Backgrounder

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The Senate's Blank Check to International Financial Institutions

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Supporters of the Multilateral Debt Relief Act of 2005 (S. 1320)[1] are gearing up to push it through the legislative process. However, S. 1320 would effectively write a blank check to international financial institutions (IFIs), such as the World Bank and the International Monetary Fund, and turn a blind eye to their irresponsible lending practices. It would also be an insulting waste of U.S. taxpayer dollars and certainly not a wise choice at a time when America needs to cut government expenditures.

Almost everyone would argue that people living in extreme poverty need help. The question is whether forgiving the debt and continuing to lend to poor countries will do anything at all to foster the growth and prosperity that would lift them out of poverty.

Similarly, most would agree that the IFIs' lending practices need to be changed because they have failed to alleviate poverty while saddling loan recipients with unsustainable debts. The question is whether the IFIs' coffers should be replenished to compensate for a history of bad lending, with incentives to change their poor lending practices. The entire debt relief proposal would cancel approximately $56 billion in debt stock owed by 38 countries.[2] Clearly, a large portion of this was funded by hardworking American taxpayers.

The heavily indebted poor countries (HIPCs) qualifying for debt relief are economically repressed and plagued with corruption—a primary cause of their poverty. Forgiving the debt owed by these countries indirectly admits that the money transfers from rich

Talking Points

- The Multilateral Debt Relief Act would effectively write a blank check to international financial institutions (IFIs), such as the World Bank and the International Monetary Fund, and turn a blind eye to their irresponsible lending practices.
- Forgiving the poor countries' debts will not free any resources for them because they *de facto* defaulted on their loans more than 20 years ago.
- No country in the world has gone from rags to riches because of foreign aid. Every rich country has become rich because it worked to eliminate barriers to economic activity and established a strong rule of law to secure private property rights and contracts and to punish corruption.
- The U.S. should forgive the debt simply to make the IFIs' balance sheets reflect the reality that the debt will never be paid, but the IFIs' coffers should not be replenished until they reform their lending practices.

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countries to corrupt governments do not alleviate poverty.

The U.S. government should nevertheless support forgiving the debt because, in reality, the money will never be repaid. The IFIs should write off the debt, and their assets should diminish accordingly. For this forgiveness to reflect the best interest of U.S. taxpayers, however, the U.S. government must hold the IFIs accountable for their decades of bad lending practices. To that end, the U.S. should:

- Support debt forgiveness without compensating the IFIs for that loss and
- Establish conditions for future replenishments. For example, the IFIs could model future aid after the Millennium Challenge Account.

This is the responsible thing for Congress and the Administration to do, not just for the poor, but out of respect for and duty to hardworking U.S. taxpayers.

What Forgiving the Debt Will Do for Poor Countries

Supporters of relieving the HIPCs' heavy debt burdens argue that these burdens stifle growth and trap people in poverty while the countries pay their debts. For example, S. 1320 states:

> Permanently cancelling 100 percent of the debt owed by the countries that are eligible for debt relief…would allow countries to increase investments in economic and social infrastructure, including improving the quality of and access to health care, education, and poverty reduction programs, and thereby help them to move towards sustainable economic growth and…[eradicate] extreme poverty and hunger and promot[e] human development.[3]

This argument has a serious flaw. What makes this bill's sponsors believe that loan recipients will choose this time to act responsibly by investing in "economic and social infrastructure" instead of misusing or stealing the funds as they have in the past? The HIPCs' roadblock on their road to prosperity is not the debts themselves, but the repression of their economies and the lack of the rule of law to enforce contracts and punish corruption effectively.

No country in the world has gone from rags to riches because of foreign aid. Every rich country has become rich because it worked to eliminate barriers to economic activity and has established a strong rule of law to secure private property rights and contracts and to punish corruption. A combination of free markets and strong rule of law is the only framework within which the poor can turn their work into something productive and build wealth over time. Without such a framework, only those who monopolize government power or have enough money to grease bloated bureaucracies can build wealth, albeit at the expense of millions of people who struggle from day to day just to get enough to eat.

