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Modernizing Development Finance to Promote Prosperity and Serve US Foreign Policy
Testimony before the Senate Foreign Relations Committee

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July 7, 2016

Thank you Chairman Corker, Ranking Member Cardin, and other members of the Committee. I appreciate being invited to testify again and the opportunity to highlight ways the United States can more effectively support private sector growth and economic opportunity around the world. I proudly served in the State Department under Secretary Condoleezza Rice and continue to work closely on global economic policy issues at the nonpartisan Center for Global Development. I have three points today, drawing on my work at CGD with my colleague Ben Leo.

First, development finance, rather than aid, is the future. Aid is the right tool for tackling health challenges and humanitarian crises. Aid has been much less effective at generating broad economic growth. However, when carefully targeted, aid can be useful in addressing specific barriers to business. The Millennium Challenge Corporation model, which uses five-year compacts to explicitly attack constraints to growth, is a great example. So too are the US Treasury's technical assistance programs and USAID's laudable coordination of the Power Africa initiative.

Yet it is development finance—or the deployment of commercial capital for public policy purposes—that is the most potent weapon we have for expanding markets and spurring private sector growth. When the United States wants to encourage job creation in Tunisia, wants to catalyze infrastructure investment in Nigeria, wants to bring Pakistani women into the banking sector, we turn to development finance.

Development finance is the future because of the changing global landscape. Many previously poor countries are richer today and are looking for more than aid. They want to partner with the United States to deliver jobs, roads, and electricity.

Development finance is the future because of the rise of China, India, and other emerging markets. These countries, along with our traditional allies in Europe, are using development finance to bolster their influence and to expand investment opportunities. The United States has made a start, but risks falling further behind.

Most of all, development finance is the future because of who we are as a country. Americans believe in our model of private sector-led capitalism. Our deep capital markets, our culture of

entrepreneurship, and our belief in free markets all provide a unique platform for using development finance to promote prosperity.

Fortunately, the United States already has a very good development finance institution, the Overseas Private Investment Corporation. Since 1971, OPIC has provided political risk insurance and debt capital to private sector projects around the world in support of US foreign policy and development objectives. For 38 years in a row, OPIC has returned money into the US Treasury. Our recent analysis at CGD has shown that OPIC has been investing principally in the very sectors that are the leading constraints to economic growth: infrastructure and access to finance.¹

While some have worried that OPIC could be a boon for large US corporations or engender corporate welfare, our recent analysis of OPIC's portfolio has shown this to be patently untrue. Instead, we find that less than 8 percent of OPIC commitments over the last five years have involved Fortune 500 companies.²

My second point is that **while OPIC is small and high-performing, it could be even better with a few tweaks that Congress could enact at no additional cost to taxpayers.**³ Chief among these reforms is allowing OPIC limited authority to make equity investments rather than be restricted to only issuing debt. Many projects in the riskiest markets where the US Government needs OPIC the most are at a stage where they need equity, not debt. In fact, nearly every other development finance institution in the world has equity authority, which accounts for nearly all of their project commitments in the poorest countries. OPIC is an exception because of a holdover from the Nixon administration.

Another simple reform that would bring large benefits at no cost is multi-year authorization. Large infrastructure projects take years to negotiate and implement, yet OPIC has been forced to rely on annual authorizations since 2007. OPIC should be authorized for an initial five-year period, with the goal of moving to permanent authorization.

A final minor reform would be to allow OPIC to retain a slightly larger portion of its profits to add staff to clear the backlog of potential projects. OPIC does not need more capital. It needs to hire a few dozen more people to deploy that capital. The agency covers more than 150 countries yet currently has only about 200 staff, or less than what we deploy to a mid-sized embassy.

My final point: if the United States is serious about promoting market solutions to poverty and insecurity, **we need a modern, full-service US Development Finance Corporation worthy of the world's largest economic power.** In the annex to my testimony, Ben Leo and I provide a series of options for how Congress and the next President could structure such an institution consistent with bipartisan support and budgetary realities.⁴ A US Development Finance Corporation could bring OPIC into the 21st Century by consolidating existing tools and instruments—currently spread across multiple federal agencies—and enable their strategic deployment to promote private sector growth. If we fail to update our development finance tools, the United States stands to lose

¹ Ben Leo and Todd Moss, "[Inside the Portfolio of the Overseas Private Investment Corporation](#)," CGD Policy Paper, April 2016.

² Ben Leo, "[Is OPIC Corporate Welfare? The Data Says...](#)" CGD blog post, April 19, 2016.

³ Ben Leo, Todd Moss, and Beth Schwanke, "[OPIC Unleashed: Strengthening US Tools to Promote Private-Sector Development Overseas](#)," CGD Policy Paper, August 2013.

⁴ Ben Leo and Todd Moss, "[Bringing US Development Finance into the 21st Century Proposal for a Self-Sustaining, Full-Service USDFC](#)," CGD Policy Paper, March 2015; Attached is a summary from *White House and the World 2016 Briefing Book*, July 2015.

out to other countries on potential opportunities in the next wave of emerging markets. We would also be neglecting one of our most powerful levers to support prosperity and stability abroad. Modernizing America's development finance would cost nothing, it would bolster our common fight against the remaining pockets of global poverty, and it would support our most pressing national security goals.

Annex: Ben Leo and Todd Moss, "[Bringing US Development Finance into the 21st Century](#)," CGD Policy Brief, White House and the World 2016 Briefing Book, July 2015.



Bringing US Development Finance into the 21st Century

Ben Leo and Todd Moss

Introduction

The future of development policy is in development finance. Developing countries need aid less and less as their incomes rise and economies grow. What they need now is private investment and finance. US development policy, however, has failed to bring its development finance tools in line with this reality. Related US efforts have not been deployed in an efficient or strategic manner because authorities are outdated, staff resources are insufficient, and tools are dispersed across multiple agencies.

Other players are doing more. Well-established European development finance institutions (DFIs) are providing integrated services for businesses, and these services cover debt and equity financing, risk mitigation, and technical assistance. Moreover, emerging-market actors—including China, India, Brazil, and Malaysia—have dramatically increased financing activities in developing regions such as Latin America and Sub-Saharan Africa.

As the needs of developing countries have changed, so has the political and economic environment in the United States. First, traditional development dynamics are shifting rapidly from a donor-recipient aid relationship to win-win partnerships involving public and private actors. Second, most US aid agencies typically are not positioned to address many pressing development priorities, such as expanding economic opportunities in frontier markets. Third, the US development assistance budget has become increasingly constrained, with growing pressure to cut programs.

