The Challenge of Global Poverty

A Conservative Agenda

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2004

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Support towards research for this Study was given by the Institute for Policy Research.

ISBN No. 1 903219 66 3

Printed by The Chameleon Press, 5 – 25 Burr Road, London SW18

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CHAPTER ONE

THE SCANDAL OF WORLD POVERTY

> More than 1.2 billion people – one in every five of the world's population – survive on less than one dollar a day. More than 50 countries grew poorer over the past decade. Each week 800,000 million people go hungry. More than 30,000 children die from preventable illness every day. Each year more than 500,000 women die in pregnancy and childbirth – one every minute of the day. In sub-Saharan Africa life expectancy is plummeting due to HIV/AIDS. 115 million children do not attend primary school. Meanwhile the top 1% of the world's population earns as much income as the bottom 57%.[1]

Because of the sheer magnitude of poverty, hunger and disease in the world many people feel powerless to help. For others the endless stories of waste, corruption and extravagance over the past 50 years raise doubts over the effectiveness of foreign aid. Wars, civil wars and ethnic conflicts compound the problem. The danger is that helplessness and scepticism lead to resignation and apathy, with the result that we in rich countries do little.

Such a state of affairs is unacceptable. The experience of many countries over the past 50 years shows that poverty can be reduced on a permanent basis. The key is more rapid economic growth in poor countries. For those countries committed to strengthening the role of markets and private enterprise in their economies, and committed to liberalising their trade and investment policies, a strong case can be made for increasing the flow of development aid to support and underpin their reforms. At the same time, the way in which aid is given can be reformed to make it more effective.

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1 *United Nations Human Development Report*, 2002.

CHAPTER TWO

THE CONSERVATIVE DILEMMA

THE CURRENT PROPOSAL from Gordon Brown, the International Financing Facility (the IFF), is one of a series of initiatives which aim to tackle world poverty.

In 1996, following the pressure of the Jubilee 2000 campaign, the G8 countries launched the Highly Indebted Poor Countries (HIPC) debt restructuring initiative. This has released 26 countries from US$ 62 billion of debt and a potential to release a total of US$ 100 billion for 38 eligible countries. Then at the UN Millennium Summit of 2000, 147 heads of state and 189 countries signed a Millennium Declaration making a joint commitment to reduce world poverty. The Declaration was set out in a series of Millennium Development Goals, which expressed the basic aspirations of people everywhere: the removal of hunger and poverty, basic schooling for their children, better health through tackling disease and the provision of clean water. Each of these involved a specific target and an indicator by which to measure progress. The year 2015 was set as a deadline in order to introduce a sense of urgency and show commitment by the richest countries. In addition, the Global Fund to fight Aids, tuberculosis and malaria, and an Education Fund to provide universal primary education, were established.

The context for these targets was a global partnership between the developed and developing countries which would increase foreign aid, reduce trade barriers and ensure the sustainability of developing countries debts. In March 2002 at a conference in Monterrey, 50 heads of state, prime ministers and finance ministers adopted a resolution – "the Monterrey Consensus" – that set out the terms of the partnership. Governments of poor countries had responsibility for setting out poverty reduction strategies, while the international community had responsibility for reducing trade barriers and increasing the amount of foreign aid. At Monterrey, Europe and the US made commitments to increase the volume of foreign aid by $12 billion or more a year by 2006, the first significant increase in official development assistance for 30 years. President Bush proposed an increase in US foreign aid of 50% over three years through the creation of a Millennium Challenge Account and then later announced a further $15 billion to fight HIV/AIDS, especially in Africa and the Caribbean. If these programmes are implemented, US foreign aid will have risen from $11 billion a year in 2002 to $18 billion in 2006.

Although the WTO conference in Doha in November 2001 was separate from the Millennium Declaration, the commitment to put the interests of the developing countries at the heart of the next round of trade liberalisation complemented the whole process.

In addition, Mr Blair, President Bush and President Chirac have all made the reduction of poverty in Africa a key item on their foreign policy agendas. In response to the Millennium initiatives, a number of African countries launched the New Partnership for Africa's Development (NEPAD) in 2001 through which they agreed to take responsibility for economic, political and administrative reforms in their own countries.

It was against this background that, in late 2002, the Chancellor of the Exchequer Gordon Brown launched the IFF. This was a proposal to double the amount of foreign aid given from rich countries to poor countries, from roughly US$ 50 billion to US$ 100 billion a year between now and 2015.

The basis of the IFF is that long-term funding pledged by the richest to the poorest countries can be used to raise substantial additional funds from the international capital markets. The objective of the proposal is to help countries meet the Millennium Development Goals, namely to halve global poverty, defined as the number of people living on $1 a day or less, provide universal primary education, reduce infant and maternal mortality and tackle HIV/AIDS. When it was announced, the then Shadow Chancellor Michael Howard immediately gave his support. Since then, the idea has been welcomed by G7 finance ministers, G8 heads of state, the World Bank, the IMF and the UNDP.

Progress so far in reaching the Millennium Development Goals by 2015 is uneven.[2] The global target for eradicating extreme poverty (halving the proportion of people living on $1 a day) is within reach primarily because of strong economic growth in China and India. But many countries in sub-Saharan Africa will not meet the targets unless growth rates accelerate, and in some cases double. Few regions of the world look like achieving the target for reducing child mortality and Africa looks like falling behind in providing universal primary education and poverty reduction as well. Africa is a long way from providing access to safe drinking water, especially in rural areas.

A conservative response

For those of a conservative disposition, the proposal to double the amount of foreign aid raises serious questions. The late Peter Bauer devoted most of his academic life to exposing the flaws and failures of foreign aid.[3] In 1998 to mark the fiftieth anniversary of the inception of foreign aid, he wrote (with Cranley Onslow) an essay entitled *Fifty Years of Failure*.[4] His conclusion was that foreign aid had not only not helped, but had positively harmed the poor in developing countries. It encouraged inefficiency and waste, and the adoption of perverse policies by governments of developing

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2 *United Nations Development Programme, Annual Report*, 2003.

