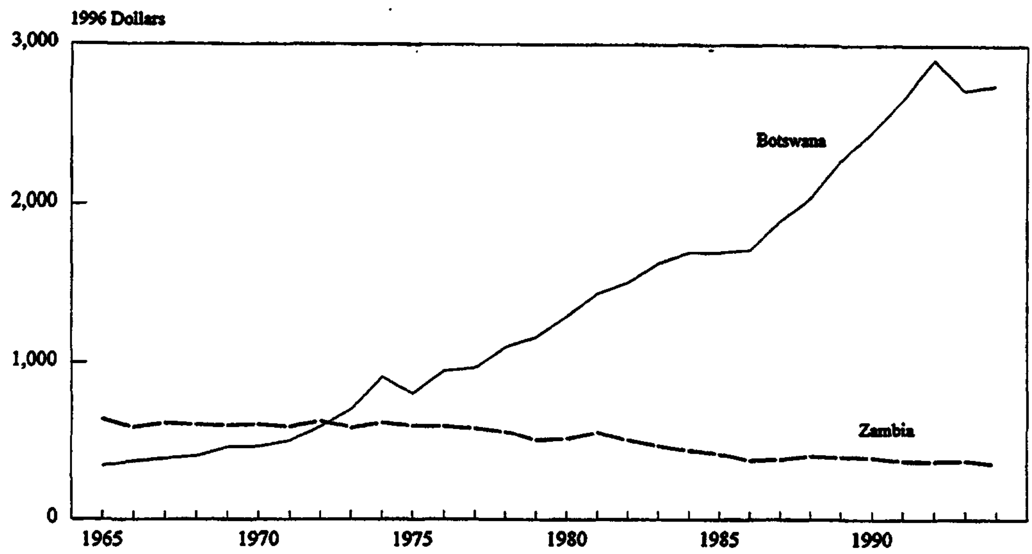
Prudent economic policies can reduce a developing country's exposure to external shocks and increase its flexibility in responding to shocks. Production of primary commodities has dominated some developing economies, and historically their development has been particularly vulnerable to swings in the world economy. Development experts generally agree that developing countries with fiscal discipline are best able to cope with the swings in energy and commodity prices and with international recession. One way in which countries can hedge their risks is by investing in physical and human capital that broadens the endowments of the economy. In addition, market-oriented policies make for a flexible economy that can adapt to external shocks better than if it was centrally controlled or if the price system were so distorted that it could not deliver the appropriate prices.

Botswana's Economic Success

Let me illustrate those points about economic management with the examples of Botswana and Zambia. Botswana has been more successful than Zambia in achieving long-term economic growth. The economies of both countries are centered around mineral deposits. When the two nations gained independence in the mid-1960s, many observers thought that Zambia had a much more promising future with its large amount of foreign exchange and extensive reserves of copper. Alternatively, Botswana had very little infrastructure or apparent means of economic growth; it was not until later that rich reserves of diamonds were discovered there. Contrary to expectations, over the 1965-1992 period, Botswana's real GNP per capita grew at an average rate of 7.2 percent a year, whereas Zambia's declined by 2.1 percent a year after adjustment for inflation (see Figure 2).

By adopting a conservative fiscal policy, Botswana's government has used its resources prudently to cover both investment and recurrent costs. In fact, as early as 1973, the government was able to cover its recurrent costs with domestic revenues. By the late 1970s, the government could even boast a surplus. Currently, the government maintains its conservative fiscal policy and in 1993 had foreign exchange reserves equal to approximately 30 months' worth of imports.

FIGURE 2. GROSS NATIONAL PRODUCT PER CAPITA OF BOTSWANA AND ZAMBIA



SOURCE: Congressional Budget Office based on data from the World Bank.

Because its manufacturing sector is small and its resources are concentrated in minerals, Botswana's economy depends highly on foreign trade. Its chief export is diamonds; its main imports are manufactured goods and food stuffs from Southern African countries. Botswana has adopted an outward-looking trade policy, in part by having joined the South African Customs Union (SACU)--a common market that also includes Lesotho, Namibia, South Africa, and Swaziland. Botswana has maintained an exchange rate policy designed to minimize distortions in its economy, particularly in trade.