Within this context, we assess the need for a modern, full-service US Development Finance Corporation (USDFC) and provide a series of options for how the next US president could structure such an institution consistent with bipartisan congressional support and budgetary realities.

POLICY RECOMMENDATIONS

- Establish a full-service, self-sustaining US Development Finance Corporation (USDFC) that delivers development results, advances US foreign and commercial policy objectives, and reduces the federal deficit through modest operating profits.
- Implement reforms to ensure that the USDFC (1) crowds in private capital and demonstrates clear “additionality,” (2) publicly reports on its development impact, and (3) has flexible portfolio and staffing levels to adapt to shifting US investor needs.

For such a USDFC, we propose below potential products, services, and tools; size, scale, and staffing requirements; governance structures and oversight functions; performance metrics; and capital structure models. We conclude with a notional implementation road map that includes the required US executive and legislative actions.

Responding to the New Development Finance Landscape

The strategic imperative for US development finance has increased tremendously. First, citizens in Latin America, Africa, and other regions are most concerned about employment and economic opportunities. According to representative surveys, more than two-thirds of African citizens cite employment, infrastructure (e.g.,



electricity, roads, water and sanitation), inequality, and economic and financial policies as the most pressing problems facing their nations (see figure 1).¹ In Latin America, roughly 60 percent of survey respondents cite employment, economic, and financial policy issues, as well as crime and security concerns. In contrast, only 20 percent of Africans and Latin Americans are most worried about health, education, food security, or environmental issues—the issues that existing US development policy targets the most.

Second, businesses in emerging and frontier markets are most constrained by inadequate access to capital, unreliable electricity, burdensome tax policies, and unstable political systems. Access to finance and reliable electricity are the most frequently cited issues in almost half of the 81 surveyed developing countries, and these issues negatively impact firms in all developing regions.² To illustrate, roughly two-thirds of surveyed Nigerian and Pakistani firms cite unreliable electricity as their biggest constraint, and nearly half of all firms surveyed in Côte d'Ivoire, Indonesia, and Zimbabwe cite access to finance as their biggest challenge.

Third, the relative and absolute importance of foreign aid has declined significantly over the past two decades. In 1990, aid exceeded 20 percent of gross national income in 13 developing countries (out of 120 examined countries).³ That figure had fallen to only four developing countries in 2012 (Afghanistan, Burundi, Liberia, and Malawi), despite a doubling of total global aid during

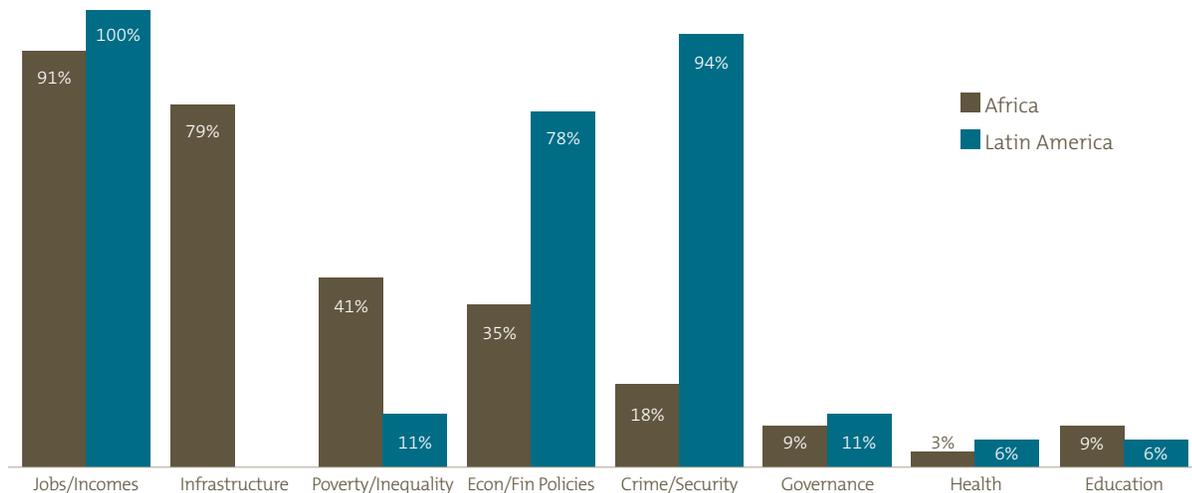
the same period from \$59 billion to \$133 billion. The exponential increase in government revenues, driven by both economic growth and improved tax administration, has been even more striking (see figure 2).⁴

Fourth, foreign government partners are increasingly focused on attracting private investment, especially in infrastructure and productive sectors. Nearly every national development strategy emphasizes attracting private investment for physical infrastructure (e.g., electricity and transport) and labor-intensive sectors (e.g., agriculture, services, and manufacturing), reflecting the political imperative of establishing more inclusive economic opportunities in the near and medium term for the rapidly expanding working-age populations in many regions.

At the same time, the development finance landscape has changed dramatically with the entry of several emerging-market actors. The China Development Bank and the Export-Import Bank of China were established in 1994. Both now have major financing portfolios throughout the world, particularly in Latin America and Sub-Saharan Africa. China is far from the only emerging-market actor in developing countries. India, Malaysia, Turkey, Brazil, and other countries now have public entities that provide project and trade finance, as well as guarantees.

