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A Hand Out Instead of a Hand Up: Where Foreign Aid Fails

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A Hand Out Instead of a Hand Up: Where Foreign Aid Fails

The alleviation of misery among the least fortunate of the world's citizens is an objective beyond reproach. Foreign aid is often uncritically presumed to further this goal. The fact that money transferred from domestic taxpayers to foreign governments is referred to as *aid* implies that these expenditures are indeed beneficial. Indeed, the organization that distributes these transfers in Canada is called the Canadian International Development Agency, a title that simultaneously prejudges the effects of the aid and helps to disarm critics (Bauer 1981: 86, 141).

Public policy should not be based on the *assumed* virtue of a program, or be judged solely by the warm feelings it generates. We should rather investigate whether the program accomplishes what it intends. Thus, foreign aid should be evaluated on whether and to what extent it benefits people within recipient countries. More broadly, the question should be whether aid facilitates the creation of an institutional environment that allows those in the recipient countries to better provide for themselves. If aid is successful, it should encourage economic growth and its associated benefits (e.g., lower infant mortality).

The purpose of this study is to evaluate critically the role Canadian foreign aid has played in the development of targeted countries. Since the object of foreign aid should be the creation of economic growth (for reasons explained below), we examine research that looks at the effects of aid on growth and specific standard-of-living indicators. An extension of this research suggests that we take a different approach to those countries with good governance than to those with bad governance. In this context, we examine the Canadian foreign aid record. Finally, this study examines the appropriate role of aid in different institutional environments and how to best assist less developed countries.

The purpose of aid

Many nations exist in seemingly perpetual states of poverty. In Bangladesh, 68 percent of the children under age five are malnourished. In Zambia, only 43 percent of the population has access to safe drinking water. In Pakistan, 76 percent of females over age 15 are illiterate (World Bank 1998). In the Sudan, 60 percent of local telephone calls fail. In Ghana, 61 percent of the main paved roads are in poor condition (Canning 1998). These countries share two characteristics. They are poor, and they have been recipients of massive amounts of foreign aid.[1] Contrast these countries with Japan, South Korea, and Chile, all former, less developed countries which have received very little aid, yet have produced superior results. The natural question is whether aid facilitates or deters development.

The Department of Foreign Affairs and International Trade has stated that "Canadians want to be sure that their aid dollars are being used effectively, that their help is making a difference in the lives of people benefitting from Canadian assistance by increasing their *self-reliance*" (DFAIT 1998, emphasis added). If self-reliance is its ultimate goal, foreign aid should seek to increase the self-generated incomes of those in developing countries, and must involve the eventual elimination of aid flows.

The only possible way to ensure the affluence of less developed countries without continuous aid

1 These nations rank in the top 20 recipients of aid from 1975-95 in nominal terms (Chang et al. 1998).

transfers[2] is through economic growth. Since economic growth benefits all members of society (not just those at higher initial starting points), economic growth can, with time, vastly improve the lives of those within growing societies (Dollar et al. 1998: 38). Within one generation, even modest economic growth can double the average income of an economy. If foreign aid is intended to make a "difference in the lives of people" and "increase their self reliance," clearly it can only do so if it elicits economic growth.

Economic growth

Economic growth can be thought of as the additional goods and services produced in an economy over the previous year due to improvements in the efficiency and quantities of labour and capital. When economic growth outpaces population growth, standards of living improve. When countries have divergent levels of growth, living standards diverge as well. In this way, past economic growth is an important factor that separates a country like Canada from a country like Chad. Thus, future economic growth is critical in bringing the standard of living of poor countries to the level found in places such as Canada. If aid is to have any long-term significance, it must foster conditions that result in economic growth.

Too often, the analysis of growth has focused on specific quantities of inputs, such as the amount of capital, while ignoring the importance of entrepreneurship, institutions, and technological change.[3] This has had detrimental effects on the disbursement of aid, and on the policy recommendations offered to developing countries.[4]

Aid and growth

Research examining foreign aid and growth has typically found that aid does not influence economic growth. A study of 97 countries from 1971 to 1990 found that "in all countries there was no significant correlation between aid and growth" (Boone 1995: 4). There was also little evidence that aid helps reform tax structures or change distortionary policies; rather, it tends to increase the size of government. In addition, aid did not improve infant mortality rates, primary school enrolment, or life expectancy. Rather "aid flows primarily benefit a wealth political elite," and thus aid "does not benefit the poor" (Boone 1995: 5, 26).

Another study of 73 countries from 1971 to 1995 found that neither aid per capita nor aid as a percentage of GDP was positively correlated with economic growth (Vásquez 1998: 276). Similarly, an analysis that examined the source of aid found no positive relationship between aid and growth. Thus, programs with different approaches to aid disbursement have had a similar lack of success, even though they share the common goal of promoting growth (Vásquez 1998: 276).

To date, foreign aid has failed to increase growth.[5] Furthermore, aid has typically focused on two areas believed to be critical to economic development: education and health care. In these areas, too, aid has failed to make a difference.

2 It is doubtful that even continuous transfers can increase the incomes of anyone but a political elite; see Boone (1995).

3 See Appendix I for a discussion of the evolution of growth theory. The impact of this evolution, while accepted in academia, has not been fully appreciated by aid-granting agencies.

4 For example, aid was sometimes conditional on the creation of economic plans, or directed towards massive capital expenditures.

5 A review of the literature on foreign aid and economic growth done for the Congressional Budget Office (1997) also found no evidence of a positive relationship between aid and growth.

Aid and education

Education is often thought to be an important development lever, and the implication that follows is that financial resources should flow to impoverished nations to increase education spending. Proponents of this view often point to the success of the Asian countries in expanding the skills of their citizens and their purportedly consequent future rapid development. They conclude, incorrectly, that the devotion of large amounts of money to education in other less-developed countries would have a similar effect. While these Asian nations were, at the time, less developed countries, it is seldom noted that these countries were not, in fact, dedicating large resources to education. If one measures education spending as a percent of GDP, or by physical inputs such as student-teacher ratios, these countries were unexceptional (Dollar et al. 1998: 77). Moreover, research that examined a large sample of countries found that "standard measures of schooling quality such as pupil-teacher ratio, class size, and teacher characteristics do not effectively explain student cognitive achievement" (Hanushek et al. 1995: 3). Thus, simply increasing foreign aid is unlikely to significantly improve a country's human capital.

Also, aid may not be directed to improving the educational attainment of everyone in a country. Côte d'Ivoire was one of the world's biggest spenders on education when measured as a percent of the government's budget, but 40 percent of the children aged 6 to 12 were not enroled in school in 1985. Studies also show that 50 to 80 percent of education spending went to higher education, and the cost per university student was among the highest in the world. This spending mainly benefited the rich, as university students were typically drawn from the richest families (Wick et al. 1998: 14-5). Quantity of spending, in this case as in many others, is no certain indication of quality.

Aid and health care

Health care is often a development priority, but health outcomes are rarely related to the level of health expenditures. Infant mortality is an example. The ten countries with the worst infant mortality rates (rates 40 percent higher than demographics justify), spend more as a share of GDP on health care than the top 10 countries (Dollar et al. 1981: 76). How institutions are organized and run is more important than the amount of money that is put into the system. This is true even in the developed world. A recent analysis found that additional funds devoted to health care are unlikely to substantially reduce patient waiting times in Canada (Zelder 1999).