3 See by Peter Bauer, *Dissent on Development,* Weidenfeld & Nicolson, 1971; *Equality, the Third World and Economic Delusion,* Weidenfeld & Nicolson, 1981; *Reality and Rhetoric,* Harvard University Press, 1984; *The Development Frontier*, Harvester Wheatsheaf, 1991.

4 Peter Bauer and Cranley Onslow, *Fifty Years of Failure,* Centre for Policy Studies, 1999.

countries. His recommendation was simple: government-to-government hand-outs should be ended.

More recently, and on the basis of empirical work in Asia, Africa, the Middle East and Latin America, Hernando de Soto has argued that the streets of Third World cities are teeming with entrepreneurs who are talented, enthusiastic and resourceful.[5] He estimates that the value of the savings of the poor in these countries is immense – 40 times all the foreign aid received throughout the world since 1945. It is however 'dead capital', because of the absence of well-defined property rights in, for example, houses built in shanty towns on land whose ownership rights are not properly recorded; or because the poor are running unincorporated businesses with undefined liabilities; or because their industries are located where investors cannot see them. As a result, these assets cannot be readily turned into capital, or used as collateral for a loan, or traded outside of a small circle who know and trust each other.

The question raised by Gordon Brown's initiative for any conservative therefore, is whether to support a proposal which involves a doubling of foreign aid between now and 2015, given the dismal record of foreign aid programmes over the past 50 years.

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[5] Hernando de Soto, *The Mystery of Capital*, Basic Books, 2000.

CHAPTER THREE

FIFTY YEARS OF FAILURE

BECAUSE OF THE CHANGED INTELLECTUAL CLIMATE of the past 25 years, it is easy to forget how courageous Peter Bauer was in challenging the prevailing consensus of the 1950s and 1960s. Not only did it involve taking on such prestigious names as Paul Baran, Ragnar Frisch, Raoul Prebisch, Sir Arthur Lewis and Nobel Laureate Gunnar Myrdal, all of whom held chairs of economics at distinguished universities, but it also involved an assault on the development establishment itself: the World Bank, UNCTAD, the NGOs lobbying for aid, the churches, the government departments of developed countries administering aid and all commentators who considered themselves civilised and liberal.

Bauer, along with others, had recognised that 'development economics' was essentially a rejection of Adam Smith's inquiry into the nature and causes of the wealth of nations. It was an attempt to apply economics to the problem of underdevelopment, but in a framework which paid scant attention to relative prices, costs or the efficiency with which markets functioned. It paid no attention to property rights, institutions or cultures. It had nothing to say about traders, entrepreneurs or the bourgeoisie. It was top-down, not bottom-up. Its intellectual framework was provided by Keynesianism, which analysed macro-economic issues in overall categories such as saving, investment, the balance of payments and the fiscal balance. Within this approach economic development was wholly or largely determined by the level of investment.

Developing countries were assumed to be caught up in a vicious circle of poverty and stagnation. Their low income was the result of low productivity which in turn was due to a lack of capital. Because they were poor they were unable to save. They therefore had no resources to devote to capital formation with which to raise their standard of living. Foreign aid was of critical importance because it was an autonomous source of investment which would provide the engine for growth and development. In 1981 Professor Hollis Chenery, who was in charge of economic research at the World Bank, wrote that:

> Foreign aid is the central component of world development.[6]

At the same time, openness to trade was perceived to be harmful. The benefits of free trade were not applicable to poor countries because of pessimism about their commodity terms of trade and the limits to their export earnings. The result was that these countries adopted inward-looking policies and sought to industrialise behind protective walls.

This pessimism fitted comfortably alongside a Marxist view of Third World poverty. The desperately poor and the vicious circle of poverty were the prevailing example of the ever-increasing misery of the proletariat, trapped in colonialism. The exploitation of poor countries by rich countries was simply an extension of the exploitation of the proletariat by the bourgeoisie based on the private ownership of property. The Third World was poor because it had been exploited by the rich West. The policy response prescribed for poor countries was to make comprehensive central planning the centrepiece of economic strategy. This typically resulted in the nationalisation of foreign companies, increased taxation of profits, compulsory reinvestment of foreign companies' profits, and state control over foreign trade.

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6 Quoted in *The New York Times*, 1 March 1981.

This prevailing climate was successfully challenged however by the critics of development economics. Bauer more than anyone else exposed in a relentless fashion the logical inconsistencies of the main pillars of development economics – and especially those relating to the need for foreign aid. Because Bauer had become interested in economic development as a result of time spent in the 1940s and 1950s studying the rubber industry in South-East Asia and the organisation of trade in the former British West Africa, he observed that what happened in these countries was in stark contrast to the tenets of development economics. He was later to be proved right in a spectacular way. Countries which in the 1950s abandoned inward-looking policies and adopted outward-looking policies, such as South Korea, Taiwan, Hong Kong and Singapore, all flourished. In the 1960s and 1970s, Thailand, Brazil, Mexico and Malaysia adopted similar policies and once again became success stories. Meanwhile those countries which clung to a more dirigiste approach and behind protectionist walls languished. It was only when China and India liberalised and abandoned state ownership and planning in the 1990s that their growth rates improved dramatically.

The case against foreign aid

In successfully challenging the prevailing climate, Bauer and others made a number of specific charges against foreign aid.

One was that aid harms not helps the poor in developing countries. Foreign aid is the compulsory transfer of tax payers' money to foreign governments or, as he preferred to express it, a flow of money from the poor in rich countries to the rich in poor countries. Aid is not given to poor people. Official foreign aid is given to governments and rulers, not to those in need and suffering whose pictures appear on the posters of aid charities. Because aid is given to governments, the money is typically used to further the political objectives of Third World governments. These have included wholesale restructuring, such as the compulsory 'villagisation' of agriculture in Tanzania which uprooted millions of people and reduced food production, the promotion of mass sterilisation in India, prestige projects such as brand new cities in Nigeria, heavily subsidised national airlines in many developing countries, war both against other countries and ethnic groups such as in the Sudan, Mozambique, Rwanda and Angola, and the payment of subsidies through commodity agreements. All of these policies harm not help the poor.