Zambia's Economic Policies

Some experts on Zambia describe its economy as badly managed. Shortly after the country's independence in 1964, the government nationalized many of its natural resources and private industries to gain greater control over the economy. Under government operation, those industries began to run large losses. The government also subsidized the agricultural sector, set price controls and trade restrictions, and kept the exchange rate fixed too high. Both the deficits of the nationalized industries and the subsidies to the agricultural sector contributed to the national fiscal deficit. The overvalued currency made imports relatively cheap, thus encouraging their consumption, and made domestic goods more expensive and thus more difficult to export.

Zambia's economy has been inextricably linked to copper, which has contributed to its decline. With an extensive copper supply and a high price on the international market, Zambia's situation was one of the most promising of African countries in the 1960s. Because the price and production of copper stayed high, the strength of that industrial sector hid Zambia's economic inefficiencies. Relying on a single commodity proved detrimental in the 1970s as external shocks sent the economy reeling: the price of copper plummeted, oil prices skyrocketed, and the level of imports remained high. With government policies limiting the economy's ability to adjust and with no rebound in the price of copper, the Zambian economy did not recover.

INFLUENCE OF GOVERNANCE ON DEVELOPMENT

A second major point is that the way in which a country is governed may affect its rate of development. Three characteristics seem key: countries that have enjoyed a high measure of political stability and social order are more likely to develop than countries that have experienced instability and chaos; the less corrupt a developing country's government, the more likely it is to achieve long-term development; and successful development usually depends on the existence of functioning governmental institutions that can support a growing economy.

Political Stability

Political instability is most likely to hinder development. Studies have shown that countries in which political authority has broken down--perhaps even to the point where civil war breaks out--are less likely to achieve economic growth and improvements in human welfare. Instability, especially civil war, may cause widespread destruction of private and public property. In addition, general political instability is likely to impede productive activities by raising the economic risk that potential investors face. In contrast, countries that have a smoothly functioning and stable political system tend to be more capable of pursuing a program of development.

Self-Serving Government Officials

Policies that damage the economy may be pursued simply because they benefit government officials and others with political and economic power. When governments require permits, licenses, and quotas that effectively create private monopolies throughout the economy, they essentially lower economic output and raise prices. Governments can also increase waste through uncompetitive contracting that favors the politically well connected rather than the most innovative or efficient. The government may charge explicitly for the monopoly or contracting privileges it

grants. Moreover, government officials may take bribes and kickbacks or even misappropriate government funds to their own accounts. In either case, the resource represented by the labor of the government employees is contributing nothing to the economy's productive capacity; even worse, it is creating inefficiency elsewhere in the economy.

Governmental Institutions

Some experts argue that governmental institutions that can support economic activity are important to development. For example, an independent judiciary can protect property rights, enforce contracts, and maintain the rule of law. Such a judicial system makes the economic system less arbitrary and lowers the economic risk of investing in productive activities. In cases in which those conditions do not exist, potential entrepreneurs--foreign or domestic--may be discouraged from starting businesses or expanding existing ones.

Other institutions also appear important to economic growth. Such institutions usually include a central bank to regulate the money supply and a ministry of the treasury to oversee national finances and investment. Development tends to benefit when a developing country has the institutions and laws that permit

effective tax collection to provide the revenue for public goods such as ports, roads, or communication systems, as well as investment in human capital.

Governance in Botswana and Zambia

Let me return once again to Botswana and Zambia to illustrate further the importance of governance. Since its independence in 1966, Botswana has enjoyed a highly stable political system and society. The government has held free and regular elections. In contrast, Zambia had one-party rule from 1972 until 1991 and has been somewhat less stable. Instability has been most notable since the late 1980s. Riots broke out after the government removed agricultural subsidies in 1986, and in 1990 a coup was attempted. Considerable anxiety now surrounds upcoming elections.

The first president of Botswana, Sir Seretse Khama, established the precedent of an accountable and relatively noncorrupt government, which has been maintained ever since. Corruption in Zambia, however, has been a greater problem. Government leaders have spent millions of dollars on personal perquisites. Zambia's government also wastes resources by employing large numbers of people for political reasons rather than for providing services.

