The Pitfalls of External Aid

Doug Bandow

Virtually everyone in the West is rejoicing over President Mikhail Gorbachev's commitment to glasnost and perestroika. The Soviet Union's rush away from Stalinism, Moscow's willingness to allow Eastern Europe to move toward full democracy and independence, and the waning of the Cold War have combined to present former adversaries with a unique opportunity to cooperate economically as well as culturally and politically.

Unfortunately, however, many people in both the East and West are proposing significant "aid" to reform governments in Eastern Europe and the USSR. The widespread pressure for large-scale financial transfers makes Peter Bauer's paper a particularly important one. It should be read by officials in Washington as well as Moscow.

Forty Years of Failure

Peter Bauer's basic thesis—that "Western subsidies to reformist governments in Eastern Europe are not generally necessary for the prosperity of these countries and the survival of their governments"—is absolutely correct. We have had roughly 40 years of experience with foreign aid, both bilateral and multilateral, and the results have been quite disappointing. Very few recipients of foreign aid have ever subsequently shown economic success: South Korea and Taiwan are a couple of very rare exceptions, and they probably prospered in spite of, rather than because of, the money they received from the U.S. government.

Reform Begins at Home

Unfortunately, receipt of foreign assistance has a number of deleterious consequences. Perhaps the most fundamental problem, one

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touched on by Bauer, is that international transfers encourage the belief that outside forces control the development process. That is, many people, including those in poorer countries themselves, believe that foreign aid is necessary for their nations to grow and prosper. Thus, they do not critically examine domestic conditions that may inhibit development.

This is a very real danger for the Soviet Union and the Eastern European countries that are attempting to reform their economies. Rigid central planning has proved to be a disaster; only a transition to a market economy can get these countries moving again. But if public officials and average citizens alike place their hopes in receiving funds from abroad and lose sight of the many politically difficult domestic reforms that are necessary, they will find themselves growing poorer, not richer.

How can reform governments and, more importantly, domestic industries seeking to modernize and become efficient, acquire the necessary capital? Bauer's point about what justifies international loans is particularly important. As he explains, "Ability to borrow abroad does not depend on the level of income but on responsible financial conduct and the productive use of funds." Although Western banks have finally—and wisely—grown more cautious after greatly contributing to the $1.3 trillion owed by Third World countries, they are still willing to extend credit where borrowers seem responsible and want the funds to undertake projects that make economic sense. Again, it is domestic reforms, which will convince lenders that the money will be well spent and ultimately repaid, that is the key to economic success.

The Perverse Effects of International Lending Organizations

Unfortunately, this willingness by lenders to demand market discipline by borrowers has never been exhibited by the international lending organizations—the IMF, World Bank, and regional institutions. The multilateral development banks have uniformly favored government projects; the World Bank helped establish many of the failing state enterprises that it now says should be privatized; the Bank even continues to pour money into such organizations to "modernize" them, actually encouraging borrowers to resist privatization. The newly formed European Bank for Reconstruction and Development (EBRD), designed to lend to Eastern Europe and the USSR, is likely to be no different. Thus, multilateral loans may actually perpetuate the existence of money-losing enterprises that are draining away scarce resources from reform governments.

Particularly dangerous would be international lending to governments that have demonstrated no firm commitment either to democracy or market economics, such as Bulgaria and Romania. As Bauer points out, aid that may "do little or nothing for economic achievement and advance" may nevertheless "alleviate acute shortages," thereby helping to "avert total collapse and conceal from the population, at least temporarily, the worst effects of destructive policies." Which, "in turn, helps the government to remain in power and to persist with these policies without provoking popular revolt."

Promoting Market Reforms

Western governments committed to seeing glasnost and perestroika succeed, along with the reform governments struggling to help their people achieve a better life, need to focus on promoting market economic reforms. The general exhilaration over the movement toward political freedom is justified, but, as Bauer rightly points out, is not enough. To prosper, and for democracy to firmly take root, reform governments must replace their failing command economies with free-market systems. For the reasons cited by Bauer this is no easy task. Opposition to the market and resentment of a system that allows failure as well as success is strong even in the industrialized West; not surprisingly, there will be powerful forces against change in former command systems.

What can the West do to help reformers in the USSR and Eastern Europe succeed? Bauer correctly points to lowering trade barriers. America's professed policy of promoting development in the Caribbean, for instance, has been hobbled by the imposition of sugar quotas to protect domestic interests, which has blocked access to the most obvious market for the region's most important agricultural crop. It is critical that the West not respond to reforming governments in Eastern Europe and the USSR in the same way. By offering markets for products, the industrialized nations can best assist the development of efficient private sector industries elsewhere in the world.

