When foreign aid is bad for the poor

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Official development assistance funds (ODA), granted to third world countries is huge relative to country size. However, in most of the recipient countries poverty has increased and inequality has widened. For some countries, for example Bolivia, ODA has fluctuated between 6 and 14 percent of its GDP and poverty has increased. Argentina received billions of dollars in support for its social programs and the result has been a substantial weakening of the rule of law and the use of ODA resources for political gain. Also, the whole sub-Saharan Africa, including South Africa, has not made any headway. Most of the countries that should have benefited from the so-called "fight" against poverty are now poorer.

The G-7 has pledged to continue their concessional lending and grants to the poorest countries to alleviate their condition. Well known economists like Jeffrey Sachs call for massive resource transfers to Africa, a call that is echoed by politicians like Gordon Brown, the British finance minister and apparent heir to Tony Blair.

Paradoxically, the current structure and modality of ODA resource transfers have increased poverty. The reason is that those funds have pushed countries to increment government expenditures and those expenditures have been, in general, very badly allocated. For example, countries that "benefited" from debt relief entering the HIPC (Highly Indebted Poor Countries) process implemented by the multilateral financial institutions (MDI) have been pushed to substitute "social expenditures" for the debt that they could not pay. Naturally, the public officials of those countries took the opportunity to spend more with great enthusiasm.

A paradigmatic case is Bolivia. The failed multilateral development agenda set the stage for the socialist take over in this country. Bolivia received significant ODA resources through the HIPC[1] initiative. This country with a GDP of about $8, 5 billion has, so far received more than $ 2 billion debt relief. The result has been a swelled public sector unable to deliver what that had been promised, frustrating the people and setting the stage for the take over by Evo Morales and his hard socialist agenda.

The so-called Comprehensive Development Framework (CDF) was another failed attempt to jump-start the development process in Bolivia. This initiative, marketed by

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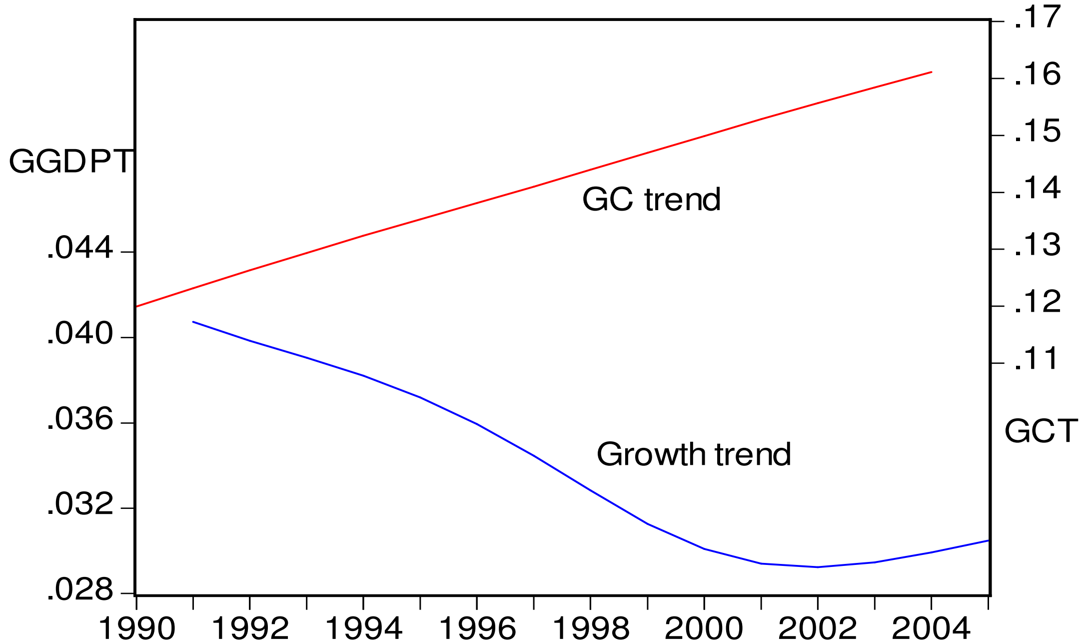
[1] According to official IMF documents the HIPC is a "framework adopted jointly by the IMF and the World Bank in 1996 for action to resolve the external debt problems of heavily indebted poor countries. The Initiative envisages comprehensive debt relief by the international financial community—including the multilateral institutions—to achieve debt sustainability, provided a country builds a track record of strong policy performance. The framework was strengthened in 1999 (enhanced HIPC Initiative) to provide faster, deeper, and broader debt relief.

then World Bank president James Wolfenshon and it Chief Economist Joseph Stigiltz as a novel instrument for development and poverty alleviation was a failure. Bolivia was made a pilot and, in addition to the HIPC funds, significant resources were put into this country's public sector. However, the country marched backwards.