Botswana's constitution provides for an independent judiciary. Although no system is perfect, Botswana's judiciary has protected civil liberties, political and workers' rights, and property. That provides a favorable climate for foreign investment. Zambia has an independent judicial system according to its constitution. The police, however, have committed serious abuses of their power, including beating and extrajudicial killing of criminal suspects and detainees. There are also many allegations of police corruption and extortion.

THE ROLE OF FOREIGN AID IN DEVELOPMENT

In those cases in which a developing country's government has a positive influence on development and pursues economic policies conducive to growth, foreign aid may contribute to development. Aid has often done so by providing an additional pool of capital that can be used for investment in infrastructure, industry, health services, education, and the like. In addition, many forms of technical cooperation--such as agricultural research and extension--have helped in transferring improved production methods to developing countries. Donors have also provided technical assistance that furthered the reform of economic policy and improved governance.

Even in countries that do not yet have all of the governmental and economic attributes that support development, aid has often been used to spur policy reform

and to ease the transition to a market-oriented economy. Donors often make their aid conditional on carrying out those reforms. In addition, aid can provide a safety net to soften the impact on people adversely affected by such policy adjustments. Without reform, however, aid can reinforce policies that do not further development.

The Evidence from Statistical Studies on the Effect of Aid

Some economists have attempted to measure whether foreign aid has a positive economic return. For example, the multilateral lending agencies have assessed the effectiveness of the projects funded by their loans. According to their analyses, foreign aid projects, as a whole, appear to yield favorable rates of return. A 1982 World Bank study found an average rate of return--weighted by the size of the project--of 21 percent on projects funded by International Development Association credits. Other project assessments by the Asian Development Bank and the Inter-American Development Bank yielded similar results.

Not everyone would accept project results as definitive proof of the effectiveness of aid. Project evaluations, though useful in judging the performance of lending institutions and their staffs, do not capture the overall economic effects of aid, whether positive or negative. Proponents of aid might argue that the transfer of technology that often accompanies major projects could have important spillover

benefits not captured by the agencies' assessments. Critics might argue that the set of projects studied--being good investment opportunities--would have been undertaken in any event using private foreign or domestic funding and that multilateral assistance could have simply diverted those funds into consumption.

For those reasons and also because aggregate national data are more accessible to the academic scholar, empirical studies of development have attempted to determine whether receiving foreign assistance at the national level can be shown to be positively related to higher rates of saving, capital formation, or economic growth. In such studies, the results are far less definitive than were those for groups of projects. If aid is wholly devoted to consumption and does not add to saving, it is not likely to promote growth. Early studies--confirmed by more recent investigations--found that foreign assistance contributed little, if any, impetus to saving (see Table 1).

Other analysts have obtained more positive results. They attribute the negative results of aid critics to statistical biases. In particular, aid flows may be targeted toward the poorer nations, biasing downward the correlation between saving or growth rates and aid amounts. Using more complex models, some analysts found a positive and significant relationship between capital formation and public and private investment flows.

TABLE 1. SELECTED STUDIES EXAMINING THE CORRELATION OF AID WITH SAVING, CAPITAL FORMATION, AND GROWTH

Study	Conclusions
Griffin and Enos (1970)[a]	Aid receipts appear to reduce domestic saving; thus, they do not add to investment.
Weisskopf (1972)[b]	The impact of foreign capital inflow on domestic saving is significantly negative.
Papanek (1972)[c]	Omitted factors that produce below-average saving rates will produce above-average foreign inflows. That biases the relationship between aid and saving.
Heller (1975)[d]	Using a multiequation model, finds a positive and significant relationship between public foreign capital inflow and investment.
Mosley (1986)[e]	Finds no significant correlation between aid and growth, once other factors such as private capital flows and domestic saving are taken into account.
Boone (1994)[f]	Finds no significant correlation between aid and growth. Virtually all aid goes to consumption.
Mankiw (1994)[g]	Concludes that empirical models of growth cannot resolve the issue of which factors dominate.