Finally, many well-established organizations in traditional donor capitals now provide integrated services for businesses that cover financing, risk mitigation, and technical assistance. These organizations include FMO

Figure 1 African and Latin American Development Priorities Are in Areas US Development Policy Targets the Least

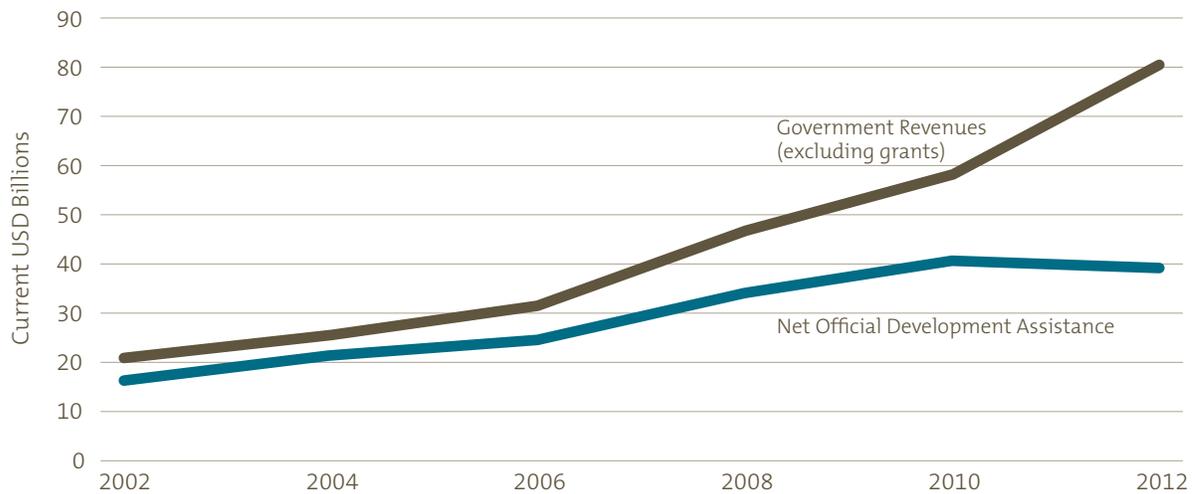


Note: Figures represent the percentage of surveyed respondents citing the issue as a top three national problem.

Source: Afrobarometer, Latinbarometer, and authors' calculations



Figure 2 Government Revenue Has Outpaced Net Aid Received in Low-Income Countries



Source: World Bank and authors' calculations

(Netherlands), DEG (Germany), PROPARGO (France), and the International Finance Corporation (IFC, the private-sector arm of the World Bank Group). This model has streamlined available private sector-based development tools under one institutional structure, thereby enhancing efficiency and effectiveness.

Adjusting to US Political and Budgetary Realities

The political and economic environment within the United States has also changed dramatically, particularly over the past five years. First, development dynamics are shifting rapidly from a traditional donor-recipient aid relationship to mutually beneficial partnerships involving public and private actors. An illustration of this trend is the Obama administration's Power Africa initiative, which uses a three-pronged approach involving (1) country government reforms; (2) private-sector investments; and (3) US government cofinancing, risk mitigation, and technical assistance.

Second, most US aid agencies typically are not positioned to address many pressing development priorities, such as expanding economic opportunities in frontier markets. In such places, the focus should be on promoting greater engagement by private investors and businesses, as noted earlier. This focus involves using non-aid agencies like the Overseas Private Investment Corporation (OPIC), the Export-Import Bank of the United States, and the private-sector windows of the multilateral development

banks. The Millennium Challenge Corporation (MCC) is the noteworthy exception to this aid agency dynamic. However, MCC is not scalable because of its grant-based model and its need for congressional appropriations, as well as its ability to work in a limited number of countries.

Third, the US development assistance budget has become increasingly constrained, with growing pressure to cut programs. At the same time, domestic political constituencies have remained strong for many social-sector issues, such as combating infectious diseases (e.g., HIV/AIDS, malaria) and promoting access to education. This suggests that any future budgetary cuts will likely be focused on program areas that lack such vocal constituencies, such as economic development programs outside of frontline states. Collectively, this also means that the next US president will be highly constrained in promoting private sector-based development models through traditional development assistance budgets.

Existing US Private Sector-Based Development Programs

The US government's primary development finance vehicle is OPIC, an independent government agency that mobilizes private capital in emerging and frontier economies to address development challenges and to advance US foreign policy objectives. OPIC provides US investors with debt financing, loan guarantees, political risk insurance, and support for private-equity investment funds. It operates on a self-sustaining basis and has



provided positive net transfers to the US Treasury for nearly 40 consecutive years. Since its inception, OPIC has helped mobilize more than \$200 billion of US investment through more than 4,000 development-related projects.

With few exceptions, OPIC has not evolved since it was first established in 1971. The most significant exception relates to debt seed capital for private-equity funds, which OPIC began providing in 1987. OPIC remains highly constrained by inadequate staff and outdated authorities. For instance, it must rely on congressional appropriations to cover annual administrative expenses (e.g., salaries, travel, and office space) despite generating significant profits on a consistent basis. This de facto constraint, driven by congressional unwillingness to expand the number of staff, has prevented OPIC from fully leveraging its existing capital base.

Other programs within US agencies that promote private sector–led development approaches are spread across multiple agencies, resulting in redundancies, inefficiencies, and, frequently, a lack of coherence.

- **The US Agency for International Development’s Development Credit Authority (DCA):** USAID’s DCA provides partial risk guarantees to unlock private financing in support of US development priorities. In 2013, DCA approved 26 new partial credit guarantees in 19 countries, which may mobilize nearly \$500 million in private capital over time.⁵
- **USAID Enterprise Funds:** Since 1989, Congress has appropriated resources for a range of enterprise funds, which are capitalized either entirely or partially by USAID grants. This program, which has a mixed track record,⁶ originally began with a focus on promoting private enterprise in former Eastern Bloc countries. Similar funds have been launched in other countries since then, such as in Egypt and Tunisia.
- **US Treasury Office of Technical Assistance (OTA):** The US Treasury’s OTA embeds highly experienced advisers into finance ministries and central banks to promote financial-sector strengthening and to improve public financial management.
- **US Trade and Development Agency (USTDA):** This small, autonomous agency is primarily focused on connecting US businesses to export opportunities in developing countries. However, it also promotes private sector–based development through small-scale financing for feasibility studies and technical assistance programs.

Lastly, the US government also supports large-scale grant operations through the MCC, USAID, and the US State Department. These programs help address a broad range of private sector–based development issues, such as infrastructure and business climate reforms.

- **Millennium Challenge Corporation:** The MCC provides large-scale grants to well-performing countries with low and lower middle incomes to support poverty reduction through sustainable economic growth. To date, the MCC has approved more than \$8 billion in compact and threshold programs that have focused largely on infrastructure, agriculture, and enterprise development.⁷
- **Other USAID Programming:** USAID has a range of grant-based programs within its Bureau for Economic Growth, Education, and Environment that promote private enterprise in developing countries. These programs focus largely on four key areas: (1) building skills and management capacity, (2) deepening access to finance, (3) supporting business climate reforms, and (4) establishing linkages with US businesses and organizations.⁸

Proposal for a Modern Scaled-Up US Development Finance Corporation

A modern, scaled-up USDFC would promote US policy objectives by harnessing America’s three greatest strengths—innovation and technology, entrepreneurship, and a deep capital base—at no additional cost to US taxpayers. It also would make a serious contribution to US foreign policy goals by aligning strongly with developing countries’ most pressing priorities (e.g., employment and economic opportunities). Lastly, the proposed USDFC would promote America’s commercial policy objectives by facilitating investment and business opportunities in the next wave of emerging markets.