The developed world also foists unrealistic goals on developing countries. Free universal health care is often touted as a goal, even while Canada's own attempts at this enterprise are failing and care is being rationed by using waiting lists (Ramsay et al. 1998). In the developing world, resources are spread even thinner, and health care providers often do not have access to the drugs or supplies needed to provide adequate care. When clinics in Cameroon began charging user fees in order to secure a reliable drug supply, use of these clinics actually increased. The increase consisted of a disproportionate number of low-income users, who were for the first time given access to a reliable source of drugs. Previous attempts to provide universal care meant that resources were simply spread too thinly, leading to even low-income earners shunning these clinics (Dollar et al. 1998: 95).

Similarly, some governments that receive aid have no intention of directing this spending towards helping the poor. In the Cote d'Ivoire, for example, rural populations received only 11 percent of health spending, while accounting for 50 percent of the population. Much of the budget was spent on "highly sophisticated treatments not suited to the needs of the majority of the population, who needed low-cost preventive care" (Wick et al. 1998: 15). Clearly, aid directed to health care systems in this manner will be unlikely to improve the quality of life for a majority of the population.

Why aid doesn't help

Government-directed aid tends to be ineffective for two reasons. First, such aid alters the political structure of a country by being a force of centralization and politicization. Second, a lack of appropriate evaluation techniques by donor governments has led to an uninformed selection of recipient countries, creating disappointing results. The following paragraphs describe how these factors have contributed to foreign aid's ineffectiveness.

Aid is centralizing

Aid can be a powerful force of centralization. Aid dollars often flow directly to the central government of a recipient country, where decisions on how to allocate this money are made. This is often not the best way to make expenditure decisions. Rather, in an efficient political system, decisions are made at the lowest level that has the capacity to make them. Local governments have more information about the needs, concerns, and goals of the local populace, and are also more accountable to them than are centralized governments with their larger constituencies. To the extent that aid discourages appropriate local decision-making, it reduces its effectiveness (Dollar et al. 1998: 22).

Aid also increases the returns to being involved in politics, diverting resources from productive activities. Because of their size, the flow of aid to some countries can be greater than their central governments' expenditures (World Bank 1998). This can have a distorting effect on the country, as the power and prestige of those in government and those who have domestic control over the aid dollars increases. Individuals previously involved in productive activities become more concerned about the workings of the political process. This encourages them to lobby, bribe, or even join the bureaucracy. Consequently, the effectiveness of business is reduced due to the lowered level of available talent for the private sector, which has adverse consequences for the whole economy. When a country's best and brightest workers dream of jobs with the government, the private sector must necessarily suffer (Bauer 1981:104).

Aid is improperly evaluated

Common aid evaluation techniques also reduce aid's effectiveness by ignoring crucial determinants of success. These evaluations focus instead on the quantity of disbursements, or on narrow project-specific measures. The reason these evaluation methods fail to generate effective aid is because they do not give donor countries adequate guidance on who should get aid. The importance of this will be discussed in the next section.

The first problem with typical aid evaluation is that it is often quantity-based. This assessment method arises from the belief that if some aid is good, more aid is better. The Canadian government is often criticized by lobby groups, church organizations and others because the percentage of Canadian GDP devoted to foreign aid is low in comparison to other countries, or some unknown socially optimal level. Even sophisticated magazines like the *Economist* have espoused this dubious argument (*Economist*, January 9-15, 1999). However, measuring only the dollar cost of foreign aid is not a satisfactory way to evaluate it.[6] This common view that more is always better has also affected aid agencies who "have too often focused on how much money they disburse" rather

6 Consumers, for example, do not evaluate the quality of goods by simply examining their price tags.

than the results of the aid (Dollar et. al 1998: 6). Clearly this is unsatisfactory.

The second problem is that aid's success is often judged on a project-by-project basis. Despite the intuitive appeal of this standard, the counter-intuitive truth is that in many circumstances the return to the recipient country is not the return to the project funded, but is rather influenced by the reactions of the recipient government to the aid. Indeed, much of aid's success or failure depends on how the institutions in a country transform revenue into public expenditures. The following example illustrates this point.[7]

Before aid enters a country, the government has its own priorities and objectives. Money given does not flow into a vacuum. Suppose a country has eleven potential projects, each costing $10 million, that it is considering. The quality of these projects range from excellent (Project 1: 100% return on investment) to poor (Project 11: 0% return). Each of projects 2 through 10 have returns successively 10 percent less than the project immediately preceding it. If we imagine a foreign government with a budget of $50 million without aid, the government may choose to fund five projects, for example, projects 1 through 5.

A donor selecting a project in this country has a number of options. If the donor funds project 1, the apparent rate-of-return of the aid-financed project is 100 percent. This looks good for the aid-giving organization but does not represent the true effect of the aid. The true effect of the aid is the additional benefit beyond what would have happened without the foreign aid. Recall that the foreign government had planned, before the aid, to fund projects 1 through 5. If the country uses the $10 million of freed resources to fund project 6, the true effect of the aid is a return on investment of 40 percent. It is also possible that the resources freed are spent on project 11, which could have a high political return for the recipient government, but a financial return of 0 percent. Finally, the $10 million could finance tax reductions, which would have an unknown effect depending on how distortionary the prior tax regime was. If the donor country finances project 6, the apparent and actual return to the project is 40 percent. For the aid organization, this is a less favourable result than financing project 1; the effect on the country is however, similar.[8]

While this example is hypothetical, the real world consequences are not. Recent research shows that recipients of aid treat aid income exactly as they treat an additional dollar of domestically-derived revenue. While a significant portion of foreign aid is *targeted* towards investment spending, "estimates suggest that the net effect of a dollar of aid is to increase public investment by only 29 cents—exactly the amount by which any dollar of government revenue would have raised investment. Similarly, an aid dollar used to finance projects in education tends to increase government spending in all sectors to the same extent as a dollar of government revenue from any source" (Dollar et al. 1998: 19). Aid is used by recipient governments as is money collected any other way (Feyzioglu et al. 1998: 54).[9]

The importance of governance

Governance is important because of the effect that governance can have on economic growth, standards of living, and the effectiveness of aid. Bad government policy puts constraints on

7 This example is taken from Dollar et al. 1998, pages 72-4.

8 The impact is equivalent to the government funding project 6, given that foreign aid funded project 1. The impact is better if the government funds project 11, and indeterminate if the government funds the lessening of tax distortions.

9 This does not mean that the money is by assumption wasted, but rather that the recipient government uses it like it would use any other funding, regardless of the donor country's intentions.

growth by thwarting private incentives and distorting choices. Research clearly shows that countries with extensive restrictions on economic activity grow more slowly than those that do not. Recent work also shows that governance plays a role in determining the success of aid in generating growth. If aid evaluation methods do not take governance into account, poor country selection may occur.