A second charge was that foreign aid is neither a necessary nor a sufficient condition for economic development. It is not necessary because many countries, certainly all in the West and a considerable number in South-East Asia, West Africa and Latin America developed before aid was conceived. Development is not critically dependent on large scale investment. Establishing and improving agricultural properties, building up small traders' inventories and establishing workshops and small factories does not require great capital. Aid is not therefore a necessary condition for development. But neither is it a sufficient condition. Aid can be squandered on prestigious projects which have small or even negative returns on the invested capital. During the Cold War, aid was allocated on the basis of geo-political considerations rather than poverty reduction or return on capital. For countries such as Côte d'Ivoire, the Democratic Republic of Congo, Kenya, Nigeria and Tanzania in the 1980s, the World Bank concluded that availability of aid money merely postponed much-needed reforms in these countries.

The case of Africa makes this point forcefully. Aid as a percentage of GDP increased steadily in Africa from just over 5% in 1970 to a peak of 17% by the mid-to-late 1990s, while GDP growth, which for most of the 1970s had averaged just under 2%, fell by the mid-1980s to zero or negative growth and remained at that rate till the end of the millennium.[7]

A third criticism of foreign aid is that it has led to the politicisation of economic life. By increasing foreign exchange

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[7] World Bank, *World Bank Development Indicators*, 2003.

reserves and allowing greater government expenditure, aid increases the resources, power and patronage of government relative to the rest of society. Productive economic activity is replaced by political economic activity, including such things as evading controls and bribing politicians and civil servants. In some cases this led to conflict, violence and civil war, as in Burundi, Kampuchea, Ethiopia, Nigeria, Tanzania, Uganda and the Democratic Republic of Congo. Aid far from helping development became a catalyst for civil unrest.

Bauer was so critical of foreign aid that he concluded that the very concept of the Third World was itself the creation of foreign aid:

> What on earth is there in common between Mexico and the Cook Islands, Saudi Arabia and Vietnam, India and Colombia, Cuba and Kuwait, Algeria and Liberia? It is evidently not poverty, stagnation, exploitation, former colonial status, political non-alignment, brotherly sentiment or skin colour. The only common feature is that their governments all receive financial donations from the West. These are known as "aid"… the Third World is the creation of Western aid… Aid has brought about a collective united solely in demanding and receiving aid from the West.[8]

The case against aid continues to be made forcefully. A recent Institute of Economic Affairs publication examining the history of aid and development in East Africa argues that:

> Most aid still goes to corrupt criminal governments. National and international aid bureaucracies, in alliance with assorted consultants, academics and NGOs, have a vested interest in the aid business, mostly with little regard to policy results… It is difficult to see how the politics of aid can be cleaned up as long as government-to-government transfers are involved.[9]

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8 Peter Bauer and Basil Yamey, 'Against Foreign Aid', *Economic Notes No. 23*, Libertarian Alliance, 1989.

9 *Journal of the Institute of Economic Affairs*, Vol. 23, No. 4, December 2003.

After being highly critical of the current political momentum for increasing aid, the author's conclusion is that "the world needs a new Peter Bauer."

One measure of the success of these criticisms has been the fall in the volume of foreign aid. Over the 1990s, aid flows fell substantially in real terms. By 2002 aid was 20% below the 1990 level adjusted for inflation. Because of the growth in incomes of rich countries over this period, foreign aid as a percentage of the GDP of rich countries fell from 0.33% in 1990 to 0.22% in 2000. While the ending of the cold war and global recession has had a part to play in explaining the fall, the forceful criticisms made against aid have been a telling factor.[10]

[10] *United Nations Human Development Report,* 2002.

CHAPTER FOUR

THE INTERNATIONAL FINANCING FACILITY

THE INTERNATIONAL FINANCING FACILITY was originally proposed by Gordon Brown in his pre-Budget speech of 27 November 2002 and set out in a paper by the UK Treasury and the Department for International Development in early 2003.[11] Following discussions at meetings of the G7 and G8, the IMF and World Bank have been asked to do further work on the proposal. An interim report will be presented in April 2004 and a final report presented at the annual meetings of the Bank and the Fund in September 2004.

The IFF involves a set of long-term conditional pledges by the richest countries of the world to the poorest over a 15 year period. Based on the pledges of rich countries to make annual payments to the Facility for a period of 15 years, the Facility would then issue bonds in the international capital markets. The funds raised would be a multiple of the annual pledges. These funds could then be channelled to the developing countries as foreign aid. Through this financing mechanism, the intention would be to double the flow of foreign aid between now and 2015.

The Facility is of fixed duration. Each country would make a pledge to pay an annual amount to the Facility each year for 15 years. On the basis of these income streams, the Facility would raise funds which would then be disbursed as aid. Every so many

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[11] HM Treasury and the Department for International Development (DFID), *The International Financing Facility*, January 2003.

years, countries might make a fresh pledge followed by further disbursements of aid.

Repayment of the bonds by the donor countries to the capital markets is expected to take a further 15 years. The IFF is therefore a temporary financing facility. It is not a new permanent financial institution such as the World Bank, the regional development banks or an aid agency. The IFF would be wound up after 30 years. The inspiration for the limited duration of the IFF was the US payment of Marshall Aid in the late 1940s to help the reconstruction of Europe which lasted for only four years. The fact that Marshall Aid was limited to four years gave American taxpayers confidence to support the proposal.

The disbursement of funds through the IFF would not be tied to the purchase of goods and services from the donor countries. In addition, aid would be primarily in the form of grants not loans. The fact that the pledges are over 15 years means that disbursements by countries could be made over a period of four to five years rather than in any one year. This would make the aid flow to developing countries more predictable and stable, so allowing them to plan long-term programmes in health, education, clean water and poverty reduction.