Next chart present the trend of Bolivian GDP growth and the trend in the Bolivian government consumption expenditures (which include social expenditures.)

Chart 1
Bolivia
Rate of GDP growth and Government Real Consumption Expenditures (GC)
1990-2005 - Trends

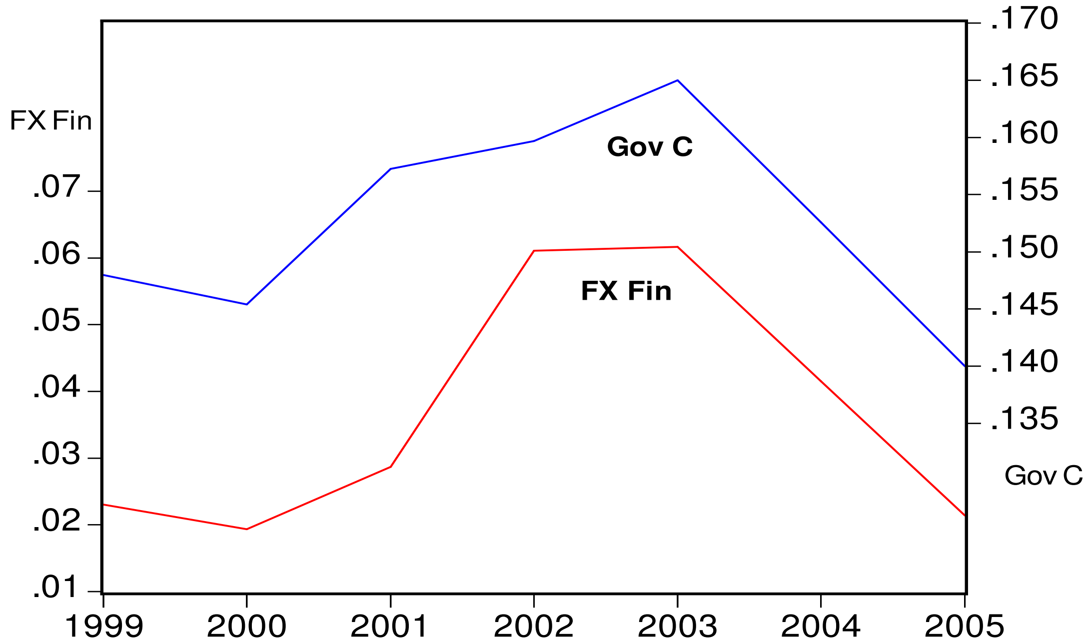


The way the debt relief initiative was implemented implied a huge shift of resources towards the public sector. The HIPC initiative does not stop with pardoning the country's debt. It imposes on the public sector the condition to spend those resources in "poverty reduction program" Moreover, additional soft credit is granted upon the completion of a Poverty Reduction Strategy Paper, which involves more money to be spent by the public sector.

The disappointing results of the resource transfer are related to the way the increased public expenditures are managed For example, resources are used to increment teachers' salaries and employment with little impact in the quality of education. Or resources that are supposed to temporarily alleviate hardships of the unemployed become permanent political instrument; Argentina is a case in point.

Next chart present evidence that in Bolivia foreign financing (ODA and other grants and loans) have been used to finance government consumption expenditures. The correlation between foreign financial assistance and consumption expenditures is 0.86.