SOURCES: As noted below.

a. Keith L. Griffin and J.L. Enos, "Foreign Assistance: Objectives and Consequences," *Economic Development and Cultural Change*, vol. 18 (April 1970), pp. 313-337, as cited in Anne O. Krueger and others, *Aid and Development* (Baltimore: Johns Hopkins University Press, 1989), Chapter 7.

b. Thomas E. Weisskopf, "The Impact of Foreign Capital Inflow on Domestic Savings in Underdeveloped Countries," *Journal of International Economics*, vol. 2 (February 1972), pp. 25-38.

c. G.F. Papanek, "The Effect of Aid and Other Resource Transfers on Savings and Growth in Less Developed Countries," *The Economic Journal*, vol. 82 (September 1972), pp. 934-950, as cited in Krueger and others.

d. Peter S. Heller, "A Model of Public Fiscal Behavior in Developing Countries: Aid, Investment, and Taxation," *American Economic Review*, vol. 65 (June 1975), pp. 429-445.

e. Paul Mosley, *Overseas Aid: Its Defence and Reform* (Brighton, England: Wheatsheaf Books, 1987), Chapter 5.

f. Peter Boone, "The Impact of Foreign Aid on Savings and Growth," unpublished paper (October 1994).

g. N. Gregory Mankiw, "The Growth of Nations," Discussion Paper No. 1731 (Harvard Institute of Economic Research, Cambridge, Mass., August 1995).

In a recent paper, N. Gregory Mankiw of Harvard University, after examining empirical models of nations' growth, suggested that the roughly 100 nations for which data on economic performance over recent decades are available offer simply too few observations to allow scholars to discriminate among the many factors said to contribute to growth, notably including foreign aid. According to Mankiw, the empirical evidence from this body of research is simply too limited to reach strong conclusions.

Foreign Aid Is Given for Many Reasons

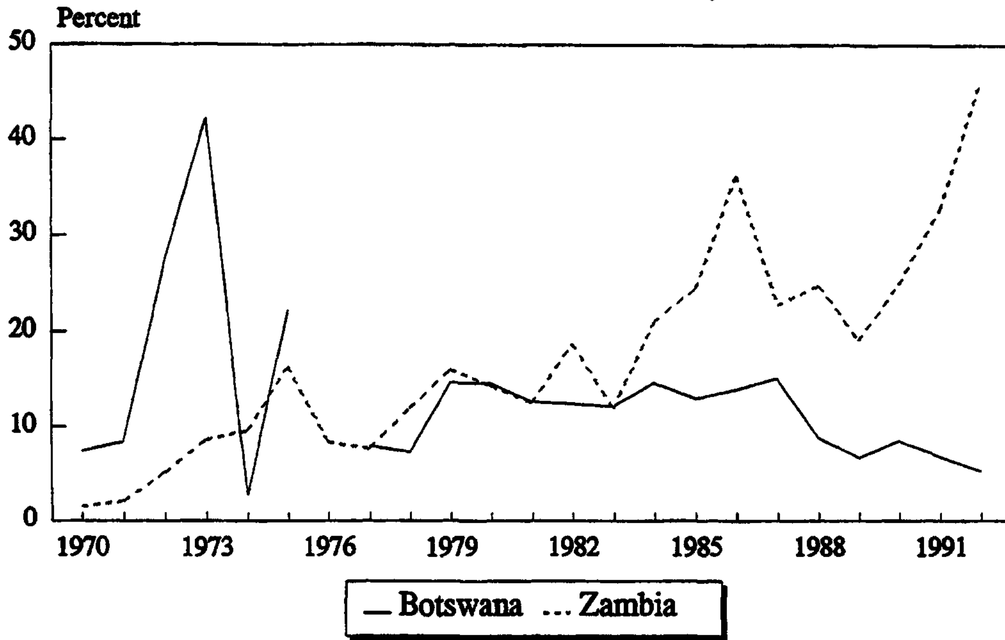
One reason for the inconclusive evidence may be that development is not the only reason that countries give foreign assistance. Aid may be given to alleviate the effects of natural disasters, protect the donor nation's political and strategic interests, or increase the donor's exports. Foreign aid may not be as useful in encouraging economic growth when the donor shapes its program with another goal in mind. For instance, when aid goes to an ally to further strategic objectives, as U.S. aid went to Honduras in the 1980s, it may even have the effect of reinforcing poor economic choices. Sometimes other economic or trade policies undermine the goals of a nation's foreign assistance program. An extreme example occurred when the United States set quotas on textile imports from Bangladesh shortly after providing foreign assistance to its government to expand its textiles exports.