Research shows that the quality of governance is an important determinant of economic growth. Burnside and Dollar (1997) conclude that better-managed countries have higher levels of growth. They estimate that changes in policy would enable some countries to increase their yearly economic growth by 2 to 3 percentage points. For example, "the difference in management between, say, Thailand and Tanzania may have been worth about 4 percentage points of growth" per year (Dollar et al. 1998: 33). Similarly, the Economic Freedom of the World project (1996, 1997, 1998) indicates that from 1985 to 1996 the countries with the greatest restrictions on economic activity shrunk at a rate of 1.9 percent per year, while those with the least government interference grew at an average rate of 2.9 percent (Gwartney et al. 1997: 34). Another study notes that "the large differences in per capita income across countries cannot be explained by differences in access to the world's stock of productive knowledge or to its capital markets, by differences in the ratio of population to land or natural resources, or by differences in the quality of marketable human capital or personal culture.… The only remaining plausible explanation is that the great differences in the wealth of nations are mainly due to differences in the quality of their institutions and economic policies" (Olson 1996: 19).

The effectiveness of aid is also influenced by the quality of governance, since aid is used as if it were regular budgetary revenue. As noted previously, a number of studies have found no evidence that aid increases economic growth. An extension of this research is a recent World Bank report that examined the influence of governance on the effectiveness of aid. The effect of aid on countries with a poor score on the economic management index created for this study is negligible, and perhaps even negative. This implies that aid sent to foreign countries with poor governance has been a waste of resources, or even a detriment to the receiving country.[10] Only aid flowing to better-governed jurisdictions was found to be beneficial (Dollar et al, 1998: 36).

The Canadian experience

Since only aid distributed to well-governed nations fulfils aid's objective of increasing growth, the quality of governance in recipient countries provides us with a good criterion with which to judge Canadian aid. While the economic management index created for the World Bank research is useful, there exists a better measure of the quality of governance. The Economic Freedom of the World project, published by 53 research organizations worldwide, uses 25 indicators to measure the extent to which governments impinge on the economic freedoms of their citizens. The economic freedom index shares a number of variables with the economic management index of the World Bank, as well as the objective of differentiating between good and bad governance. Using this index and the results of recent research, we can examine Can-ada's foreign aid record. (Table 1 gives background data.)

10 Tornell et al. (1999) offer additional support for this view. In their paper, the authors create an economic model of countries with powerful special interest groups and weak institutional structures. Their model predicts that windfall gains (such as foreign aid) will provide little benefit to this type of country due to the interaction of these groups. Their view is supported by the empirical evidence they present.

Figures 1-4 illustrate how Canadian aid has been distributed. Figures 1 and 2 show the percentage of Canadian foreign aid that has gone to each quintile of the economic freedom index. Figure 1 indicates that 74.4 percent of Canadian aid has gone to the bottom 40 percent of countries ranked according to the quality of governance (the level of economic freedom). Figure 2 shows that bilateral aid[11] has followed a similar pattern. Figures 3 and 4 show in per capita[12] terms how Canadian aid varies with the quality of governance. Figures 3 and 4 demon-strate that the lower the level of economic freedom in a recipient country, the higher the level of Canadian aid received per person.[13] These figures clearly indicate that aid has disproportionately gone to the most poorly governed countries.[14]

As previously discussed, aid sent to countries with bad governance has no beneficial effect on development in that country. This suggests that a significant portion of Canadian aid has not

Figure 1: Total Canadian Aid versus Economic Freedom of the World Quintile

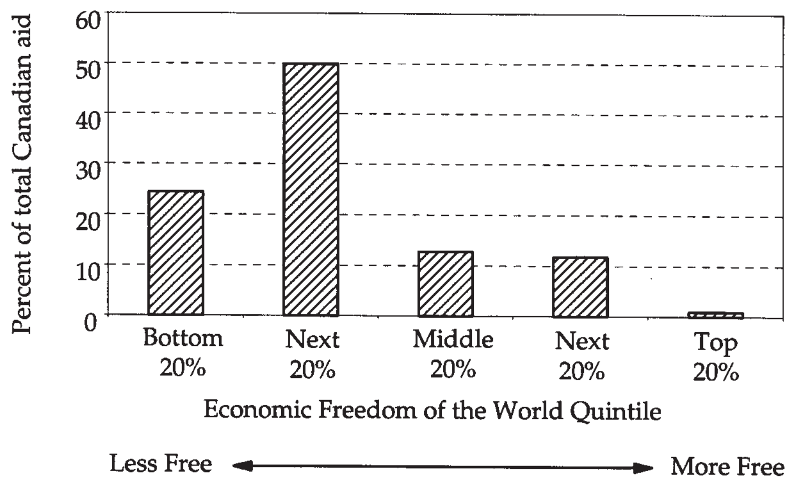
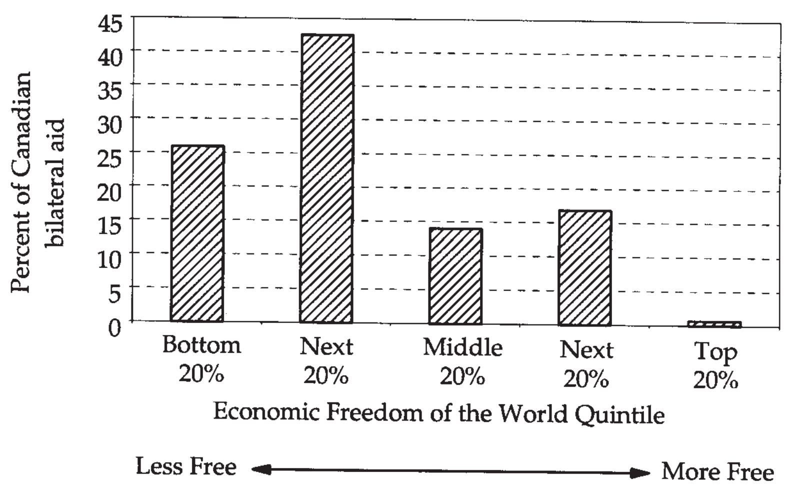


Figure 2: Canadian Bilateral Aid versus Economic Freedom of the World Quintile



11 Total aid refers to the sum of Canadian foreign aid from the government, whether the aid is bilateral or from a multinational agency partly funded with Canadian tax dollars. Bilateral aid refers solely to that portion of total Canadian foreign aid which is directly controlled by the Canadian government.

12 Per capita aid in these charts represents the per capita aid received by the average country in each quintile.

13 It is interesting to note that per capita bilateral aid (aid which Canada has sole discretion over distributing) is skewed more towards the least free countries than per capita total aid (aid which in part is distributed by multi-national organizations). This suggests that Canada makes worse aid disbursement decisions than the multinational aid-granting organizations to which it contributes.

14 This is a similar finding to research by Alesina et al. (1999), which notes that “according to most measures, corrupt governments actually receive more foreign aid rather than less” (p. 20).

been beneficial to recipient countries. Figures 1-4 demonstrate that we have significant latitude for reforming and improving the Canadian foreign aid record by reallocating and even reducing the total resources committed to it.

