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485

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By Thomas P. Sheehy

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By Thomas P. Sheehy

The Clinton Administration, with its proposed Peace, Prosperity, and Democracy Act of 1994, has identified the commitment to free market generated economic growth shown by recipients of U.S. development aid as a criterion in deciding how that aid is allocated. The Administration's attention to free markets is welcome, but not sufficient. The commitment to free market generated economic growth shown by recipient countries should be the *primary* criterion for allocating U.S. development assistance. Otherwise, U.S. aid is sure to be wasted or even used counterproductively, as has been the case so often in the past. The Index of Economic Freedom—a quantitative gauge of a country's economic freedom—measures this free market commitment. The Index should be the centerpiece of the revamped U.S. development aid program, supplanting the laundry list approach to development aid which characterizes the Administration's proposed reforms.

It is no secret that many of the countries that have received the billions in U.S. development aid given out over the last thirty-plus years have little progress to show in developing their national economies. Sadly, many of these countries find themselves worse off today economically than twenty and thirty years ago. This is particularly true throughout Africa, a continent where economic growth has stagnated and infrastructure and social services have deteriorated while corruption has become rampant.

Of course, many factors have contributed to economic stagnation in Africa and elsewhere. Large swaths of the developing world have been plagued by bad government. Leaders intent on little more than personal power and enrichment at their countries' expense, some supported by the U.S. for Cold War strategic reasons, have been all too common. Widespread civil war and ethnic unrest have retarded economic development. The developing world has also had to contend with deteriorating terms of trade, among other difficulties.

Nevertheless, the single most detrimental factor to economic growth throughout the developing world unquestionably has been statist economic policies. Wherever industries have been nationalized or protected, monopolies for the distribution of agricultural products have been established, regulations have been heavy-handed, and incentives for production have been destroyed through taxation, economic stagnation has quickly followed. This has been as true in Brazil as in Tanzania. On the other hand, those countries that have graduated from the ranks of the developing to middle- or high-income countries have all pursued largely open and market-oriented development strategies.

Chile, Singapore, South Korea, and the other economic successes have also received a minimal amount of development aid, far less on a per capita basis than most of the world's poorest countries. Chile's economy actually took off to its current heights only when it was essentially cut off from foreign aid for political reasons in the early 1970s. This being the case, you may ask why provide development aid at all? Its record of accomplishing little is substantial, it often has served to subsidize countries' pursuit of self-destructive economic policies, and its contribution to development is at best marginal.

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This is his March 1, 1994, testimony before the Subcommittee on Foreign Agriculture and Hunger of the House Committee on Agriculture.

ISSN 0272-1155.

Recognizing that development aid spending will continue, in part because under the right circumstances it can do some good, it is essential that the U.S. learn from the past and ensure that its development aid is directed only to those recipients who have demonstrated a commitment to free market generated economic growth. The President's Commission on the Management of AID Programs (1992), chaired by George M. Ferris, Jr., came to this conclusion. Its report recommended that the Agency for International Development concentrate its development assistance on nations that promote private sector economic growth as the best method for eliminating poverty and promoting stable development. In the report, Chairman Ferris urged AID to establish an Index of Economic Freedom for the purposes of gauging this commitment by others.

A quantitative measure of economic freedom—the Index of Economic Freedom—would take into account numerous factors, including the following:

1) **Private Property Rights.** Does a government expropriate property? Are there restrictions on what citizens can own? Is there an independent judiciary to protect a citizen's property against both other citizens and the government?

2) **The Size of the State Sector.** What percentage of the gross national product is owned and controlled by the state?

3) **Taxation.** How high are the top rates and at what income levels do they become effective?

4) **Private Banking and Financial Institutions.** Is private banking allowed? Does the government control banking and give preferential access to funds to privileged elites? Do government policies prevent small, private cooperative banks from being established?

5) **Regulation.** How difficult is it to secure a business license? What sort of red tape do entrepreneurs face? What regulations favor established businesses at the expense of newcomers?