Each country which made a pledge to the Facility would have the right to specify how the funds raised on the basis of its pledge were spent. They could be dispersed bilaterally, government-to-government, or partly through multilateral institutions such as the World Bank, regional development banks and the International Development Agency (the IDA), or through NGOs and the private sector.

One important aspect of the IFF is conditionality. While each pledge made by a donor country to the Facility is a binding commitment, it is subject to recipient countries meeting certain conditions, such as not being in arrears to the IMF or subject to UN sanctions. If these are breached, donor commitments would be suspended. Countries who agree to join the Facility might also agree among themselves certain conditions, for example that the funds would be used to support poverty reduction programmes, that they should not be tied to a country's exports and so on. Individual donor countries would in addition be able to specify a wide variety of conditions which had to be met by recipient countries before they dispersed funds.

Finally, although the IFF is a technical financing facility it is set in the context of a partnership between the richest and poorest countries. The former promise to increase aid and agree to reduce the trade barriers facing developing countries; and the latter undertake to introduce reforms which provide greater transparency in public sector governance, and to create a legal and regulatory structure which will give confidence to the private sector and to implement credible policies to reduce poverty.

THE CHANGED CONTEXT OF FOREIGN AID

IN THE 1960S, foreign aid was widely perceived as the central component of economic development in the Third World. The reason was the perceived failure of free markets and a presumption that incentives, institutions and markets played little, if any, role in fostering economic growth. It was this which Peter Bauer and others rightly attacked.

As the Treasury and DFID make clear in presenting the case for the IFF, the context for aid in the twenty-first century is different from that of the 1960s:

> We cannot achieve the 2015 development goals if we revert to the old approach of providing aid as short-term compensation for the effects of poor policies, misdirected expenditure and corrupt behaviour… Instead of a compensation for failure aid must be an investment for success based on clear, country-owned poverty reduction strategies, building on the foundations of stability, trade and investment.[12]

These foundations of stability, trade and investment are crucial in providing a changed context to the aid debate.

The market economy as the engine of growth

The key to reducing world poverty is more rapid economic growth in developing countries. The most recent dramatic examples of this are China and India. China has averaged more

12 HM Treasury and DFID, op. cit.

than 8% real per capita growth for over a decade, and India has raised its growth rate to over 4% for almost as long. According to World Bank estimates based on consumption surveys, the result has been that the proportion of people living on less than $1 per day in China has declined from 33% of the population in 1990 to 16% in 2000, and in India from 42% in 1994/5 to 35% in 2001.[13] Many more examples could be given. China and India are examples of countries which have opened their economies to trade and investment. Others were Mexico, Vietnam and Uganda. All have done well. Over the 1980s and 1990s these countries doubled the ratio of their exports to GDP, and in the 1990s growth in their countries averaged 5%. By contrast, countries such as Myanmar, Ukraine and Pakistan saw the ratio of exports to GDP fall during the 1980s and 1990s, with the result that GDP per capita fell on average by 1% a year in the 1990s.[14]

Despite its reservations about the way free markets operate in developing countries, the World Bank has stated unambiguously that:

> Clearly, experience shows that the private market economy must be the engine of growth. [15]

The IFF stresses the same theme: governments in developing countries must create a more favourable private sector environment in which business investment can be productive so that these countries "can become engines of growth for the world economy".[16]

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13 *United Nations Human Development Report*, 2003.

14 D Dollar and A Kraay, *Globalisation, Growth and Poverty,* World Bank, 2002.

15 The World Bank *A Case for Aid: Building a Consensus for Development Assistance,* 2002.

16 HM Treasury and DFID, op. cit.

The importance of macro-economic stability

One prerequisite for a successful market economy is macro-economic stability. The IMF has done a great deal of empirical research on this subject with the overwhelming conclusion that high inflation, large budget deficits, unsustainable debt burdens, and distorted foreign exchange markets reduce economic growth. For example, the Fund examined data for 75 low-income countries over the period from 1995 to 2001. While other factors including politics and terms of trade deterioration had an adverse impact, weak macro-economic policies were found to be crucial.[17]

For investors to have confidence in macro-economic policy, transparency in government monetary and fiscal policy is critical. Reliable and timely data on the monetary and fiscal position, including debt and the health of the banking system, are essential to minimise corruption and to reassure potential investors. The IMF and the World Bank estimated that public sector governance was less than satisfactory in three-quarters of low-income countries.[18] In tracking the Highly Indebted Poor Country Initiative in 24 countries, they concluded that 15 needed substantial upgrading in their management of public spending and revenue collection, that 88% of these countries had ineffective audit arrangements and that 83% did not integrate a medium-term programme into their budgetary process.[19]

Overall stability, however, is not enough. A stable economy requires defined property rights backed by an effective legal system, a robust and well-regulated financial sector and an effective public administration. Recent research has found that the quality of

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[17] In 2001 per capita GDP growth in just over half of the low-income countries (with a combined population of 800 million) was less than 2% and in nearly a third of the countries (combined population of 225 million) there was negative growth.

[18] IMF & World Bank, *Achieving the MDGs and Related Outcomes: A Framework for Monitoring Policies and Actions*, 2003.

[19] Ibid.

institutions explained much of the observed differences in growth rates between countries, and in particular that institutions matter more than geography and trade. Rodrik, Subramanian and Trebbi have found in particular that the quality of the bureaucracy, the strength of the rule of law, and the risk of expropriation are critical determinants of development.[20] Similarly, the World Bank's *Doing Business* project has developed indicators reflecting business entry, contract enforcement, property rights, access to credit, labour regulation and the bankruptcy regime in various countries. They found, based on a survey of 40 low-income countries, that it took an average of 70 days and costs 114% of per capita GNI to complete registration procedures for a business start-up. In 70 middle-income countries the corresponding figures were 50 days and 23%. In Canada and New Zealand, it takes two days – and in Denmark there is no charge for registration.