Figure 3: Per Capita Aid versus Economic Freedom of the World Quintile

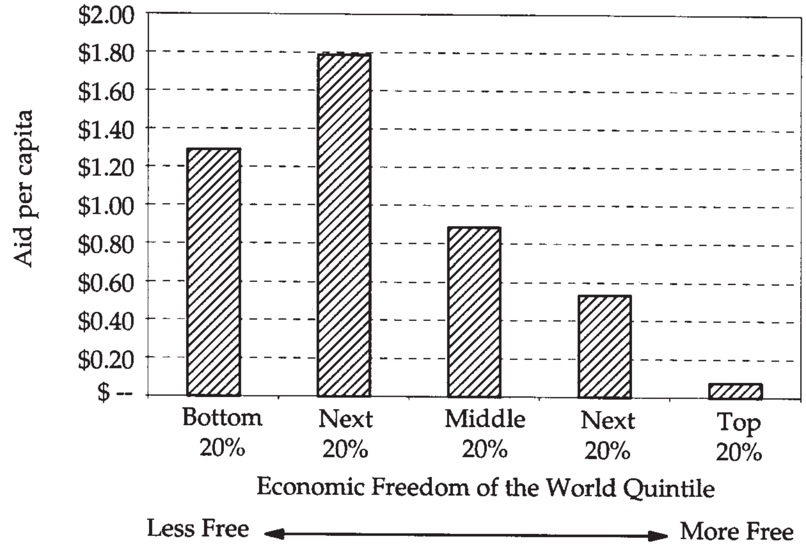
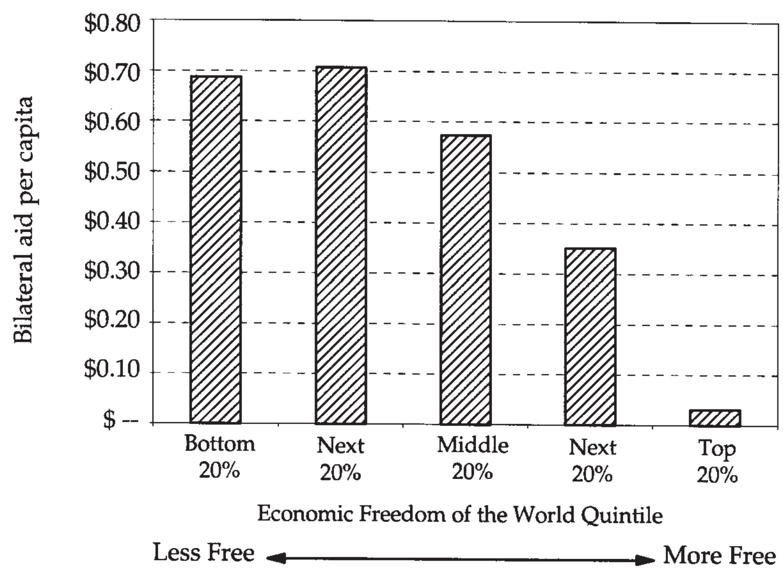


Figure 4: Bilateral Aid per Capita versus Economic Freedom of the World Quintile



Poorly governed nations are the world's poorest, and their governments receive relatively large inflows of aid. Figure 5 shows that countries with lower levels of economic freedom have lower per capita incomes. Since aid tends to flow disproportionately to the poorest nations, this inadvertently distributes significant resources to those countries with the lowest levels of economic freedom. Measured as a percentage of GNP, the differences in aid flows between the economic freedom quintiles are unmistakable (figure 6).

Ironically, these flows, which represent a significant portion of the nation's resources, protect the policies that made the nation poor in the first place. Foreign aid, unlike domestic revenue, is sheltered from the ups and downs of the domestic economy. Since those within the political apparatus are in part subsidized and protected from the negative consequences of their own policies, these high levels of dependency serve to dampen the incentives and even the grassroots support for widespread programs of liberalization. Prudent aid should strive to encourage reform and lessen the effects of this subsidization of bad governance.

There are two ways to mitigate these effects. The first option, discussed below, is to condition aid expenditures on legitimate reform. The second option is to counterbalance some of the concentrated power of the government by directing aid expenditures to groups outside of the government in the hope that better governance might ensue.[15] In this regard, the Canadian record is disappointing.

Figure 7 illustrates the relationship between the quality of governance and government control of aid dollars. The lower the level of economic freedom in a country, the more likely the country is to get Canadian aid. Even more distressing, the more intrusive and controlling the government, the more likely is Canadian aid to be given directly to the government.

Figure 5: Freedom and Affluence—Per Capita GDP versus Economic Freedom of the World Quintile

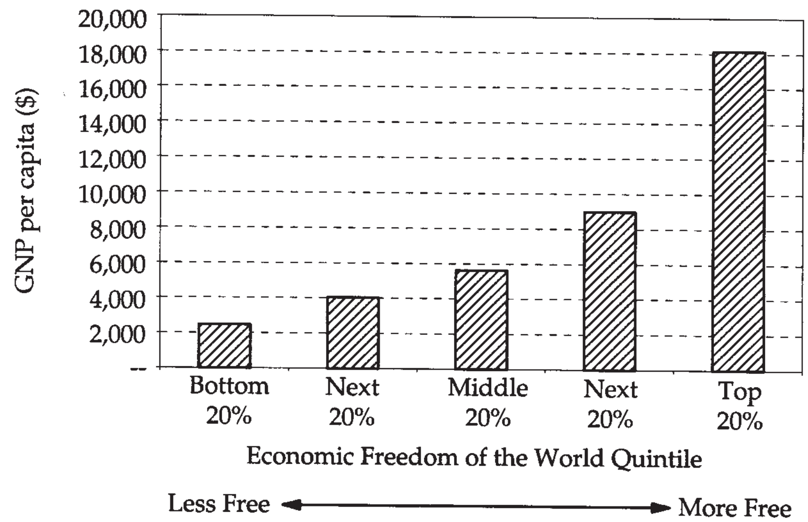
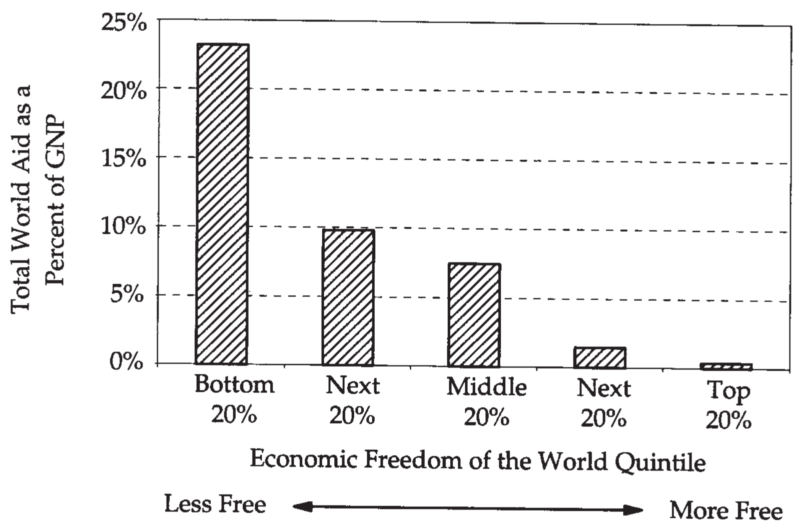