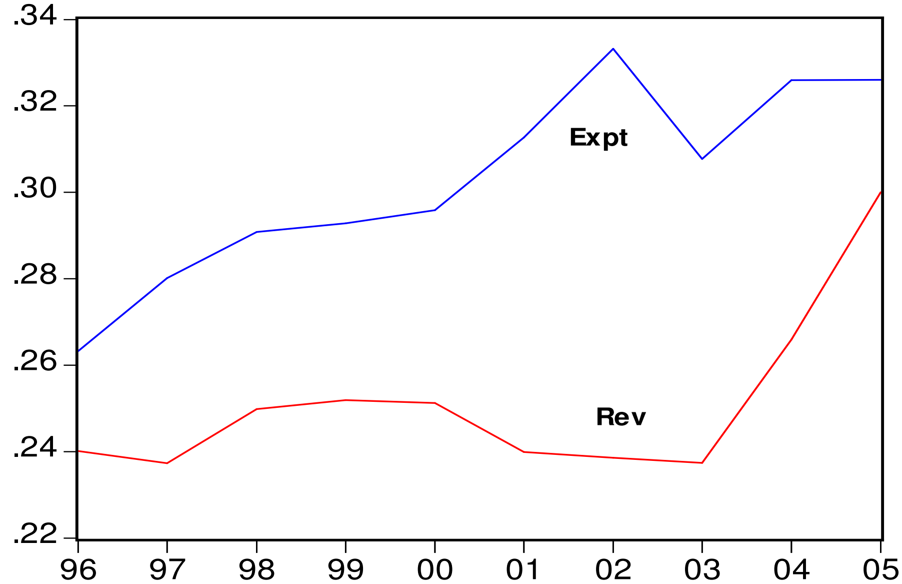
Chart 2
Bolivia
Government Consumption expenditures and Foreign Financing of Fiscal Deficit
Ratios to GDP



In Bolivia, and in other countries, foreign aid has been responsible for a widening fiscal gap. This gap, financed by such aid makes those countries "aid dependent" in an increasing fashion.

Next chart shows Bolivia's pattern of primary government expenditures and government revenues.

Chart 3
Bolivia
Government Revenues and Expenditures
Ratios to GDP



The Bolivian Fiscal Account deteriorated until 2003 because of foreign financing of the deficit. Chart 3 shows that until 1996 Bolivia's public sector expenditures were about 26 percent of GDP. By the end of the century it had climbed to 30 and currently is about 33 percent. Fiscal revenues during the late nineties remained about 23 percent of GDP and experienced a significant increment during the last three years as a consequence of the oil boom.

<u>Other reasons for the disappointing results of the HIPC and other ODA programs</u>:

a) No serious cost-benefit analysis is made on the projects imposed by the initiative For example roads are built with the pre-condition that they reach poor communities. Their social and economic rates of return are easily maneuvered to show convenient figures. This course of action benefits the town with immediate access to the new roads but ends hurting the nation's poor.

b) The initiative funds many "social programs" that are not used for alleviate temporary hardships but for long-term political gain. Argentina, which funded programs of this type with non-concessionary loans, is a good example of bad policy.

c) Money is fungible, and a share foreign aid is used for other endeavors. When governments of poor countries receive resources for capital expenditures their budget constrain is relieved opening the way for other types of public consumption expenditures.

d) As the public sector increases it expenditure it suctions more resources from the rest of the economy. For the additional public expenditure to have a positive impact on growth the productivity of those resources when used by the public sector has to be greater than when used by the private sector. This shift of resources from a more productive less corrupt private sector to a less productive more corrupt public sector is detrimental to poverty alleviation and to sustained growth.

e) Additional public expenditure causes distortion in relative price of production factors When ODA provides the extra resources to the public sector, its additional expenditures drive up wages creating a wedge between the price of labor and its marginal productivity. Consequently the private sector has an incentive to substitute capital for labor in its production function laying off or hiring less labor. Under these circumstances the "excess" labor continues to exercise pressure on the public sector for employment resulting in a vicious circle.

f) Grants and concessional assistance have produced exchange rate appreciation, the so-called Dutch Disease. The government use of those funds in non-traded goods has exacerbated the problem because such shift appreciates the exchange rate, and:

- Exchange rate appreciation is bad for exports
- Exchange rate appreciation is worse if the country has low productivity in the tradable sector
- Exchange rate appreciation has worsened the drug problem, for example giving coca producers more comparative advantage over other products (fruits, forestry, soybeans, textiles, etc.)

g) Grants and concessional assistance have produced inflation as the receiving country tries to mitigate the process of exchange rate appreciation
Many countries have tried to avoid exchange rate appreciation by having the Central Bank buy dollars. However, as the Central Bank buy dollars it issues local currency and the excess supply of money generated by this policy causes inflation.
The basic reason for Central Bank failure to stop the appreciation of the real exchange rate is that no Central Bank can control the real exchange rate. They can only fix and control the nominal exchange rate.
Letting inflation adjust the real exchange rate is a painful process because inflation causes social tensions, strikes, and income redistribution against the poor: the rich can always hedge against inflation.