According to the *2006 Index of Economic Freedom*,[4] of the 18 countries that would qualify immediately for debt relief (Benin, Bolivia, Burkina Faso, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda, and Zambia), few have the kind of economic structure that could take advantage of it. Most of these countries provide little protection of property rights and little domestic security while permitting high levels of corruption and state intervention in the economy. Thirteen are "mostly unfree" economies (that is, they have significant barriers to entrepreneurship and other economic activities), and only five are "mostly free" economies. Some of these countries,

1. S. 1320 was introduced in June 2005 by Senators Mike DeWine (R–OH), Rick Santorum (R–PA), Russ Feingold (D–WI), Richard Lugar (R–IN), and Barack Obama (D–IL).
2. Multilateral Debt Relief Act of 2005, S. 1320, § 2(8).
3. *Ibid.*, § 2(6).
4. Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), at *www.heritage.org/index* (April 10, 2006).

such as Bolivia, are political enigmas, and others, such as Niger, Rwanda, and Uganda, are *de facto* one-party states.

Forgiving the debt will not free any resources for the HIPCs. According to Adam Lerrick, professor of economics at Carnegie Mellon University and visiting scholar at the American Enterprise Institute, the HIPCs *de facto* defaulted on their loans more than 20 years ago.[5] This means that any resources that could be freed by forgiving their debts were effectively freed over two decades ago, yet the poor in the HIPCs are just as poor now as they were then. The only reason that these loan obligations continue to appear on the World Bank's balance sheet is because the bank issues new loans to pay the old ones when they come due—a process known as "rollover." According to Lerrick, real International Development Association[6] resources amounted to a "de facto $84 billion" in 2005, as opposed to the $130 billion on the World Bank balance sheet.[7]

To foster economic growth and eliminate poverty, the HIPCs need more open markets, more transparency, and a strong rule of law so that the people living in these countries can have greater opportunity to make a living and more resources to invest in their future and that of their children. More spending on social programs by their governments or the IFIs will continue to do nothing for the poor in these countries except to burden them with more unsustainable debt.

IFI Accountability

Because countries with unfree economies generate poverty *en masse*, they are also the largest recipients of aid money to fight (in theory) the poverty that their policies generate. Therefore, far from having worked to eliminate poverty, the IFIs, with the blessing of donor countries, have fed the corruption that keeps markets closed, rule of law a joke, and the poor as poor as they could ever be. They have done so by repeatedly lending to poor countries regardless of the corruption and economic repression that the leaders of these countries impose on their citizens. As a result, all of the countries that qualify for debt relief today are basically just as poor as they were many decades ago when the lending started.

Since the debt has not been paid for decades, forgiving it simply means making the IFIs' balance sheets reflect reality. However, this action would also send the perverse message to the world's poorest (and most corrupt) countries that the U.S. government is willing to overlook funds mismanagement, dictatorship, and corruption—the very circumstances that led many countries to pile up unsustainable debts. To avoid sending such a message, the U.S. government must hold the IFIs accountable for their bad lending policies and must not compensate them for the money that they lost on bad loans.

The debt relief is structured so that the richest countries (the G7) would assume the payments for qualifying debtors. Each year for the next 40 years, the G7 would pay the IFIs the exact amounts that the poor debtors are obligated to pay. If the debt stock is worth $56 billion (as S. 1320 indicates), the G7 would pay an average of $1.4 billion per year—a large share of which would be paid by the U.S. government.[8]

The IFIs claim that they need this "offsetting compensation" to avoid compromising future lending, but this claim should be viewed with considerable skepticism. The loss of these funds, for example, would represent less than 16 percent of the World Bank's total commitments ($8.7 billion) for fiscal year 2005.

It is disrespectful to U.S. taxpayers that some Members of Congress are pushing for a bill that, on

5. Adam Lerrick, "Forgive the World Bank But Don't Forget: Debt Relief Should Fund a Turnaround in Development Aid," American Enterprise Institute *Development Policy Outlook* No 1, February 6, 2006, at *www.aei.org/publications/filter.all,pubID.23836/pub_detail.asp* (April 10, 2006). See also Marc A. Miles, ed., *The Road to Prosperity* (Washington, D.C.: The Heritage Foundation, 2004).