Figure 6: Aid Dependency versus Economic Freedom of the World Quintile



Canada and bad governments

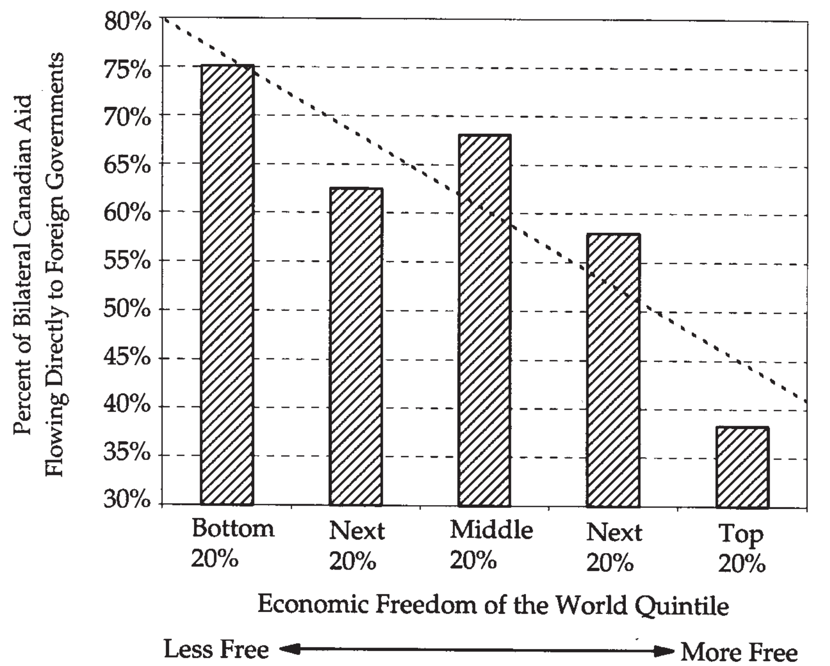
The World Bank study indicates that when a country is poorly managed, aid is not a sufficient ingredient for economic growth, but that good institutions and policies are. This supports what the Economic Freedom of the World project has already shown. Economic freedom (or good economic management, to use the World Bank terminology) produces economic growth. This research also shows that aid flowing to governments with poor economic management (or limited economic freedoms) is not helpful to development: there is no increase in economic growth, no lessening of poverty, and no increase in living standards. If aid is meant to fund development, its use cannot be justified for countries with low levels of economic freedom.

If aid is not the answer, what is? First, if one can identify reformers and elements of change within the government or country, public policy research and technical knowledge shared with these groups could go a long way toward encour-

15 This, however, is only a second best solution. Countries with low economic freedom will have lower levels of economic growth even if all aid expenditures are directed to organizations outside of the government.

aging change. By disseminating and discussing this knowledge, support for extensive programs of liberalization can accumulate. Public education projects in countries unfamiliar with western concepts of democracy and governance may also be fruitful. These options are unlikely to produce immediate results, yet long-run changes may be substantial.

Figure 7: Subsidizing State Control—
Economic Freedom and Aid to Governments



Second, linking aid expenditures to reform will provide the incentive to make meaningful changes. This option, however, is fraught with potential difficulties. In the past, aid-granting organizations have had too much incentive to give out promised monies and too little incentive to ensure that the conditions of the grant were indeed upheld. A study of a particular subset of conditional loans found that although only 53 percent of loan conditions were met, almost all promised funds were distributed. Research suggests, however, that adjustment lending given to countries committed to reform helps ensure that the reforms are carried out (Dollar et al. 1998: 50-2). If Canada wishes to pursue this option, aid must actually be conditional. Third party information should be used to judge policy reform in order to prevent internal biases from creeping in, and aid must be withheld from governments failing to meet expectations.

Canada and good governments

While this research gives some indication that better managed countries are able to use aid more effectively, it does not give us a complete rationale for aid. While a positive correlation between aid and growth in well-managed countries is a good sign, all this tells us, however, is "that capital could be used productively in the recipient countries" (Bauer 1981: 103). The correlation does not justify government capital flows, unless private flows are not forthcoming. Indeed, the existence of modern capital markets and extensive private flows to developing countries negate much of the rationale for foreign aid. While foreign aid was once a significant portion of the flows entering Third World countries, this is no longer the case. Private flows, in the form of investment and voluntary charity, are almost five times as large as foreign aid, when at one time these flows were approximately equal (Dollar et al. 1998: 7).

Developed countries may, however, have one role to play. Foreign aid in the form of technical knowledge can help ensure appropriate investments in public infrastructure and institutions. These investments can provide the basic structures needed to attract investment and provide domestic sources of government revenue. By increasing a country's ability to enforce the rule of law, and protect people and property, foreign aid given for a limited period of time may be fruitful.

Allocating aid

The fact that aid is only beneficial in countries with higher levels of economic freedom indicates some guiding principles for the allocation of aid. There should be a shift of aid money from countries with low levels of economic freedom towards countries with more economic freedom. Public choice theory suggests, however, that it is questionable whether a political process can reach this perceived optimal allocation.[16] As noted before, research by Vásquez (1998) indicates that there has not been a system used by any government agency that has been able to distribute aid in a way that enhances economic growth. It is unlikely that government will be able to improve on this poor record.[17]

Voluntary organizations and action tend to move towards optimality without prompting. Investment naturally flows to countries that are well-managed and where the economic freedoms of citizens are secure. In countries with repressive regimes, voluntary organizations typically work with the poor themselves rather than with government bureaucrats. There are also organizations that exclusively focus on political and economic education in developing countries. This sharing of knowledge and the development of contacts between the developed and developing world can only prove to be fruitful. While research has only recently shown us an 'optimal' policy for distributing government aid, for some time, private actions on the part of individuals have distributed assistance more effectively than governments.[18]

Since private investment tends to gravitate toward well-managed countries, this lessens the need for foreign aid. If a country is well-managed, aid is not as greatly needed, due to the country's ability to attract private foreign capital.[19] Research indicates that if a country is mismanaged, aid does not help development. What, then, is the appropriate role for government foreign aid? We should encourage the development of institutions that protect the rule of law and private property,[20] and policies that move the country towards greater economic freedom such as freer trade, low and stable inflation, and the ability to exchange domestic currency for foreign currency;[21] after that, foreign aid has little role to play, since "developing countries are to a large extent masters of their own fate" (Dollar et al. 1998: 23).

16 Special interest groups may have vested interests in funding particular countries in spite of a lack of economic freedom. For example, a recent *Vancouver Sun* editorial recounted how aid dollars were used in a foreign country to 'educate' foreign engineers about Canada's nuclear technology. Essentially, this activity was a marketing program for Candu reactors (Cassels 1999). See also Alesina et al. (1998) for a description of the political/strategic considerations entering into aid allocation decisions.

17 Governments around the world, for example, maintain minimum wage legislation even though its detrimental effect has long since been shown (Law 1999). Clearly, governments do not always do that which is in the best interest of the whole population.

18 Voluntary organizations should be mindful of this research, however, in selecting countries to receive aid.

19 Alesina et al. (1999) and Alesina et al. (1998), for example, show that foreign direct investment (money *not* from governments) is greater in less corrupt nations, as well as in nations with good economic policy and respect for the rule of law.