More controversial is Bauer's support for narrowly targeted foreign aid. Bauer rightly warns that official transfers are more likely to hinder than advance liberal economic policies. However, he suggests that aid that helps reduce serious shortages, especially of imports, "might secure the survival of market-oriented reformist governments."

In theory, Bauer's argument has much to recommend it. Official transfers might promote the shift to a market economy if the following conditions were present: (a) the government is "irrevocably committed to promotion of the market economy" and would be likely to collapse without aid because of the economic problems left over from the previous command system; (b) the aid is administered by people in sympathy with the move to a market economy; (c) the donor is willing to terminate the transfers if the recipient backslides; (d) the assistance is in the form of grants rather than loans; (e) the donations are bilateral rather than multilateral; and (f) the transfers are temporary.

The practical problems in implementing this theoretical policy, however, are enormous. How do we know that the government, which may incorporate different parties and factions and may be beset by powerful institutional resistance and special interest pressure, is "irrevocably committed to promotion of the market economy?" How do we judge the likelihood of a collapse without aid? (Poland, for instance, seems to be moving in the right direction despite not having received the levels of aid that it had initially requested.)

Where do we find aid administrators who support market reforms? How do we convince government officials to admit failure and cut off assistance—something neither bilateral nor multilateral officials have ever proved very willing to do—if the reformist government falters? And how do we overcome a problem acknowledged by Bauer, namely, the tendency of programs to be self-perpetuating? The Marshall Plan did end, but the scope of government and power of interest groups have both greatly expanded over the last four decades. And although the evidence is overwhelming that American transfers to poor states have done nothing to promote overall development, the programs continue.

Indeed, an equally serious, but more subtle, problem is the ability of special interests and bureaucracies to twist even well-intentioned programs to their own advantage. External aid, for example, has been tied to the purchase of U.S. products, and monies are almost invariably allocated to advance perceived U.S. political interests. Trying to implement Bauer's theoretically well-conceived assistance program would risk creating all of the deleterious effects that he so eloquently catalogues elsewhere in his paper.

Debt Relief

Interestingly, the one form of "aid" that might have the least perverse impact on reformist governments is the one dismissed out of hand by Bauer—debt relief. He worries that it would reward the "profligate," yet the debt forgone would have been accrued by ousted Communist regimes, rather than the new democratic governments. Contrary to his argument, there is nothing inconsistent with Western governments agreeing not to demand payment on debt amassed by illegitimate Stalinist systems and market reformers guaranteeing property rights and providing for restitution to individuals of confiscated assets. And a one-time debt write-down or forgiveness would not provide more power to politicians and bureaucracies, subsidize statist economic policies, or have most of the other ill-effects of official financial transfers.

Conclusion

Bauer's message is an important one, and it should be heeded by those in the West who want to assist and those in the East who have the responsibility for implementing needed reforms. Official aid transfers would be more likely to hurt rather than help. Instead, reformers need to recognize that the only way to create the conditions necessary for self-sustaining economic growth is to move toward a market economy as fast as possible.

Half or Full Reform?

Oleg T. Bogomolov

The Need for Radical Reform

What is now going on in the Soviet Union and Eastern Europe can be best denoted by the word "revolution." Up to 1989, the administrative system underwent partial changes. The basic principles remained intact: the leading role of the party, domination of the state form of ownership, and the monopoly of Marxism in ideological life. The first attempt to restructure did not satisfy the society, nor did it resolve the crisis state. On the contrary, it only aggravated the situation.

While new structures and mechanisms have not been established, the old ones have become imbalanced. The very idea of reforms under socialism has become discredited, and faith in socialism's possible renewal has weakened. The people's confidence in the ruling clique has lowered drastically, and explosive material has been accumulating. As a dangerous malaise has been pushed deeper underground, the threat of its sudden and violent outburst has become increasingly likely.

In the autumn of 1989 the people's movement exploded in the GDR, causing a wave of detonations in Czechoslovakia, Bulgaria, and Romania. Changes that took many months and even years in Hungary and Poland were accomplished within several weeks. In light of these events, it has become clear that the existing system cannot be improved by partial perestroika; the system has fully discredited itself. It is necessary to form a qualitatively new social organization that would ensure true social and economic progress.

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