The benefits of trade liberalisation

The case for aid is now being made in the context of trade liberalisation, and not as before, in the context of protectionism. The case for free trade is stronger today than it was a hundred years ago. Openness to trade typically benefits all countries. It increases the possibility of exploiting economies of scale; competition from imports introduces pressure on domestic firms to raise productivity; and increased foreign investment transfers know-how from country to country. Put together, these factors improve the efficiency of the capital stock.

Campaigners who object to free trade typically have based their case on market failures. If market failures exist because of domestic distortions (sticky wages, pollution, unfair trade) these

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20 See D Rodrik, A Subramanian and F Trebbi, *Institutions Rule: The Primacy of Institutions over Integration and Geography in Economic Development,* IMF Working Paper, 2002. This paper expanded the use of a proxy of the quality of the above-mentioned institutional arrangements from earlier work by Rodrik (NBER Working Paper 1997) and is compelling on these issues.

distortions are best dealt with by appropriate domestic policies (taxes and subsidies), not by the imposition of tariffs or quotas. If the distortions are external, intervention through retaliation will in all probability only make matters worse. The case for free trade is not the same as *laissez faire*. For free trade to be effective, some market failures will involve government intervention.

The IFF makes a strong case for trade liberalisation as a way of reducing world poverty. Many rich countries have higher tariffs on agricultural products and simple manufactures that they do on other products. For example, in the 1990s the average OECD tariff on manufactured goods was 0.8% but on manufactures from developing countries it was 3.4%. Bangladesh exports about $2.4 billion to the US each year paying 14% tariffs while France exports more than $30 billion paying just 1%. In agriculture, the tariffs of the rich countries are highly discriminatory against low-priced farm products from developing countries. Quotas against clothing and footwear in which developing countries have a comparative advantage still remain even though they are due to be phased out.

The most glaring case of protection is the payment of subsidies to farmers in rich countries. These subsidies, which total over $300 billion per year, are larger than the combined national income of all of Sub-Saharan Africa. The dairy subsidy in the European Union is $913 per cow while the average income in Sub-Saharan Africa is only $490 per year. The EU through subsidising agricultural exports has directly contributed to the decline of the dairy industries in Brazil and Jamaica and the sugar industry in South Africa. Cotton is crucial to certain West African countries (Benin, Burkina Faso, Chad, Mali, Togo) and the only commodity they can export. But the US, EU and China provide such large subsidies (which in 2002 amounted to 73% of world production) stimulating artificial production, reducing world prices and lowering the incomes of small cotton producers in these countries. There is a high degree of hypocrisy among developed countries on the one hand making the case for free trade while on the other punishing exports from poor countries.

It was because of the inequity resulting from trade barriers that the Doha Round was launched as a 'development' round by the WTO. The Cancun talks in 2003 made no progress. More recent proposals from the EU on agriculture, and statements from the US administration covering agriculture and services suggest that trade liberalisation remains a priority and that governments are committed to getting the Doha agenda back on track.

The role of development aid

The case for development aid must be made against the background of the private sector as the engine that will drive growth in poor countries; and that these countries will adopt free trade. If governments have decided to introduce suitable reforms and if they have put the right policies in place, then development assistance can be effective in strengthening those policies.

In the first place, aid can be of value in improving the quality of those institutions which are critical for an effective market economy: public administration, the legal system and corporate governance. Next, aid can be a catalyst for the adoption of new policies such as privatisation, deregulation and trade liberalisation. Third, when countries have embarked on a programme of reform, they need help to ensure that the basic infrastructure – such as clean water, universal primary education, public health and roads – will be improved and bottlenecks in the provision of public goods removed. In time these would be provided in a market economy without external help. But the process is likely to be uncertain and drawn out. The role of aid is to accelerate economic growth and reduce poverty that much more rapidly.

In this context, aid is neither central to economic growth nor to development. The growth of the country will depend on the skills and quality of the labour force, the extent to which property rights are protected, the opportunities which exist for productive capital investment, the openness of the economy to trade and investment and the domestic policies of recipient countries. The role of aid is to underpin and support the reforms which the government has initiated and to accelerate the provision of basic infrastructure. But it is not itself centre stage.

Many attempts have been made to test empirically the effectiveness of aid. This is inherently difficult for a number of reasons. One is that aid is made up of technical as well as financial assistance. Another is that economic development is such a complex process that it is difficult to separate the impact of aid from that of other factors such as the policies of the recipient countries. Moreover, measuring the effect of aid on outcomes such as improved public administration or the demonstration effects which aid may give rise to is far from easy. Finally, before the end of the Cold War aid was given for defence, foreign policy, and commercial reasons which had nothing directly to do with raising growth or reducing poverty.

It is partly because of these difficulties that no simple correlation exists between aid and growth or between aid and poverty reduction. In an influential paper published in the late nineties, two World Bank economists, Burnside and Dollar, using data based on the experience of 56 countries, found that:

> Aid has a positive impact on growth in developing countries with good fiscal, monetary and trade policies but has little effect in the presence of poor policies.[21]

It was this research which provided the underpinning for the major increase in aid in recent years and also for the confidence that governments such as the UK and the US have had in expanding their aid budgets. Since then however further research has suggested not that aid is ineffective but simply that policy-makers should be less sanguine about making the strong statement that aid will, *in all cases,* raise economic growth if the government is pursuing sound policies.

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[21] C Burnside and D Dollar, *Aid, Policies, and Growth*, World Bank Policy Research Working Paper, 1997.

It is because of the difficulty of establishing conclusive empirical evidence using statistical techniques that emphasis has been placed on the experience of individual countries. In the past two decades, Uganda, Mozambique, China, Vietnam, India and Poland are all countries which have both introduced market-oriented reform policies and placed a premium on maintaining macro-economic stability. The result has been more rapid economic growth driven in all cases by their private sectors. The World Bank has argued that development aid has certainly helped in these transitions. In China, this has included advice on how to open its economy to foreign investment and the provision of funding to improve its ports, while in Uganda it has given advice on fiscal policy, exchange rate reform and trade liberalisation and also provided funding for, among other things, primary education. Over a longer period of time, South Korea is an example of a country which first borrowed from the IDA (a facility for the poorest countries), then from the World Bank (for middle-income countries), and finally from the private international capital markets. In addition to country experience, international aid programmes have also been successful in helping the green revolution, in developing efforts to control severe diseases such as river blindness and in expanding healthcare programmes such as immunisation against childhood diseases.