20 This role may not be a financial one, rather one of simply sharing technical knowledge.

21 Since these options are not cost-free and it may be impossible for a country to reform all policies simultaneously, we need to be able to choose among the various dimensions of economic freedom. See Appendix II for further discussion.

Recommendations

Enhanced understanding of the consequences of government foreign aid, as this paper has provided, gives rise to a number of basic recommendations.

- *Immediately stop foreign aid to countries with low levels of economic freedom.* The World Bank research noted above shows that aid to these countries does not foster development. Without development, poverty is not alleviated, and standards of living do not improve. There are no rational arguments in favour of funding these countries.
- *Slowly cut back aid to countries with higher levels of economic freedom.* Research does indicate that aid can play a role in the development of countries with better economic management. However, private investment in well-managed countries lessens the need for aid. If aid is given, it should focus on helping to build the infrastructure and institutions necessary to encourage private investment and to secure self-sufficient sources of domestic financing. Aid should be given cautiously, and for a limited number of years, in order to encourage independence. Aid must be stopped if there are large reversals in economic freedom.
- *Economic freedom should be promoted in the developing world.* The research is clear: greater economic freedom means greater economic prosperity. Increasing economic freedom in developing countries has been shown to increase the standards of living, whereas foreign aid has been, for the most part, ineffective. If aid can induce governments to give their citizens more economic freedom, it should be used for these purposes.
- *Tariffs, agricultural subsidies, and other trade restrictions should be eliminated.* If we are concerned with reducing global poverty, freer trade is essential. Removing trade restrictions imposed by the developed world could significantly improve growth prospects in the developing world (Mihlar 1997).
- *The role of voluntary action should be highlighted.* Voluntary organizations and investment flows have always tended to distribute financial and non-financial resources more effectively than government. As the level of aid from the government is decreased, the role that these organizations can play should be emphasized to Canadians.

Table 1: Background Data

Country	Population (millions) mid-1995	Aid/GNP, 1995 (%)	Total Bilateral (all sources) 1995-96	Total Canadian Aid (all sources) 1995-96	Government-to-Government Aid (including bilateral food aid)	Index of Economic Freedom 1997
	1	2	3	4	5	6
Afghanistan	23.5	~	6.1	10.5	0.6	
Albania	3.3	8.1	0.1	2.8	0.1	4.1
Algeria	28.0	0.8	3.9	4.1	3.6	4.2
Angola	10.8	10.2	4.1	10.5	0.4	
Antigua & Barbuda	0.1	~	0.0	0.4	0.0	
Argentina	34.7	0.1	2.1	5.8	0.3	8.7
Armenia	3.8	10.3	0	0.3	0.0	
Australia	18.0					8.6
Austria	8.0					7.9
Azerbaijan	7.5	3.1	0.1	0.2	0.1	
Bahamas	0.3					6.1
Bahrain	0.6	1.1	0.0	0.0	0.0	8.0
Bangladesh	119.8	4.4	74.2	112.2	73.0	4.4
Barbados	0.3					6.1
Belarus	10.3	na	na	na	na	
Belgium	10.0					8.2
Belize	0.2	2.9	0.4	1.5	0.3	5.6
Benin	5.5	14.0	15.5	18.4	13.8	4.7
Bhutan	0.7	24.8	0.3	0.8	0.3	
Bolivia	7.4	11.9	19.9	33.2	19.3	7.8
Bosnia Herzegovina	4.4	~	~	~	~	
Botswana	1.5	2.2	1.9	3.1	1.8	6.6
Brazil	159.2	0.1	5.8	11.9	1.9	5.5
Bulgaria	8.4	na	na	na	na	5.1
Burkina Faso	10.4	21.1	11.7	20.1	10.6	
Burma	45.1	~	0.2	1.2	0.0	

Table 1: Background Data

Country	Population (millions) mid-1995	Aid/GNP, 1995 (%)	Total Bilateral (all sources) 1995-96	Total Canadian Aid (all sources) 1995-96	Government-to-Government Aid (including bilateral food aid)	Index of Economic Freedom 1997
Burundi	6.3	27.4	5.6	8.4	0.6	4.8
Cambodia	10.0	20.5	3.5	13.1	2.2	
Cameroon	13.3	5.9	20.5	30.1	19.3	5.0
Cape Verde	0.4	~	0.6	1.5	0.6	
Central African Republic	3.3	~	1.3	4.3	1.3	4.2
Chad	6.4	21.4	0.7	6.3	0.6	4.8
Chile	14.2	0.3	2.2	2.6	0.0	7.9
China	1200.2	0.5	70.9	139.4	62.2	5.6
Colombia	36.8	0.3	5.0	14.8	2.0	5.7
Comoros	0.5	17.9	0	1.2	0.0	
Congo-Brazzaville	2.6	7.6	0.2	5.0	0.1	4.5
Congo-Kinshasa (Zaire)	43.9	~	1.0	2.7	0.4	3.2
Costa Rica	3.4	0.3	3.9	4.7	1.9	7.9
Côte d'Ivoire	14.0	16.1	31.7	67.5	12.2	5.2
Croatia	4.8	~	~	~	~	
Cuba	0.8	~	1.9	2.1	0.4	
Cyprus	11.0					6.2
Czech Republic	10.3	na	na	na	na	6.6
Denmark	5.0					8.3
Djibouti	0.6	~	0.2	0.6	0.2	
Dominica	0.1	11.0	1.2	2.5	1.1	
Dominican Republic	7.8	1.1	0.4	2.6	0.0	6.8
Ecuador	11.5	1.4	3.7	6.9	2.3	7.1
Egypt	57.8	4.3	89.2	93.2	12.2	5.9
El Salvador	5.6	3.2	2.5	5.6	1.7	8.2

Table 1: Background Data

Country	Population (millions) mid-1995	Aid/GNP, 1995 (%)	Total Bilateral (all sources) 1995-96	Total Canadian Aid (all sources) 1995-96	Government-to-Government Aid (including bilateral food aid)	Index of Economic Freedom 1997
Equatorial Guinea	0.4	22.5	0.1	0.4	0.1	
Eritrea	3.6	21.8	5.2	5.8	4.7	
Estonia	1.5	na	na	na	na	6.7
Ethiopia	56.4	17.0	18.5	29.5	16.2	
Fiji	0.8					5.5
Finland	5.0					8.2
France	58.0					8.1
Gabon	1.1	3.9	3.3	3.8	3.2	5.3
Gambia	1.1	~	0.7	1.6	0.4	
Georgia	5.4	9.1	0.1	0.2	0.1	
Germany	82.0					8.2
Ghana	17.1	10.6	30.9	43.4	29.7	6.0
Greece	0.1					7.5
Grenada	10.0	3.8	0.1	0.9	0.0	
Guatemala	10.6	1.5	4.4	5.7	3.0	7.7
Guinea	6.6	11.7	6.0	13.2	5.7	
Guinea-Bissau	1.1	46.9	0.7	2.1	0.7	3.1
Guyana	0.8	15.8	3.7	7.7	3.4	
Haiti	7.2	36.1	30.8	35.8	25.8	
Honduras	5.9	11.2	7.2	15.2	5.6	6.9
Hong Kong	6.5					9.6
Hungary	10.2	na	na	na	na	7.2
Iceland	0.3					7.7
India	929.4	0.5	51.7	100.0	43.9	5.3
Indonesia	193.3	0.7	22.3	23.9	17.2	7.2
Iran	64.1	~	0.0	0.5	0.0	5.1
Iraq	20.1	~	2.1	3.1	0.0	