Products, Services, and Tools

Almost all major DFIs have become full-service institutions that promote private sector–based development (see table 1). As with other institutions, the USDFC would offer a full suite of products, services, and tools to promote such development approaches. Currently, OPIC can offer direct loans, loan guarantees, risk insurance, and seed financing for independently managed investment funds. A full suite would add advisory services, feasibility studies, direct investments including equity, and technical assistance for business-climate reforms, which other US agencies such as USAID, the State Department, USTDA, and the US Treasury Department have the authority to support. The USDFC



Table 1 Development Finance Institutions, Product and Service Coverage (2013)

Institution	Equity Authority	Technical Assistance	Grants Window	First-Loss Funding	Equity (Percentage of Revenues)
OPIC (US)	No	No	No	No	0
FMO (Netherlands)	Yes	Yes	Yes	Yes	17
PROPARCO (France)	Yes	Yes	Yes	Yes	9
CDC Group (UK)	Yes	No	No	Yes, for some impact funds	95
DEG (Germany)	Yes	Yes, including via BMZ	Yes, feasibility studies	Yes	28
IFC (World Bank)	Yes	Yes	Yes	Yes	36

Source: DFI annual reports

would consolidate all of these authorities and programs within a single, efficient, market-based institution. This change would require congressional authorization.

The USDFC also should have the authority to support non-US investors in certain circumstances. OPIC currently can only support firms or investors with significant American ownership or operational control. No other major DFI ties their financial engagement to national firms. This flexibility enables other DFIs to promote economic growth and job creation through local businesses in developing countries. This restriction has prevented OPIC from supporting strategic objectives where US investors are not active or prospective participants in a given country’s market or sector. The expanded authority could be limited to low-income countries and local firms domiciled in the respective developing country. Firms from developed or middle-income countries, along with their respective subsidiaries, could remain ineligible for USDFC operations unless there were highly compelling benefits to US development or other foreign policy objectives.

Size, Scale, and Staffing

The USDFC’s size and scale should be determined by the combination of market demand, the ability to demonstrate clear “additionality” (see further details below), and the maintenance of rigorous credit-quality standards and oversight. In addition, it must demonstrate tangible development results throughout its portfolio. As a result, *there should not be an ex ante target size*. Instead, the USDFC should have the ability to access significant sources of capital to respond to market dynamics and US development objectives, with appropriate oversight by the US Congress and the

Office of Management and Budget. Currently, OPIC has legislative authority to support a \$29 billion portfolio of loans, guarantees, and insurance.⁹ As of 2013, \$11 billion of this capacity was undeployed because of insufficient staff and constrained authorities.

Existing bilateral DFIs provide a rough benchmark when considering the USDFC’s potential scale. Their portfolios range from 0.15 percent of gross domestic product (GDP) in the United Kingdom to more than 1 percent in the Netherlands. If these same simplistic ratios were applied to the United States, the USDFC could have a total portfolio ranging between OPIC’s current statutory authority of \$29 billion and \$180 billion.

The USDFC’s staffing size and administrative expenses also should reflect its operational requirements and objectives. Currently, OPIC has nearly 230 employees and an operating budget of \$67 million.¹⁰ The average OPIC employee is responsible for approximately \$8 million in portfolio exposure. If OPIC’s existing portfolio-to-employee ratio remained constant, then the USDFC could require between 370 and 2,200 employees, depending on its portfolio size. This increase would entail an annual operating budget of between \$110 million and \$665 million, which would be *self-financed through the partial retention of USDFC profits* (see figure 3).¹¹ By comparison, the current staffing size of peer DFIs is as follows: 4,000 in the World Bank’s IFC, 499 in Germany’s DEG, 336 in the Netherlands’ FMO, 177 in France’s PROPARCO, and 102 in the United Kingdom’s CDC.



Governance Structure

The USDFC would be an independent government agency led by a management team appointed by the White House and overseen by a board of directors that includes both government and private-sector representatives. In this manner, the board would reflect the Corporation’s development and foreign policy objectives, as well as serve as a model for promoting private sector–based development. The Corporation also should include an equal number of public-sector representatives from each major political party. This would promote greater strategic continuity and help minimize short-term political pressures. Moreover, the board’s composition should seek to ensure coverage of several core competencies, such as international development, risk management, human resources and legal matters, global financial institutions, and specific priority sectors (e.g., power and transportation).