Foreign Assistance to Botswana and Zambia

Botswana and Zambia received comparable amounts of aid in the 1970s and 1980s if measured relative to the size of their economies (see Figure 3). However, it appears that Botswana was able to use its foreign assistance more effectively to contribute to its investment needs as identified in its National Development Plan. That plan serves as a guide for public expenditure and investment; it does not plan the economy or control the private sector. It also serves as an investment guide for donors, since any project that is financed must be in the plan and the recurrent costs must be incorporated into the budget. That practice ensures that donors are undertaking projects that are in the best interest of Botswana, as identified in the plan.

Through the development plan, the government in essence takes on the role of donor coordinator, thus giving it greater influence in designing and establishing the projects. The government encourages individual donors to specialize in particular sectors of the economy. By focusing on certain areas, donors have been able to learn from their experiences, and the staff of the Ministry of Finance and Development Planning works with the same organizations from year to year. Donors have focused their efforts on several distinct areas. For example, the United States has focused on education and the development of skills in the private sector.

FIGURE 3. FOREIGN AID AS A PERCENTAGE OF BOTSWANA'S AND ZAMBIA'S GROSS NATIONAL PRODUCT



SOURCE: Congressional Budget Office based on data from the World Bank and the Organization of Economic Cooperation and Development.

NOTE: Data for Botswana for 1976 are missing.

Zambia provides an example of an attempt to use foreign aid to encourage economic reform. In 1985, at the urging of the International Monetary Fund and the World Bank, the government of Zambia undertook its first comprehensive structural adjustment program. The program made sweeping macroeconomic changes including devaluing the currency, moving to an auction system for determining the exchange rate, reducing budget deficits, liberalizing prices, removing subsidies in the agricultural sector, and taking steps toward reforming government-run industries. In 1987, however, the government of Zambia reverted to its old distortionary economic policies. In so doing, it lost the support of many institutions, including the International Monetary Fund and the World Bank.

ECONOMIC GROWTH AND HUMAN WELFARE ARE INTERTWINED

So far, I have focused mainly on one dimension of development--growth in per capita national income or GNP--and how economic and governmental policies affect it. But as was noted earlier, development has many dimensions.

Some experts argue that to a large extent economic growth is the first essential ingredient of development. It may provide the resources for further investment and growth. Richer countries are better able to feed their populations--either through domestic production or by buying the necessary foodstuffs on the

international market. Growing economies also tend to generate demand for a better-educated labor force and for better health care. Economic growth provides the resources and technological capabilities for slowing population growth.

But it is equally important to recognize that improvements in education, health, and nutrition can promote increased economic activity. The links do not stop there. A better-educated population not only contributes to the economy by being more productive but is more knowledgeable about the benefits of good health, safe medical practices, and child spacing. Similarly, healthier individuals are more productive at work and more readily attend school.

An Example from Zambia

Shortly after independence, Zambia invested large amounts of resources in its social sectors. The living standards of Zambians did improve, particularly with respect to education and basic health care. Enrollments in primary and secondary schools greatly increased, as well as enrollments in adult education classes. Access to hospitals and clinics improved.