6) **Wages and Prices.** Are wages and prices set by the voluntary mutual transactions of individuals in the market or by government bureaucrats?

7) **Trade.** How high are tariff levels? What value of imports are controlled by quotas or other trade restrictions?

8) **Capital Flows and Investments.** Does the government restrict foreign investment? Are there limits on repatriating capital or profits?

The Index of Economic Freedom is not untested. *Development and the National Interest: U.S. Economic Assistance into the 21st Century* (1989), produced by then-AID Administrator Alan Woods, unveiled an Index of Economic Freedom, which it called an Economic Opportunity Index. The Woods Report noted that AID economists had made a preliminary effort at developing a policy matrix that permitted comparisons of overall economic policy in specific developing countries over time. Their 42-country survey was based on country-specific rankings of several factors, including property rights, official corruption, effectiveness of legal remedies to enforce contracts, the extent of directed credit, taxation (the incentive effect of marginal taxation), foreign exchange controls, and the size of the black market. Not surprisingly, the Economic Opportunity Index found that countries with more opportunity-oriented policies have had, on average, better rates of economic growth than more statist-oriented economies.[1]

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1 p. 52.

The Index of Economic Freedom is not unlike the *Survey of Freedom in the World*, produced by New York-based Freedom House. Whereas Freedom House measures and ranks countries according to the political rights and civil liberties accorded their citizens, the Index measures and ranks countries based on the economic liberty they permit their people in the cause of national development. In fact, the Freedom House survey considers factors that should be part of any Index, including freedom from government corruption and freedom from exploitation by bureaucrats who deny citizens legitimate economic gains.

Like the political rights and civil liberties ranked by Freedom House, economic freedom cannot be perfectly measured. Economics is an imperfect science. Indeed, U.S. trade, GNP and other crucial economic figures are imprecise. Yet despite this imprecision, economic analysis provides the basis for public policy. Likewise, the State Department Country Reports on Human Rights Practices are a valuable tool for directing U.S. foreign policy. As with the Freedom House survey, the State Department Report relies on judgment. To some extent, so too does the Index. Nevertheless, solidly rooted in quantitative analysis, the Index of Economic Freedom would prove invaluable in judging which countries warrant U.S. development aid. Its capability and potential usefulness in picking where U.S. aid dollars can have the greatest impact in assisting those countries committed to development was demonstrated by *Development and the National Interest.*

Moreover, while some level of judgment will always be required, refinements in measuring economic freedom are continuously being made. In fact, the task of quantifying economic freedom has engaged the energies of some of this and other countries' finest economists, many of whom have regularly convened to share their work under the auspices of the Fraser Institute in Vancouver.[2] These efforts mean that AID's economists would have an even more substantial body of literature to draw upon in developing their Index of Economic Freedom than they did in developing the Economic Opportunity Index several years ago.

A process of ranking and comparing countries according to their economic policies for the purpose of allocating funds is actually being developed within AID today. Yet a recipient country's economic policies are but one of several factors in AID's global ranking system. Other factors include progress toward democracy and lawful governance, social indicators or "pro-poor" policy trends, environmental policies, and respect for human rights.[3]

The relegation of economic policies to being merely one of several considerations for the allocation of development assistance is troublesome. Free market policies are the key to development. It makes little sense to commit development resources to countries that fail to offer this pro-growth environment.

Unfortunately, this diluting of economic policy considerations in AID's global ranking system is reflected in the Administration's foreign aid reform proposal. Programs under Title I (Sustainable Development), the Peace, Prosperity, and Democracy Act states, are to be concentrated in countries with a high hunger and poverty rate, an "enabling environment," or favorable economic policies, transparent government decisionmaking, government institutions that are accountable to the public, an independent and honest judiciary, democratically elected local governments, and political parties, non-governmental organizations, and media that operate without undue constraints, among other criteria. The additional criteria very likely will reflect the perceived ability of AID to achieve

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2 Stephen T. Easton and Michael A. Walker, eds., *Rating Global Economic Freedom* (Vancouver: The Fraser Institute, 1992).