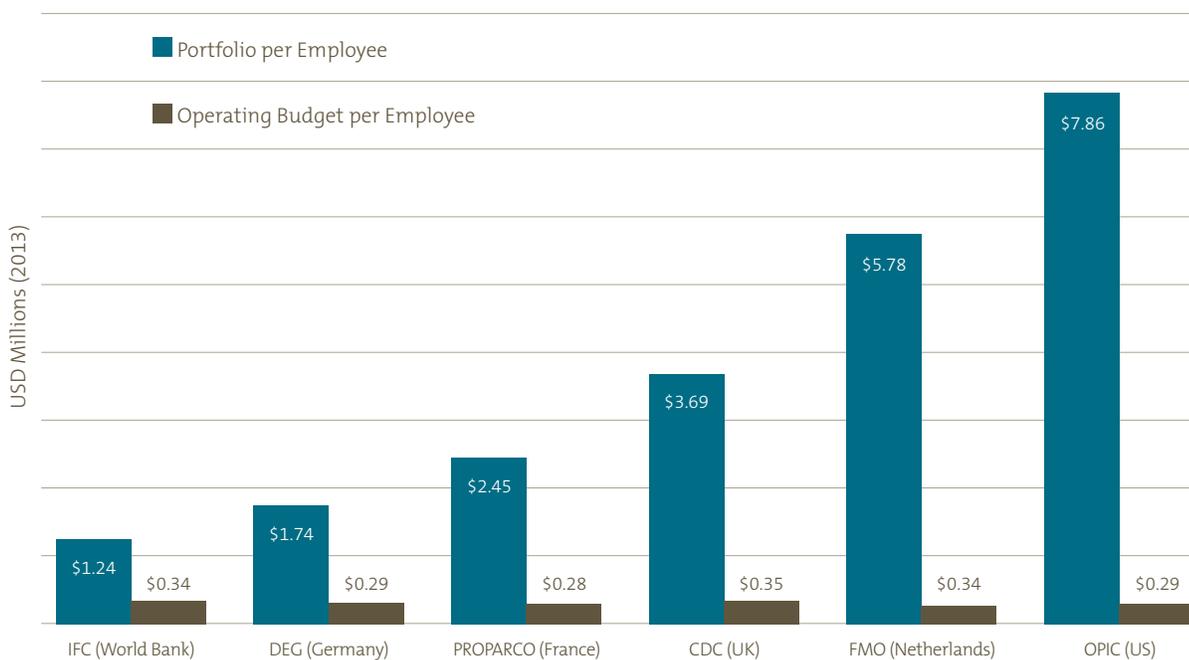
Monitoring, Evaluation, and Reporting

The USDFC should establish a performance measurement system that is modeled on global best practices.¹² OPIC

currently uses a Development Impact Matrix to evaluate and monitor both prospective and approved investment projects; however, the information is not reported publicly. The USDFC’s performance measurement system should expand upon OPIC’s existing approach by measuring, considering, and reporting on the “additionality” of its operations. This would require both ensuring that the institution does not compete with private sources of investment capital and maintaining appropriate financial performance within its portfolio. Lastly, the USDFC would collect and publicly report on a series of institutional efficiency and performance metrics, such as financial performance, operating budget ratios, and average investment transaction review time.¹³

Across its operations, the USDFC should publicly disclose information by default and have a high bar for withholding information in deference to commercial confidentiality concerns. At a minimum, this would include all project description summaries and Development Impact Matrix scores (at the time of project approval). Moreover, the Corporation should publish project-level development performance data on an annual basis.

Figure 3 OPIC Outperforms Other DFIs on Portfolio Size and Operating Budget Per Employee



Source: DFI annual reports and authors’ calculations



Capital Structure

The USDFC's capital structure should reflect its desired scale, comparative advantage, and role within the US government's development and foreign policy toolkit. In particular, its structure should only represent its potential maximum portfolio size. The actual size, as measured by total contingent liabilities, must reflect the institution's ability to support individual transactions with strong development impact, prudently manage financial risks, and consistently demonstrate strong "additionality" vis-à-vis private-sector alternatives.

- **Status Quo Structure:** Under this option, the USDFC would rely upon OPIC's existing maximum contingent liability limit of \$29 billion.¹⁴ This limit has not been changed since 1998, when it was increased from \$23 billion. Future adjustments to the USDFC's contingent liability limit would be considered on an ad hoc basis. Advisory services and technical assistance activities would be financed out of retained earnings at no additional cost to taxpayers.
- **Revised OPIC Contingent Liability Limit:** Under this option, the USDFC would rely upon an updated version of OPIC's existing contingent liability. This limit would be adjusted upward to roughly \$42 billion, thereby converting the current exposure limit from 1998 dollars to 2014 dollars.¹⁵ Going forward, the maximum contingent liability limit would be inflation adjusted, which would prevent the erosion of the USDFC's potential portfolio size in real terms. It would likely be many years, if ever, before that limit is approached. However, setting this limit would provide the USDFC with adequate flexibility to execute scaled private sector-based development approaches, while simultaneously ensuring proper portfolio risk management and oversight.

Policy Recommendations and Implementation Road Map

The implementation road map for the proposed USDFC will require actions by the US executive and legislative branches. These actions include the following:

- 1 **The next US president should put forward a proposal to establish a consolidated US Development Finance Corporation, along with template legislation.**

This should take place within the first 100 days in office. Such action would instill an appropriate level of political commitment and help build momentum within Congress. This proposal would be further fleshed out and amended as appropriate in close partnership with Congress.

- 2 **The US Congress should pass legislation that will establish a USDFC to function as the premier development agency focused on private sector-based approaches.**

At a minimum, the legislation should address the following components: products, services, and tools; size, scale, and staffing requirements; governance structures and oversight functions; performance metrics (including stringent "additionality" requirements); and capital structure models.



Further Reading

Homi Kharas, George Ingram, Ben Leo, and Dan Runde. “Strengthening US Government Development Finance Institutions.” Washington: Center for Global Development, 2013, www.cgdev.org/sites/default/files/strengthening-us-government-development-finance-institutions.pdf.

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Notes

¹ Benjamin Leo, “Is Anyone Listening? Does US Foreign Assistance Target People’s Most Pressing Priorities?” CGD Working Paper 348, Center for Global Development, Washington, 2013.

² These figures cover 81 low- and lower middle-income countries with recent completed World Bank enterprise surveys. For details, see the enterprise surveys at www.enterprisesurveys.org/data.

³ World Bank, World Development Indicators data set, 2014, <http://data.worldbank.org/data-catalog/world-development-indicators>.

⁴ Excluding the BRICS (Brazil, Russia, India, China, and South Africa), government revenues quadrupled from roughly \$600 billion in 2000 to \$2.6 trillion in 2012. This trend has been equally as striking in low-income countries, which experienced a fourfold increase in government revenues between 2002 and 2012. Source: World Bank, World Development Indicators, 2014.

⁵ For additional details, see USAID, “USAID Development Credit Authority Activity in 2013,” www.usaid.gov/sites/default/files/documents/2155/2013_Deals_Public_SummaryFinal.pdf.

⁶ Government Accountability Office, *Enterprise Funds’ Contributions to Private Sector Development Vary*, GAO/NSIAD-99-221 (Washington: GAO, 1997).

⁷ For additional details, see MCC, “About MCC,” www.mcc.gov/pages/about.

⁸ For additional details, see USAID, “Supporting Private Enterprise,” www.usaid.gov/what-we-do/economic-growth-and-trade/supporting-private-enterprise.

⁹ This authority is detailed in Section 235(1)(a) of the Foreign Assistance Act.

¹⁰ This figure includes salaries, benefits, travel, contractual services, and other general administrative expenses. Source: OPIC, *Annual Report 2013* (Washington: OPIC, 2013).