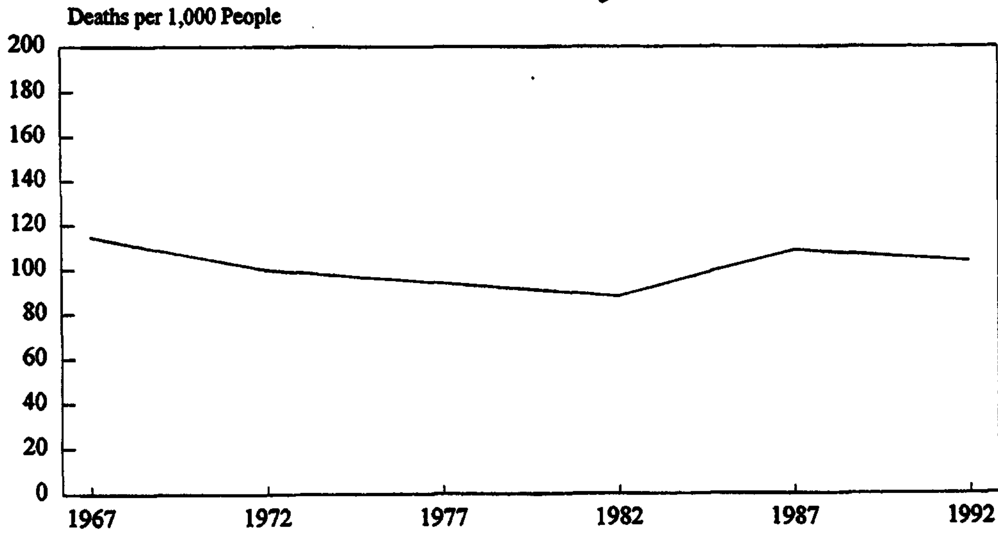
In the 1980s, Zambia was unable to maintain funding for those sectors, and thus, some of the gains in welfare measures previously made were reversed. Life expectancy decreased and infant mortality rates increased (see Figure 4).

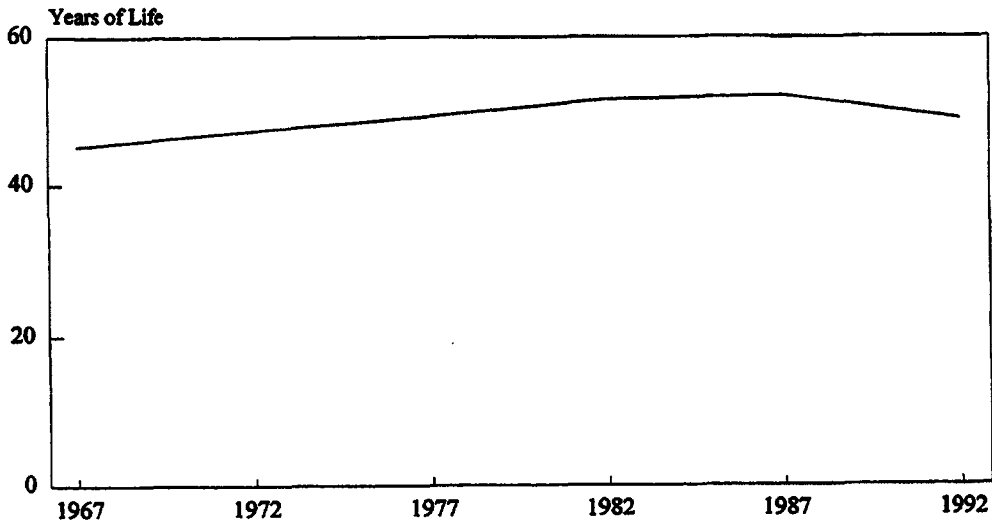
CONCLUSION

Many developing countries and foreign aid donors face a dilemma. Some developing countries figuratively--if not literally--may be consuming their seed corn. Those that are unable to feed their populations are unlikely to be able to save enough to begin the economic growth process. Foreign aid may allow a country's economy to get beyond the point where it is eating its seed corn. However, as pointed out in the World Bank's 1990 World Development Report, most aid to the poorest countries does not even do that--it just helps their economies reach the subsistence level of consumption. But even if that point is reached, there is no guarantee that foreign aid recipients will adopt the political and economic policies that favor growth and development.

Overall, the literature on development and the post-World War II experience of many developing countries suggests that the sources of economic growth and improvements in social welfare lie primarily within a country. Foreign aid may help or hurt the development process if it is given to countries that adopt policies that are

FIGURE 4. ZAMBIA'S SOCIAL INDICATORS





SOURCE: Congressional Budget Office based on data from the World Bank.

not conducive to growth or if it is given for reasons unrelated to development. But I would caution that the themes I have discussed here today should not be overplayed. As the development field continues its research, the themes we identified from a broad review of literature may change. In the meantime, CBO intends to see whether those themes are borne out by a detailed examination of all of our cases.