3 Joan M. Nelson and Stephanie J. Eglinton, *Global Goals, Contentious Means: Issues of Multiple Aid Conditionality*, Policy Essay No. 10, Overseas Development Council (Washington, D.C., 1993), p. 114.

within various countries some of the objectives, including promoting micro-enterprise, protecting wildlife, and promoting biological diversity, that have made the U.S. foreign aid program the hodge-podge almost everyone agrees it is.

Not only does this wide array of criteria befuddle the management of AID, it also opens the door to the continuation of development aid to countries whose economic climate kills the chances of self-sustained economic growth. Under these circumstances of operating within a country burdened by a non-reforming government, continued AID programming certainly would focus on basic human needs—that is, food and nutrition, population control and health, and basic education programs. Yet basic human needs programming in countries with anti-growth economic policies in place is not development aid—it is humanitarian assistance. This is not the type of investing in America's interests abroad that the Administration claims distinguishes its development aid vision.

The use of the Index of Economic Freedom by the U.S. to determine where it should invest its development assistance would hold the added advantage of distancing itself from the destructive games that the International Monetary Fund and the World Bank now play with foreign aid recipients. The U.S. currently directs much of its development aid to supporting IMF and World Bank-sponsored structural adjustment programs, designed to liberalize the economies of developing countries. Yet some half of all economic reform programs agreed to by the multilateral financial institutions and restructuring countries break down.[4] In other instances, development aid recipients pretend to comply with the conditions of economic adjustment programs while donors pretend to believe them. In either case, the games continue, with the multilateral financial institutions and bilateral donors almost always soon returning to countries to do business as usual. These arrangements hardly engender the respectful "partnership" that has become the mantra of the international donor community.

A truly respectful partnership between donors and developing countries can only be based on the recognition that donors are serious about economic reform and are prepared to invest their resources elsewhere if need be. In such a relationship, countries would be encouraged to compete by actually providing a market-friendly economic climate, and not merely making promises that get broken. Then relations between donors and development aid recipients would better approximate the type of market relationships that recipients will have to accommodate themselves to if they ever hope to compete in the world economy. The status quo of loose to non-existent conditionality only breeds contempt by the beneficiaries of development aid and fuels their misguided assertions that the donor countries are obligated to assist them. The Index of Economic Freedom would work to reduce U.S. complicity in this charade.

President Kennedy spoke of seeing U.S. development aid recipients "take off" into self-sufficiency. For Kennedy, development aid was strictly transitional. Over thirty years later, many developing countries are worse off than they were during President Kennedy's time, despite billions spent in the overseas development effort. Besides losing dollars, we have also lost Kennedy's sense of development aid being transitional.

While the Peace, Prosperity, and Democracy Act speaks in Kennedy-like terms of the success of U.S. development programs being measured by their becoming unnecessary, this language rings hollow. The fact is that development aid policy since Kennedy, including the current emphasis on basic human needs and protecting the environment, has increasingly taken on the sense of permanence. When is the health system in a developing country ever going to be "adequate"? This Administration believes the U.S. health system is inadequate. Similarly, when is the environment in developing

4 *Ibid.*, p. 42.

countries ever going to be satisfactorily pristine? What about in the U.S.? We have set ourselves up to seek elusive goals.

This commitment to elusive goals sets the U.S. on the path of endless transfers of wealth to the developing world. It debilitates the self-sufficiency of those we seek to help. Development is more than dollars, or "inputs," as the development community is fond of saying. It is also attitude. And self-reliance is as important an attitude as any in achieving national development.

Placing the Index of Economic Freedom at the center of the U.S. development aid program would help to reinstate the sense of transition that has been lost. It would say that the U.S. is investing in countries not based on their perceived need or America's supposed interests—largely a function of the bureaucratic survival game—but rather on the basis that these are the countries taking steps to establish the free market means that will afford their people the standard of living the U.S. would like to see them attain yet never could nor should try to provide.

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