6. The International Development Association is the part of the World Bank that provides loans to the poorest countries.

7. *Ibid.*

8. According to Adam Lerrick, the timing spread over 40 years and the present value is much less.

top of overlooking corruption, provides unlimited funds to compensate the IFIs for the U.S. share of the estimated $56 billion that they have lost in bad loans. This is disturbingly similar to the U.S. government's bailout of the savings and loan institutions in the late 1980s.

S. 1320 states that "there is authorized to be appropriated to the President *such sums* as may be necessary for the United States contribution to the implementation of the agreement [to forgive the debt]."[9] In this bill, "such sums" is equivalent to signing a blank U.S. Treasury check to the IFIs and deciding only after the fact how much money the United States will contribute to this charade in the name of helping the poor. "Such sums" is an irresponsible diversion of the earnings of American families, who forgo some of their own personal goals when they pay their taxes. In its current form, this bill sets the stage for the IFIs to continue their current lending practices, which would lead only to more bad debt and another bailout. Replenishing their coffers would reward the IFIs' poor lending practices and insult the efforts of U.S. workers.

The Responsible Thing to Do—for the Poor and for U.S. Taxpayers

If the U.S. forgives the debt because it will obviously never be paid, then debt relief should come with strings attached, and the U.S. government should be a leader in attaching those strings. To that end:

1. Congress should clarify exactly how much forgiving the debt will cost the U.S. The only sum specified in S. 1320 is the approximate amount of the debt stock owed by the 180 countries that would immediately qualify for debt relief ($40 billion) plus those who could eventually qualify (an additional $16 billion). Based on that information, S. 1320 should establish the exact amount that will be forgiven on behalf of the United States.
2. Congress should not compensate the IFIs for the share of debt that the U.S. forgives. The IFIs lent irresponsibly, and they should find it costly to continue to do that in the future.
3. The Administration should work with the U.S. representative to the Board of the World Bank and the IMF to encourage reform of the IFIs' lending practices. For the poorest countries with no access to capital markets, the reform should change the type of aid from loans to grants so that they do not pile up debt. For these countries, most of which qualify now for debt relief, it makes little sense for the World Bank to provide loans that are unlikely to be repaid when the aid is intended to alleviate the immediate consequences of poverty, such as immunizing children, rather than to spur growth. Such activities should be funded not by loans, but by performance-based grants that would pay for actual accomplishments, such as the number of people vaccinated or miles of roads paved. Payments for these services should be made directly to the service providers, as the International Financial Institutions Advisory Committee[10] proposed in 2000. Future replenishments should be conditioned on the IFIs' reforming their aid practices from a system of loans to one of grants for poor countries.[11]

Conclusion

Behind its good intention, the Multilateral Debt Relief Act in its current form represents a blank check to irresponsible lending institutions, a blind eye to corrupt governments, and a waste of taxpayers' dollars. To help the HIPCs, the debt should be forgiven, but future aid should be based on performance-based standards that the countries must

9. S. 1320, § 4(c); emphasis added.

10. Congress created the International Financial Institutions Advisory Committee to assess the performance of international organizations. It was chaired by Allan H. Meltzer of Carnegie Mellon University.

11. For more details about a proposed reform of the IFIs, see Ana Isabel Eiras and Brett D. Schaefer, "A Blueprint for Wolfowitz at the World Bank," Heritage Foundation *Backgrounder* No 1856, June 2, 2005, at *www.heritage.org/Research/TradeandForeignAid/bg1856.cfm*.

meet in order to qualify for aid and avoid further waste. In addition, the IFIs should absorb the losses resulting from their bad lending decisions, and future replenishments should be conditioned on reform of the IFIs' aid practices that uses the U.S. government's Millennium Challenge Account as a model. This is the responsible thing to do, both for the poor and for the hardworking U.S. taxpayer.

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