Table 1: Background Data

Country	Population (millions) mid-1995	Aid/GNP, 1995 (%)	Total Bilateral (all sources) 1995-96	Total Canadian Aid (all sources) 1995-96	Government-to-Government Aid (including bilateral food aid)	Index of Economic Freedom 1997
Ireland	4.0					8.6
Israel	6.0					6.0
Italy	57.0					7.9
Jamaica	2.5	3.4	7.5	9.6	6.7	7.2
Japan	126.0					8.3
Jordan	4.2	8.5	12.9	15.8	11.9	5.8
Kazakhstan	16.6	0.4	1.1	1.2	1.1	
Kenya	26.7	9.7	7.7	17.3	5.8	7.0
Kuwait	1.7	0.0	0	0.1	0.0	7.6
Kyrghzstan	4.5	9.3	0.1	5.7	0.1	
Laos	4.9	18.0	1.3	5.9	0.2	
Latvia	2.5	na	na	na	na	6.1
Lebanon	4.0	1.6	4.2	5.8	2.6	
Lesotho	2.0	7.8	1.0	1.9	0.8	
Liberia	2.7	~	2.1	5.3	1.1	
Libya	5.4	~	0	0.0	0.0	
Lithuania	3.7	na	na	na	na	6.5
Luxembourg	0.4					8.6
Macedonia, FYR	2.1	~	~	~	~	
Madagascar	13.7	10.0	1.5	4.9	1.2	4.2
Malawi	9.8	33.8	13.5	20.9	12.8	4.1
Malaysia	20.1	0.1	4.5	5.3	3.4	7.6
Maldives	0.3	22.3	0.0	0.5	0.0	
Mali	9.8	23.4	19.9	29.6	18.9	5.0
Malta	0.4					6.0
Mauritania	2.3	22.8	1.1	7.2	1.1	
Mauritius	1.1	~	0.3	1.1	0.1	7.9

Table 1: Background Data						
Country	Population (millions) mid-1995	Aid/GNP, 1995 (%)	Total Bilateral (all sources) 1995-96	Total Canadian Aid (all sources) 1995-96	Government-to-Government Aid (including bilateral food aid)	Index of Economic Freedom 1997
Mexico	91.8	0.2	5.0	6.6	0.4	7.4
Moldova	4.3	na	na	na	na	
Mongolia	2.5	24.9	0.0	1.3	0.0	
Morocco	26.6	1.6	9.2	10.1	6.8	5.5
Mozambique	16.2	84.8	19.2	32.4	18.7	
Myanmar	46.0					2.5
Namibia	1.5	6.2	1.4	1.8	1.1	5.2
Nepal	21.5	~	6.1	10.9	4.9	4.8
Netherlands	16.0					8.6
New Zealand	4.0					9.2
Nicaragua	4.4	42.0	18.3	25.7	17.8	6.5
Niger	9.0	15.1	4.9	8.6	4.9	5.0
Nigeria	111.3	0.9	2.2	6.1	0.9	4.6
North Korea	23.9	~	0.1	0.3	0.0	
Norway	4.0					8.3
Oman	2.2	0.6	0	0.0	0.0	7.9
Pakistan	129.9	1.3	-0.1	17.3	-1.0	5.0
Panama	2.6	0.7	0.7	1.8	0.2	8.6
Papua New Guinea	4.3	8.2	0.1	0.6	0.0	5.5
Paraguay	4.8	1.9	0.3	2.2	0.2	7.6
Peru	23.8	0.8	25.8	29.0	22.6	7.6
Philippines	68.6	1.2	22.8	24.2	19.3	7.8
Poland	38.6	na	na	na	na	6.2
Portugal	0.6					7.7
Qatar	10.0	0.0	0	0.0	0.0	
Romania	22.7	na	na	na	na	4.2
Russian Federation	148.2	na	na	na	na	5.1

Table 1: Background Data

Country	Population (millions) mid-1995	Aid/GNP, 1995 (%)	Total Bilateral (all sources) 1995-96	Total Canadian Aid (all sources) 1995-96	Government-to-Government Aid (including bilateral food aid)	Index of Economic Freedom 1997
Rwanda	6.4	62.9	17.5	20.8	9.3	3.5
São Tomé and Principe	0.1	~	0.2	0.7	0.2	
Saudi Arabia	19.0	0.0	0	0.2	0.0	
Senegal	8.5	~	19.6	32.7	17.0	5.0
Seychelles	0.1	2.7	0.6	1.6	0.6	
Sierra Leone	4.2	26.9	0.6	5.0	0.2	4.1
Singapore	3.0					9.4
Slovak Republic	5.4	na	na	na	na	6.1
Slovenia	2.0	na	~	~	~	5.9
Somalia	9.5	~	1.6	2.7	0.1	
South Africa	41.5	0.3	16.4	16.7	10.8	6.5
South Korea	46.0					7.5
Spain	39.0					7.8
Sri Lanka	18.1	4.3	7.7	12.3	4.6	6.1
St Kitts and Nevis	0.1	1.9	0.0	0.9	0.0	
St Lucia	26.7	9.0	5.3	6.6	4.9	
St Vincent/ Grenadines	0.4	19.2	0	0.9	0.0	
Sudan	0.9	~	4.7	6.9	0.5	
Suriname	9.0	21.7	0.1	0.1	0.1	
Swaziland	7.0	5.3	0.9	1.6	0.9	
Sweden	0.0					8.0
Switzerland	0.2					8.5
Syria	14.1	2.2	0	1.2	0.0	4.7
Taiwan	5.8					7.6
Tajikistan	21.7	3.4	0.0	0.1	0.0	
Tanzania	29.6	~	12.0	22.9	10.8	5.2

Table 1: Background Data

Country	Population (millions) mid-1995	Aid/GNP, 1995 (%)	Total Bilateral (all sources) 1995-96	Total Canadian Aid (all sources) 1995-96	Government-to-Government Aid (including bilateral food aid)	Index of Economic Freedom 1997
Thailand	58.2	0.5	16.4	17.1	14.8	7.9
Togo	4.1	15.5	0.9	5.8	0.8	4.4
Trinidad and Tobago	1.3	0.5	1.6	2.1	1.1	7.7
Tunisia	9.0	0.4	0.0	7.6	-0.9	5.9
Turkey	61.1	0.2	4.9	5.3	2.9	6.3
Turkmenistan	4.5	0.7	0.0	0.0	0.0	
Uganda	19.2	14.8	2.2	14.5	1.0	6.2
Ukraine	51.6	na	na	na	na	4.2
United Arab Emirates	2.5	0.0	0	0.0	0.0	
United Kingdom	59.0					9.0
United States	265.0					9.1
Uruguay	3.2	0.5	1.9	2.5	0.3	7.7
Uzbekistan	22.8	0.4	0.0	0.2	0.0	
Venezuela	21.7	0.1	1.3	1.6	0.3	6.1
Vietnam	73.5	~	12.4	27.7	7.8	
Yemen	15.3	4.4	0.7	3.0	0.2	
Yugoslavia*	10.5	~	19.5	28.4	6.9	
Zambia	9.0	56.8	11.4	127.6	9.8	5.5
Zimbabwe	11.0	8.0	16.7	26.7	14.8	5.7

Note: na = not applicable
~ = not available
* = borders since modified

Sources: Columns 1-5, Canadian Development Reports, 1996-1997, 1998 CD-Rom, Ottawa: The North-South Institute, 1998.
Column 1: Supplemented with data from the World Bank, http://www.worldbank.org, and Colombo, John Robert (editor), *The 1999 Canadian Global Almanac* (Toronto: Macmillan Canada, 1998).
Column 6: Gwartney and Lawson, *Economic Freedom of the World 1998/1999 Interim Report* (Vancouver: The Fraser Institute, 1998).