CHAPTER SIX

SIX WAYS TO MAKE AID EFFECTIVE

DONOR GOVERNMENTS have a responsibility to their own taxpayers to ensure that money given in aid is well spent. This chapter considers six changes which could be made to the way aid is given which would make it more effective.

Grants not loans

The IFF proposes, and for good reasons, that the bulk of the funding from the IFF should be dispersed as grants rather than loans, with perhaps a small percentage being in the form of highly concessionary lending.

This is very much in line with a suggestion of Peter Bauer:

> Aid should consist of straightforward grants rather than soft loans with long maturity and subsidised interest rates. These loans set up tensions between donors and recipients. Donors seem them as gifts or subsidies, and recipients feel them to be a burden.[22]

Providing grants rather than loans would help reduce the risk that low-income countries become over-indebted. In the past, governments of poor countries have been willing to take on large amounts of inexpensive long-term debt partly because the immediate debt servicing costs are negligible, and also because the individuals concerned will probably not be around when the time for repayment arises. Such governments therefore had little incentive to ensure the funds earned an appropriate return.

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[22] Peter Bauer and Cranley Onslow, op. cit.

In addition, if loans are replaced by grants, donors will not receive a return flow of funds and will have some incentive to be more selective in giving aid. Moreover, for the poorest countries which have been subject to the ravages of war and disease, and which are excluded from raising funds on the international capital markets because of their lack of credit worthiness, grants are a more appropriate form of aid than loans.

Traditionally two arguments have been used against grants. One is that the need to repay loans is an incentive for recipient countries to invest aid well and to raise growth so that repayments can be readily made from increasing tax revenues. The evidence of the past 25 years however does not suggest this has been an effective discipline on irresponsible governments. In addition, the HIPC initiative and the Jubilee 2000 campaign for debt cancellation have weakened this incentive, as countries now expect to be bailed out if they can show their debt burden is unsustainable. The second argument for loans is that they generate a return flow of funds, which can then be recycled as loans to other countries. South Korea is still repaying loans it received from the IDA in the 1960s, which are now being recycled to fund low-income countries. The expectation must surely be that in 40 years time the need for development assistance will be greatly reduced so that such recycling is unnecessary. If aid were given as a loan and if the poorest countries are still receiving aid, the danger is that these countries will be over-indebted and that new loans will be used simply to cover debt service. This would be of little value to stimulating future growth.

Conditionality and selectivity

At the heart of the IFF is the concept of conditionality. In the introduction, the proposal states that:

> The founding principle is long-term but conditional funding guaranteed by the poorest countries to the richest countries.[23]

[23] The following quotations are taken from HM Treasury and DFID, op. cit.

Then, in explaining the proposal in detail, it argues that there would need to be two kinds of conditions:

> Necessary safeguards for donors compromising one or two high level financing conditions… and more detailed conditionality based on clear development criteria, that governs the disbursement programmes.

The first set of conditions recognises that if donor countries are to continue to make payments to the Facility, recipient countries would have to meet certain high-level financing conditions. These conditions would be few, clearly laid out as part of the IFF agreement and capable of independent assessment.

A second set of conditions has to do with achieving greater value for money:

> While no country genuinely pursuing stability and reform should be denied the possibility of help to finance education, health and anti-poverty policies, each country drawing on the Facility will have to show the commitment to reform necessary to ensure that money will achieve the results intended.

This is elaborated in some detail so that each recipient country is expected to:

- pursue anti-corruption and pro-stability policies and agree the necessary transparency in policy making, in public sector financial management and in the corporate governance of private sector companies;
- commit to a sequenced opening-up of domestic markets to international trade as part of the Doha development agenda;
- improve the business environment to encourage increased investment and private sector-led growth; and,
- agree clear and costed plans for improving education, health and economic capacity building as part of the recipient country's poverty reduction strategy.

Conditionality is a contentious issue in the current debate over the future of development aid. Conditionality is associated with past programmes in which the IMF and World Bank have introduced conditions in order to try to ensure that governments change their domestic policies. The evidence of recent years suggests that it has met with limited success. This is due to a number of factors.

One is the fungibility of money. Even if aid is given for a specific purpose, there is no guarantee that a government will not use the funds which are then freed up for an entirely different purpose, which may be wasteful. Next the number and kind of conditions have got out of hand. When the IMF introduced the concept of conditionality in the 1950s, it was restricted to imposing limits on domestic credit expansion, public sector borrowing and exchange rate policy. Today the conditions by donors have included privatisation, labour market reforms, pension reforms, policies for women, human development, reduced military spending, environmental matters and so on. Monitoring, let alone enforcing, these conditions is a nightmare. In addition, unless the country is committed to reform and has created a political consensus in favour of change, the imposition of external terms may not be implemented, despite promises to do so. The evidence suggests that only if recipient countries "own" the policies and have created a political consensus in their countries will they be fully implemented. Finally, aid-giving agencies have been reluctant to cut off funding to governments because of non-compliance with the terms of the loan.

If donor governments are to justify aid programmes to their taxpayers they need assurance that the funds given will be put to good use. If simple conditionality will not work, the onus is then on donor countries to set out the criteria for selecting those countries to which they are prepared to extend funding.

The current approach of the US in this regard has plenty to commend it. President Bush has established the Millennium Challenge Account separately from US Aid in order to extend funds to countries which pursue pro-growth policies. These are elaborated as “ruling justly, investing in people and encouraging economic freedom”.