¹¹ These administrative budget estimates assume that OPIC’s current cost structure would remain unchanged. This is likely a conservative assumption given the potential for greater efficiencies due to economies of scale.

¹² Reporting practices include performance metrics and requirements that are regularly and prominently included in organizations’ annual reports or development impact reports.

¹³ This would include the time required for each stage of transaction process. This information would be reported at the project and portfolio level.

¹⁴ This limit is outlined in Section 235(a)(1) of the Foreign Assistance Act of 1961. The relevant language was last revised through Section 581(a) of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1998 (Public Law 105-118).

¹⁵ This figure is calculated using the US Bureau of Labor Statistics CPI Calculator tool, which is available at <http://data.bls.gov/cgi-bin/cpicalc.pl>. The adjustment could be based off of alternative methodologies as well, such as the cost of capital.

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Testimony of Jeffrey Herbst

“An Assessment of U.S. Economic Assistance”

U.S. Senate Committee on Foreign Relations

July 7, 2016

Mr. Chairman, Ranking Member Senator Cardin, other distinguished members of the Committee, it is a great honor for me to testify before the committee on the panel “An Assessment of US Foreign Economic Assistance.” My observations are mainly based on my own academic work that has focused on the political economy of sub-Saharan Africa over the last thirty years.

Without a doubt, the necessary condition for economic growth in a developing country is the commitment of the government to create the enabling conditions for growth. In particular, governments must create policy environments that are attractive to local and foreign investors. We have seen, in Africa and elsewhere, that governments (e.g., Ethiopia, Rwanda) that create the necessary conditions are able to attract private investment even if there are very challenging historical legacies. We have also seen that countries that may seem more attractive (due to infrastructure and the existing private sector) but with a poor governance climates (e.g., South Africa) do not attract investment. Governments must also be able to make hard decisions, including a focus on building infrastructure rather than spending on consumption and be able to close state enterprises that are not viable. Finally, corruption must be kept to a low and predictable level.

Absent the necessary will to make economic reform, it can be guaranteed that there will not be sustainable economic growth. There are several dozen countries in the developing world that are currently trying to attract investment and many recognize that they are in a global competition for investment. There are only a few cases (mostly in mining but even then there are often choices) where a company has to invest in a particular country.

Whether US economic assistance promotes growth is a complicated question. It must first be noted that economic growth is not the primary goal of US foreign policy. The largest component of bilateral assistance (61% in FY2015) is devoted to global health, notably to support treatment of HIV/AIDS.¹ According to the State Department’s own framework, promoting economic growth is a priority but so is promoting peace and security, investing in people, governing justly and democratically, and humanitarian assistance. Underneath these

¹ A good review of overall trends can be found in Curt Tarnoff and Marian L. Lawson, “Foreign Aid: An Introduction to U.S. Programs and Policy,” Congressional Research Service, June 17, 2016.

major priorities are no less than twenty-four sub-goals ranging from counter-terrorism to agriculture to health to good governance.

Many of these goals are aligned but not all. There are, for instance, some African countries that are growing but who cannot be considered democratic (again Rwanda and Ethiopia are examples). While all of these goals are admirable, it must be noted that the breadth of such priorities spread over many countries makes it very hard for US government agencies to focus on any one priority and therefore tie aid to results. For instance, the US was constrained from using aid to protest the unfair elections held in Uganda in February 2016 because of the important security role that Kampala plays in the region.

More generally, aid will be used well by countries that are committed to economic growth and will be wasted in countries where the government has other priorities. Outsiders can never instill a seriousness of purpose that is lacking in the national government.

As the US government has so many stated priorities it would be all but impossible to say that aid was sufficiently tied to outcomes and objectives. The US, whether deliberately or not, has developed a very broad portfolio of aims spread over a large number of countries. There are strategic advantages to such a posture—displaying American involvement globally, participating in a broad range of issues, and flexibility to move across different sectors depending on felt need—but policy coherence naturally suffers.

Economic assistance should only be expected to succeed when government is committed to having a private sector that thrives. Once that basic commitment is discerned, economic aid can be used in a variety of ways that would be productive, including building infrastructure, rationalizing and enhancing the competency of government ministries and state-owned enterprises, and fostering entrepreneurs. Foreign economic assistance cannot be expected to substitute for local political will.

A policy stance which aimed for a sunset on American assistance in a given country is an attractive idea but would have to be based on a much smaller set of priorities than is currently the case and greater discernment in the disbursement of funds. Greater capacity-building will only occur with governments that want to enhance their fundamental structures, as opposed to enrich leaders, develop patronage networks, or pump up the economy for an upcoming election.

A policy framework with a clear sunset would have to have well defined metrics that would be announced in advanced and then tracked. The US would also have to have the discipline to reduce aid if progress was not being made on the metrics.



Assessing US Economic Assistance: Context, Impact, and Implications

**Testimony before the Foreign Relations Committee
United States Senate**

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Chairman Corker, Ranking Member Cardin, and Members of the Committee, thank you for the opportunity to appear before you this morning to speak about something as critical as the shape and impact of the US Government's foreign economic assistance programs.

I serve as Vice President for Global Development at InterAction, an alliance of nongovernmental organizations (NGOs). Our 180-plus members work around the world and in every country that receives economic assistance from the United States. What unites us is a commitment to working with the world's poor and vulnerable, and a belief that we can make the world a more peaceful, just, and prosperous place – together. InterAction's members range in size from 4 employees to 40,000 employees and – through a combination of private fundraising and official donor financing – they are collectively responsible for the delivery of billions of dollars in development and relief programs around the world.

InterAction's membership is as diverse as it is strong, and the views of our membership organizations are equally extensive. Consequently, my remarks today are informed by the experiences and lessons of InterAction's members, but they should not be taken to represent the specific view of any individual member organization.

Because the specific key drivers and constraints to inclusive economic growth vary by country, the US can maximize support for positive economic outcomes with a diverse portfolio approach to economic assistance. In essence, this is the same approach taken by any investor who diversifies his or her assets to ensure some level of return. To be effective, this requires more purposeful application of analysis, transparent evaluation and reporting, and a willingness to add legislative authorities that would allow existing assistance mechanisms to be responsive to global economic changes. Finally, given the ever deepening relationships among global economic, political, and societal changes, it remains in the US national interest to provide both economic development assistance, as well as other types of support.