Appendix I: Evolution of Growth Theory in Development Economics

There is no question about the wide disparity in economic outcomes among countries. In the 1950s, some economists hypothesized that some nations were poor due to a lack of capital. For them, increasing economic growth was simply a matter of increasing the country's capital stock. Using a relatively simple mathematical model, development economists calculated the capital required to induce certain levels of growth. Domestic savings were deducted from required savings to create a "financing gap" between what was needed for growth and what was available domestically.[22] Significant amounts of foreign aid have been spent and justified in the name of filling this gap. Ironically, the original author of this viewpoint, Evsey Domar, disavowed this analysis in 1958, while the concept survived mainly due to its rhetorical and mathematical simplicity (Easterly 1997: 2).

The "financing gap" view of economic growth ignores the reality of modern capital markets. In the past 20 years, there have been large net capital flows to developing economies. This analysis also ignores the fact that in some developing nations, there are high-income earners who produce a significant portion of the nation's output. Presumably, these individuals are not near subsistence levels, and thus have money to invest locally. An important question to ask is why these individuals "choose to invest domestically in some countries while in others they don't" (Boone 1995: 1). As one author concludes, "There is no theoretical or empirical justification for using such a 'financing gap' calculation to influence policy or the allocation of foreign aid. After 40 years, the Ghost of Financing Gap can finally be laid to rest" (Easterly 1997: 25).

Newer economic theory can fill the void left by this unsatisfactory model. Most modern approaches focus on the importance of basic education, technological advance, and freeing the market from restrictive government intervention (Barro 1996: 20-2). An extensive analysis of modern thinking on economic growth by Olson (1996) examined the possible roles of capital and labour in influencing the wealth of nations. Even given different natural endowments, a large portion of the income gap between nations remains to be explained.[23] Where countries differ, in Olson's opinion, is in the quality of their institutions and government policies.

The specific aspects of government intervention and their implication for growth is thus an expanding research area. One study of particular interest is the recent work by Burnside and Dollar (1997). These authors created an economic management index examining such variables as openness to trade, the budget surplus, inflation, and institutional quality. Burnside and Dollar concluded that countries that are better managed have higher levels of growth. These findings suggest "that poor countries have been held back not by a financing gap, but by an 'institutions gap' and a 'policy gap'" (Dollar et al. 1998: 33). In other words, Third World countries can be differentiated from developed countries not only because of a lack of income, but in fundamental terms by the institutional structures they lack, such as the rule of law, as well as by poor government poli-

22 Citizens of low-income countries close to subsistence levels were, according to this model, trapped. If they saved, they would be unable to consume enough to survive, but without saving they could not generate the economic growth required to leave these conditions.

23 Similarly, calculations by Robert Lucas, Jr. (1990) using a simple neo-classical growth model indicate a rate-of-return differential too large to be explained by differences in labour, capital, or human capital.

cies, rampant inflation, and fiscal deficits. "Put simply, failures in policymaking, institution building, and the provision of public services have been more severe constraints on development than capital markets" (Dollar et al. 1998: 11). Changes in policy would enable some countries to increase their yearly economic growth by an estimated 2 to 3 percent. The authors note that "the difference in management between, say, Thailand and Tanzania may have been worth about 4 percentage points of growth" per year (Dollar et al. 1998: 33). Over time this would make an enormous difference in the quality of life of the citizens in the countries concerned.

Another pertinent study is the Economic Freedom of the World project (1996, 1997, 1998). This project examines 25 different components to determine the extent to which governments impinge on the economic freedoms of their citizens. The economic freedom index shares a number of variables with Burnside and Dollar's economic management index, as well as the objective of differentiating between good and bad governance. The results of this study indicate that from 1985 to 1996, the bottom quintile (least free) economies shrunk at a rate of 1.9 percent per year, while the top quintile grew at an average rate of 2.9 percent (Gwartney et al. 1997: 34). If a developing country were able to grow consistently at this higher rate, income would double in as little as 25 years.[24]

Clearly, growth, and therefore development, are hampered by poor policies. Poverty is not a characteristic inherent to a particular geographical region or people. Indeed, at one time, the whole world was mired in unimaginable levels of poverty. "Western society progressed in conditions far more difficult than those of the present Third World, which can draw on huge external markets, on external capital markets, on a vast range of technology and on diverse skills unavailable before" (Bauer 1981: 99). Through contact and trade with the developed world, and through the liberalization of policies and institutions, the developing world has the ability to achieve higher standards of living by replicating the patterns of success that have been traced out in history.

24 Work by Olson (1996) suggests that developing countries that improve their institutions and policies are able to grow at faster rates than wealthier countries already with these institutions and policies. This result is confirmed by Dollar et al. 1998. This indicates an ability of developing countries to improve standards of living more quickly than noted.

Appendix II: Initial Policy Advice

The easiest advice to give to developing countries is to increase the economic freedoms granted their citizens. Unfortunately, moving from one policy regime to another is not cost-free. For instance, lowering tariffs in order to increase trade, while beneficial in the long run, may deplete government revenues.[25] There may also be political constraints on a government's ability to reform its economy. These financial and political constraints emphasize the importance of prioritizing reforms.

A study by Ayal and Karras (1998) on the components of economic freedom provides us with some guidance. The authors looked at the relationship between the various components of economic freedom and growth, controlling for initial incomes, population growth, and levels of investment. Their investigation identified a number of policies significantly correlated with economic growth. Based on this research, developing counties may wish to focus on the following: "low money growth rate; small role played by government enterprises; rare negative real interest rates; small difference between the official and black market exchange rates; large size of the trade sector; and freedom of citizens to engage in capital transactions with foreigners" (Ayal et al., 1998: 334).

Countries reforming their economies should focus first on the above suggestions. Depending on the costs of the various reforms in a particular country, developing countries may place different priorities on implementing these reforms. A successful reform agenda should gain its own momentum where the success of one reform leads to demands for further reform. By carefully selecting for reform those areas with the most promise first, reforming governments are more likely to gain this momentum.

25 Lowering tariffs may in fact result in more government revenue due to the stimulation of trade. Many countries have tariffs clearly larger than their revenue-maximizing level. These tariffs are instead used to protect special interest groups in the domestic economy. This suggests that in many cases, financial barriers to reform may be less important than the political ones.

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