Since they were announced the Administration has developed a set of indicators which can be used to measure a country’s commitment to these policies. For example, the commitment to developing strong political institutions and good governance (ruling justly) is to be measured by the strength of civil liberties, political rights, accountability in governance, effectiveness in public sector administration, rule of law and control of corruption. Investing in people will be measured by public expenditure on health as a percentage of GDP, immunisation rates and primary education completion rate. Encouraging economic freedom will be measured by the country’s credit rating, inflation, budget deficit, the number of days to start a business, trade policy and regulatory quality rating. Each of these 16 indicators are to be measured by independent bodies. While the process of selection cannot simply be reduced to numbers, making a systematic evaluation in this way is an important discipline.

What can a donor government do if a recipient country fails to honour the terms on which it is was selected? The test will come when recipient countries fail to deliver. If donor governments do not take effective action at this point, then however much may be made of the IFF being a new approach to aid, such words will mean very little. One of the major criticisms of aid in the past is that aid has been poured into countries when they have clearly pursued anti-growth policies. President Bush’s Millennium Challenge Account makes it very clear that meeting the benchmarks is the key to continued funding. If the benchmarks are not met, funding will be withdrawn. The IFF must be equally clear in demanding accountability and performance from recipient governments.

The private sector and NGOs

Traditionally foreign aid is money given from governments in developed countries to government and public sector bodies in developing countries. The private sector and the voluntary sector have been marginal to the way in which aid finance is spent. As a result, one of the criticisms of foreign aid is that it has strengthened the power of corrupt governments whose policies have destroyed rather than created wealth.

In certain developing countries, especially in Sub-Saharan African the voluntary sector, especially the churches, have played a key role in establishing schools and hospitals. More recently the private sector has played an increasing role. As the UN has noted:

> Public provision of social services (health care, primary education, water and sanitation) is not always the best solution when institutions are weak and accountability for the use of public revenue is low – often the case in developing countries.[24]

It goes on to observe that in the 1980s, and especially in the 1990s, private provision in these areas began to increase rapidly. The reason was the lack of government resources, low quality public provision and the pressure to liberalise the economy.

More creative thinking is needed on the way in which the private sector and NGOs could be used in the delivery of services financed by aid. To the extent that domestic NGOs in these countries have a track record of success in delivering services, are able to tap the resources and goodwill of the voluntary sector and are less corrupt, then direct funding to these bodies will strengthen the mixed economy of provision. NGOs and the private sector could also be used in delivering services for aid using performance grants. Because of corruption and inefficient administration some countries would not be selected by donor governments as partners. But these countries may nevertheless

[24] *United Nations Development Programme Annual Report*, 2003.

wish to initiate programmes in areas such as primary education or healthcare. If these programmes were confirmed by the development agency, then it could solicit bids directly from private sector suppliers and charitable organisations. Payment would be by results. Improvements in reading and writing targets in schools, the number of vaccinations or operations performed, the miles of road built, kilowatts of electricity generated, clean water supplied and better sanitation could easily be measured and then paid for.

Apart from transferring funds through NGOs and contracting-out the delivery of aid-financed services to private companies, it might also be possible to explore ideas such as cash grants given directly to the poor, vouchers for education and health, and direct support for programmes to start small businesses and micro-enterprise credit. More generally, anything that donors can do to strengthen civil society is likely to make aid more effective. For example, in aid given for schools, conditions could be introduced with respect to governance, financial transparency and published information on their performance.

Independent external scrutiny

In terms of effectiveness, aid agencies have been criticised on two grounds: first, that their output becomes defined as the total of money dispersed rather than the additional services provided; and second, that the effectiveness of aid programmes is rarely independently monitored.

It is easy for development banks to develop a lending culture, in which incentives are put in place to reward the volume of lending, not project performance. The Meltzer Commission is highly critical of the World Bank on this score:

> The project evaluation process at the World Bank gets low marks for credibility: wrong criteria combined with poor timing.[25]

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[25] The International Financial Institutions Advisory Commission (The Meltzer Commission), *Report to the US Congress,* 2000.

Most audits take place far too early. When the report was written, only 5% of its programmes were reviewed three to ten years after the final disbursement of funds.

Less attention seemed to be paid to ensuring that loan conditions were actually observed. William Easterly gives the example of Argentina which between 1950 and 2001 received 33 adjustment loans from the IMF and World Bank during repeated financial crises, yet at the end went into an even worse crisis.[26]

Performance could be verified by independent, external auditors. Certainly the recipient countries should not be responsible for the work and audits by governments and development banks should be published and open to scrutiny. At present the culture of the aid community is too closed and secretive and needs to be made more publicly accountable.

Untying aid

One of the least contentious proposals for making aid more effective is untying it from the export promotion by donor countries. Tied aid restricts the freedom of choice of recipient countries. Recipient countries may have to buy more expensive products or services. In addition, because different donors will place different restrictions on the use of aid money, recipient countries may find themselves having to buy different kinds of equipment, which are not compatible with each other and which have different maintenance terms. A World Bank study estimates that tied aid is 25% less effective that untied aid.

The UK Government untied all the UK aid from April 2001 and the 23 member of the OECD's Development Assistance Committee have also agreed to reduce it. In 2001, it stood at roughly one half of all development assistance, but in some countries it remains higher: Canada ties 79% of its aid, Greece

26 W Easterly, *What did Structural Adjustment Adjust?*, Centre for Global Development, 2002.

87%, Italy 93% and the US 91%. It is lowest in Scandinavian countries, Switzerland and Ireland.[27]

Bilateral not multilateral

The IFF makes it clear that each country will have complete discretion over the disbursement of funds raised from the Facility. Each country then has the choice of allocating the funds on a bilateral or multilateral basis. The most common multilateral form of disbursement would be through the World Bank, the IDA or regional development banks. The case for multilateral disbursement is that it imposes less costs on recipient countries which otherwise would have to deal with numerous donor countries.

Foreign aid can be thought of as a subsidy from developed to developing countries. One criticism of development banks is that the true subsidy element is difficult to discover, because most lending is done at below market rates of interest. Another has been that development banks developed a lending culture in which a major objective of the bank was meeting annual lending targets and "moving money" rather than evaluating the projects financed by subsidised loans. A third criticism, developed in detail by the Meltzer Commission, was that lending had not gone to the poorest countries withoutaccess to the international capital markets. It estimated that 70% of World Bank non-aid lending went to 11 countries all which had access to the capital markets. Finally, 55-60% of self-audited valuations by the World Bank revealed a failure to achieve sustainable results.