<u>What is the way out? How can the Multilateral Development Institutions really help?</u>

Multilateral development institutions can play a positive role if they:

- **Realize that they can only be effective if the know how to choose a few targets out of the myriad factors playing a role on the development process**

- MDI are small players in today's world. They should think strategically on what are the fields in which they can have a lasting impact and then agree on simple tactics to leverage their loans, grants or technical assistance.

➢ **Do no generate unrealistic expectations**
  - Make it clear to the countries that development takes time. Unrealistic expectations fed from donors and international financial institution frustrates the poor and causes them to rebel against the measures that in short time "fail" to radically improve their standard of living

➢ **Do not try to "empower" any segment of society. Let societies alone in working-out problems derived from deeply imbedded cultural traits. Natural, home-bred changes will be sustainable; changes imposed through deux-ex-machina will not**
  - The multilateral development institutions have been meddling into the social fabric of poor countries with an agenda of "empowerment" be that of women, indigenous groups, or, the latest fad "empowerment of the young" of for that matter any segment of society that they feels may be disfranchised. Banks and financial institutions do not have a comparative advantage to pry in such endeavors. By introducing sociological elements in their agenda they loose focus of their main task. Also, when they intrude into the countries' social fabric they create tensions and negative reactions. Instead of stepping into these matters they should let societies' natural dynamics to produces the desired changes. Changes will come sooner than later because in the information age societies, no matter how poor, are more culturally integrated within the world than nobody dreamt a few decades ago

➢ **Do not grant assistance unless the public sector reduces total expenditures and diminish its burden on the private sector**
  - The MDI have indeed promoted fiscal solvency by insisting in the reduction of fiscal deficits. However, and paradoxically, their lending and grants program have also produced fiscal problem by feeding an explosion of public expenditures. This policy has increased the burden on private sectors either directly by increasing taxes (to comply with the deficit reduction policy) or indirectly by driving up wages. Higher wages derived from higher government expenditures tend to reduce productive employment and consequently increase poverty

➢ **Strong and independent National Institutions are of critical importance in the development process. However, there is not much that banks can or should do to make those institutions stronger and independent**
  - Independent and strong national institutions have to evolve from inside. For example, the IMF has been instrumental in the development of independent Central Banks. However, Central Banks can be independents and central banker can be extremely dependent. For example, declaring

the independence of the Central Bank in countries like Liberia or Sudan would be a futile exercise, a waste of resources and the illusion that the new system works. There are many countries in the same league as Liberia and Sudan.

- **Strengthen regulatory agencies**
  - Not only as a by-product of a lending program but a self standing program there is scope for strengthening regulatory agencies which differ from national institutions in the government hierarchy. For example, agencies regulating road maintenance, or agricultural extension or community health can be made more transparent, efficient and accountable.

- **A positive agenda should promote virtuous incentives**
  - Virtuous incentives are those induce growth in a direct way and, at the same time generate positive externalities, including the fight against corruption.

The MDI should focus on programs that:

- Reduce government tax burden. Impose low (i.e. less than 10 percent) uniform personal and corporate income tax
- Reduce government expenditures, including privatization of SOE
- Promote market solutions in allocation of resources. For example agricultural water rights
- Reduce rent seeking by reducing and drastically simplifying all type of regulations
- Reduce tariffs and non-tariffs barriers to international trade in a multilateral or unilateral context
- Promote transparency through public accessibility to government records, including SOE, and all type of financial information
- Reduce transaction cost for any kind of business
- Promote respect for property rights including intellectual property rights
- Introduce vouchers in the school system
- Introduce private management and private incentives in the health system
- Deregulates labor markets
- Whenever possible the MDI should channel resources directly to private concerns in charge of delivering the agreed products

Last but not least, the MDI should not lend to any country not having a long-term structurally strong fiscal stance. In many instances the MDI have lent to countries whose Treasuries were insolvent making a bad situation worse by delaying the turn-around to sound policies. The poor were surely made worse-off from policies that hid a bad macroeconomic situation thus causing later a harsher adjustment and again “coming to the rescue”.