Bilateral aid makes donor governments more accountable to their electorates; makes it easier for a donor government to be clear about conditionality; encourages political debate so that funds can be channelled to those areas most favoured by the electorate; and makes independent external scrutiny that much easier.

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27 Data from the OECD Development Assistance Committee Online Database.

CHAPTER SEVEN

THE CHALLENGES OF ABSORBING INCREASED AID

INCREASING AID ON THE SCALE ENVISAGED BY THE IFF could provide poor countries with serious challenges in terms of their ability to absorb the increased funding.

Large inflows of aid can easily overwhelm the existing administrative capacity of governments to manage it effectively. Throughout the 1990s the official development aid commitments of the European Union exceeded the amounts paid out by roughly $1.6 billion each year. The reason given for the shortfall was the limited administrative capacity of recipient countries. In Uganda, a large increase in the resources for health, education and water exposed a number of administrative deficiencies, especially payroll systems. Even if extra resources are provided, for example in education, it can take a number of years before teacher-training programmes are established, and more teachers trained. Because aid agencies can offer much higher salaries, they can siphon off the best talent from the civil service and so weaken the administrative capacity.

Another problem with a sharp and substantial increase in aid is a variation of the "Dutch disease".[28] An increase in foreign aid may well be spent entirely on imports, in which case the balance of payments would remain unchanged as the inflow of aid dollars was offset by spending on imports, such as for example, drugs.

[28] The "Dutch disease" refers to a situation in which a boom in exports, such as oil, causes problems for the rest of the economy. The term originated in Holland after the discovery of North Sea gas.

This would create little disruption to the domestic economy. By contrast the extra dollars could be spent on non-tradable goods. For this to happen the government would have to use the dollars to purchase local currency. If the nominal exchange rate were fixed this would expand the money supply and increase inflation, which would mean that exports would become less competitive. If the government attempted to neutralise the process, interest rates would rise and the capacity for growth jeopardised. If the exchange rate was floating, the purchase of local currency would lead to an increase in its nominal price relative to the dollar and extra spending on non-tradable goods would raise the overall price level. If the exchange rate is fixed or floating poor and middle-income groups would suffer from inflation and an appreciation of the real exchange rate would halve the country's traditional exports.

A third problem of absorbing increased aid is dependency. Aid can be very substantial relative to the size of poor countries. In Kenya, in the early 1990s, aid was the equivalent of almost 27% of Kenya's entire GDP, and 55% of its government expenditure. In 2001 aid as a percentage of GDP was 14% in Uganda, 17% in Rwanda, 13% in Tanzania, 23% in Malawi, 26% in Mozambique and 46% in Sierra Leone. Aid can strengthen good governance, but for those countries which become dependent on aid, it can create perverse incentives. Far from building capacity and improving the quality of institutions, aid can weaken accountability, encourage corruption, politicise economic life, create conflict over the control of aid funds and reduce pressures to reform inefficient bureaucracy. High levels of aid would mean that recipient governments had greater accountability to aid agencies rather than to their own domestic taxpayers. Using cross-country data for about 80 countries World Bank research suggests that higher aid levels erode the quality of government.[29]

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[29] Steven Knack, *Aid Dependence and the Quality of Government: A Cross-Country Empirical Analysis*, World Bank, 2000.

CHAPTER EIGHT

A CONSERVATIVE AGENDA

THE PRESENT LEVELS OF poverty, hunger and disease in developing countries are simply unacceptable. The recognition that the developed world has a moral responsibility to do more is the reason for the HIPC initiative, the Millennium Summit, President Bush's creation of the MCA and Gordon Brown's proposal for the IFF.

The new Millennium has seen a new approach to foreign aid, one based on the recognition that successful development can only come from developing countries themselves. It is they who must embrace the market economy. This is a sea-change from the past. Gordon Brown deserves great credit for recognising this and making it the foundation of his proposals for increasing foreign aid. But the market also needs an institutional framework – transparent public administration, property rights protected by an effective legal system and an infrastructure of health, education, transport and the provision of clean water.

A Conservative agenda should welcome this new approach to foreign aid. This would involve:

- **Supporting the IFF**. Rich countries should be prepared to increase development aid and reduce trade barriers. In return, developing countries should strengthen private enterprise in their economies and improve the quality of their institutions. Foreign aid can be a catalyst to encourage poor countries to reform and attract additional direct foreign investment.

- **Give aid in creative, radical and demanding ways**: this entails grants not loans, conditionality, the use of the private sector and NGOs in the delivery of services, the untying of aid and bilateral rather than multilateral donations.

- **Granting aid in a more open and accountable fashion**: all aid programmes should come under independent external scrutiny. The results of granting aid should be open to public scrutiny; and both development banks and aid agencies should be required to publish detailed reviews of loan programmes and grants given.

- **Avoiding hubris**: the IFF is not a panacea for reducing world poverty. Developing countries will still face major challenges in absorbing extra foreign aid because of the limited management capacity of the public sector, the prospect of the Dutch disease producing a rise in the real exchange rate and the danger of aid dependency.

- **Recognising that everyone has a role to play**: this paper has focussed on the IFF proposal. Aid given through the public sector is only part of the response of rich countries to global need. Those of a conservative disposition will wish to place great stress on the freedom of individuals, charities, religious bodies and NGOs in developing countries to take their own initiatives and to devise ways in which these can be supported from individuals and organisations in developed countries.

The last 50 years provide numerous examples of countries which have moved from poverty to prosperity. Their success has been based on economic freedom, low taxes, internal stability, the rule of law and honest government. It is an achievable objective to ensure that by the next Jubilee the world should be free of absolute poverty, and Third World aid should be seen as a historical anomaly. That would be a legacy of which Peter Bauer would be proud.

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