In order to inform your assessment of US economic assistance, I have organized my remarks around responding to three broad questions:

- I. What drives and constrains economic growth in developing countries?
- II. What does a diverse portfolio approach for US economic assistance entail?
- III. How can US assistance respond to today's reality that economic and non-economic issues are deeply intertwined?

I. We know that drivers and constraints to inclusive economic growth vary by country

Questions about what drives or constrains national, *inclusive*, economic growth are the fundamental basis of an ever growing collection of economic research. While others on the panel are better positioned to provide details on the breadth and depth of current research, it is worth noting here two key research findings that continue to have significant implications for how the US constructs its economic assistance programs, both in policy and in practice.

The first is a tangible shift in recognizing the variety of policy combinations that other countries can adopt to effectively drive sustained and inclusive economic growth. While macroeconomic research in the 1980s and 1990s often focused on a specific combination of policies that correlated with growth and stability, research in the 2000s began to recognize more diverse paths to growth. The World Bank Growth Commission, for example, concluded in 2008 that, "...no generic formula exists. Each country has specific characteristics and historical experiences that must be reflected in its growth strategy."¹ This recognition of countries' unique drivers and constraints to growth is significant because it opened a new door to how growth diagnostics can shape assistance programming outside of multilateral economic institutions.

The second key development was a growing body of research on the effect of foreign assistance itself on economic growth. A seminal *American Economic Review* article in 2000 by Burnside and Dollar found that assistance leads to more growth in countries with good policies, but is ineffective elsewhere.² The article was so influential that many credit it with inspiring the establishment of the Millennium Challenge Corporation, which is explicitly focused on promoting economic growth as a model of foreign assistance, and uses a data driven approach to make large investments in "the most well governed poor countries." Since then, the field has seen a proliferation of econometrically rigorous studies, ably summarized by my fellow panelist's colleagues from the Center for Global Development in 2014 as, "the majority of studies on aid are positive—but the impact of aid is often modest."³

¹ *The Growth Report: Strategies for Sustained Growth and Inclusive Development*. The Commission on Growth and Development. The World Bank. 2008. Overview: p 2

² Burnside, Craig and David Dollar, "Aid, Policies, and Growth," *American Economic Review* 90(4) (September 2000): pp. 847–68.

³ <http://www.cgdev.org/blog/1385-billion-question-when-does-foreign-aid-work>



Based on this, we cannot say that a single type of foreign assistance intervention is the one silver bullet for all countries that produces sustainable, inclusive economic growth. However, in policy terms, over the last 10 years there has been a clear recognition that inclusive growth fundamentally underpins a variety of foreign assistance, and therefore foreign policy, goals. Whether looking at the 2010 Presidential Policy Directive on Global Development,⁴ or either of State and USAID's first two Quadrennial Diplomacy and Development Reviews (QDDR),⁵ advancing inclusive economic growth is stated as a clear US foreign policy priority.⁶

Practically speaking, this sentiment also informs the way providers of economic development funds consider the structure of their programs. Specifically, the last ten years brought greater application of preliminary economic assessment as a means of designing assistance programs that better contribute to sustainable, inclusive economic growth.

While economic analysis in general is certainly not new to US foreign assistance agencies, the MCC's "growth diagnostics," first implemented in 2007,⁷ put research about a country's binding constraints to growth at the center of decision making about how to allocate assistance dollars. By transparently basing the entirety of its (often half billion dollar) investments on economic research into what specifically constrained inclusive economic growth in a country, MCC provided a proof of concept that US bilateral assistance programming could be based on publicly available evidence.⁸ Similar diagnostics were subsequently adopted by a variety of presidential initiatives (PFG,⁹ SGI¹⁰), and now play a key role at USAID as well.¹¹

Over this same time frame, the notion of inclusive growth as a precursor to nearly all human development outcomes has also been increasingly recognized by non-profits, foundations, and advocates. While individual organizations may disagree on the best way to promote inclusive growth, or how to manage the gains from economic growth, there is clear recognition that inclusive growth itself is a fundamental element of global development and poverty reduction.

II. As an investor, the US needs a purposeful, diverse, economic assistance portfolio

Because the specific drivers and constraints to inclusive economic growth vary by country, the US can maximize support for positive economic outcomes with a diverse portfolio approach to

⁴ Presidential Policy Directive #6. <http://fas.org/irp/offdocs/ppd/ppd-6.pdf>

⁵ 2010 Quadrennial Diplomacy and Development Review <http://www.state.gov/documents/organization/153139.pdf>

⁶ 2015 Quadrennial Diplomacy and Development Review <http://www.state.gov/documents/organization/241430.pdf>

⁷ <https://www.mcc.gov/our-impact/constraints-analysis>

⁸ The results of these analysis further supported the notion that individual countries have distinct binding constraints to growth by ranging from a lack of electricity, to poor population health outcomes, to over-regulated labor markets.

⁹ <http://www.state.gov/r/pa/prs/ps/2011/11/177887.htm>

¹⁰ <http://www.state.gov/p/af/rls/2016/253906.htm>

¹¹ "USAID increasingly looks to inclusive growth diagnostics (IGD) to sharpen its strategy development process." <https://www.usaid.gov/who-we-are/organization/bureaus/bureau-economic-growth-education-and-environment/office-economic>



economic assistance. In essence, this is the same approach taken by any investor who diversifies his or her assets to ensure some level of return.

This does not imply that we want a haphazard proliferation of overlapping programs. Capacity constraints in partner countries are real at the human resource, organizational, and system levels, and disorganized US efforts to simultaneously support economic activity with all available tools are likely to lead to both haste and waste. Maintaining a diverse economic assistance portfolio means recognizing the primary value of different tools and deploying them in the country contexts in which they can have maximum impact. Key to this is the continued recognition of the different roles for public and private investments in stimulating economic activity, such as:

- **Non-profit initiatives to identify and expand financial tools for traditionally under-banked populations.** Although sometimes not directly supported by USG assistance, non-profit implementers of economic development programs are increasingly experimenting with new financial services. For example, Mercy Corps launched an early stage impact investment fund focused on East Africa in 2015,¹² while Habitat for Humanity used its own seed money and expertise to partner with OPIC and the Omidyar Foundation to create MicroBuild, a mortgage fund for low income families in the developing world.¹³
- **Funding for public goods:** MCC provides public capital for large scale, multi-year investments in public goods such as infrastructure, sustainable public services, or institutional and market reform. Such funds support investment in large, often multi-faceted public works that are unlikely to be independently supported by private sector actors because the gains cannot be captured, or even realized in the absence of government led policy reform. These investments are prioritized for the greatest growth potential through a politically-insulated cost-benefit analysis tool that estimates the return for each dollar investment
- **Integrated approaches:** USAID, present in nearly every country and capable of supporting year on year programming and sustaining long term relationships is perhaps the most flexible. In recent years USAID has not only provided both public funds and technical capacity building, but has also prioritized efforts to bring private sector actors to the table for joint investment. Whether looking at the agency's big push to build public-private-partnerships for investment in Power Africa, the way USAID moved ahead with USAID forward reforms to better align its operating styles with the private sector, or new momentum at the Global Development Lab to bring break through innovations to bear in development, the agency has taken significant steps over the last several years to maximize the economic growth impact it can have within its current mandate and earmarks.
- **Facilitation of US private investment:** OPIC leverages funding to stimulate US-based private sector activity in a country by providing US companies with debt financing, loan guarantees, political risk insurance, and support for private-equity investment funds. Such

¹² https://www.mercycorps.org/sites/default/files/Mercy_Corps_Social_Venture_Fund_Overview_May_2016.pdf

¹³ <http://www.habitat.org/sites/default/files/2015-microbuild-fund-annual-report.pdf>

funds not only crowd in US investors, but support expansion of US businesses, and generate income for the US treasury.

- **Focus Areas:** Though they are not always economic growth focused, some recent sectoral initiatives explicitly recognize the need to address binding constraints to growth in multiple countries. This includes Power Africa as codified through the Electrify Africa legislation, or Feed the Future and the (pending) the Food Security Bill, which explicitly calls out the importance of functional markets in ensuring food security for populations and livelihoods for small holder farmers.

To be effective without feeling chaotic, this approach requires more purposeful application of analysis and coordination, transparent evaluation and reporting, and a willingness to add authorities that would allow existing assistance mechanisms to respond to global economic changes.

Prioritizing the results of economic analysis over politically popular solutions can feel counter intuitive, but may serve as a tangible way to push greater coordination and impact. For example, over a particular transport corridor in West Africa, a visual inspection would suggest that the primary driver of high shipping costs was the road's condition (too narrow to bear the largest modern trucks, pot holes that required serious reduction in speed, and lack of shoulders for accident bypass). But deeper analysis shows that the greater constraint for the first stretch of transit was the sheer number of police check points at which bribes were solicited, and the greater constraint for the second stretch was the grip of a national trucking monopoly. Simply trusting the visual inspection would have led to a heavy dollar investment that feels satisfying to donors and is politically easy for recipient countries – but would have missed maximum impact by overlooking the effects of corruption or monopolistic behavior. Identifying the totality of the constraint also makes it possible to coordinate across actors who provide infrastructure funding, technical assistance, and support for regulatory reform.

Once programs start, transparent, rigorous monitoring and evaluation is the most significant tool available to determine whether economic assistance is achieving intended outcomes. Impact evaluations and rigorous monitoring are more common at MCC and USAID, but are still mostly underfunded and therefore mostly un-adopted by other agencies responsible for funding or implementing economic assistance. This information, on whether programs achieved the specific impacts they set out to accomplish, is fundamentally necessary if the US is to first understand the effectiveness of different interventions intended to support inclusive growth, and eventually make cost benefit decisions about subsequent investments. To this end, the passage of the Foreign Assistance Transparency Act is a positive step and has been broadly supported by InterAction and its members.

Finally, keeping the portfolio up to date will also require more creative thinking about the authorities required for the US to support national level financial instruments as tools, and to respond to evolving global trends. This may include new authorities for OPIC to self-fund expanded administrative services, regional or sub-national investment authorities for MCC, and greater flexibility for operational and program budgets for USAID so that it can begin a shift to



the kind of systematic evaluation which would eventually allow the agency can to make evidence-based decisions about continuing and adjusting programming.

III. US assistance as a whole must recognize that economic and non-economic issues are ever more intertwined

Economic development assistance represents only one part of the broader US foreign assistance tool box, which also includes humanitarian relief, security assistance, and support for democracy and good-governance. These other tools not only alleviate human suffering, but they remain critical pieces of maintaining US leadership abroad. Interventions in traditional human development sectors have also had tremendous impact –scholars document the eradication of small pox, a near doubling of the proportion of children enrolled in school in Sub-Saharan Africa, and planet wide improvements in life expectancy.¹⁴

There are compelling and credible cases to be made for a each these of investments, from maternal health, to water and sanitation, to post-conflict community development. What may be less immediately intuitive is that there are also economic rationales for supporting the broader range of US foreign assistance. Economic growth doesn't happen in a social or political vacuum. Consequently, when considering the efficacy of US economic assistance, it is worth bearing in mind the following inter-relationships, and the implications they have for how to ensure economic assistance funds generate positive economic outcomes.

Reform, political will, and democratic societies

When it comes to economic reform – even at the micro- regulatory level – no amount of US economic assistance can compensate for a lack of political will. Because it is ultimately the other-country government that reforms and enforces new laws, decisions about which economic assistance tool to deploy should take incentive structures into account. Critical reforms – like subsidy reduction or tariff structure reform – are domestically controversial. In some places, a government's desire to secure public funding for infrastructure or to attract international investors serves as sufficient incentive. In other places, domestic politics may mean that governments can only take difficult reforms if they are accompanied by popular traditional development programs that support health, education, or agricultural services. In this same vein, no amount of economic assistance to a government will fundamentally alter the degree of space for civil society actors, or respect for the rights of citizens. Democracy support remains a critical, and separate, way for the US to support our values abroad.

Exclusion, inequality, and economic opportunity

Because there are fewer economic opportunities for traditionally excluded populations (women, youth, minorities, the elderly) many development programs designed to support these groups have an economic dimension to them. Consequently, a variety of development programs that appear non-economic at first glance may in fact directly support economic goals. For example,

¹⁴ *Getting Better: Why Global Development is Succeeding and How we can Improve the World Even More.* Charles Kenny. Basic Books. 2012.



an agricultural program in the Sahel that focuses on small holder women farmers adopting more efficient irrigation practices may directly increase community incomes.

Pandemics and economic loss

While the health of a labor force has known implications for economic productivity, we have recently seen how the state of a country's health system has deeper implications in the face of a pandemic. For example, the economic consequences of the Ebola outbreak in West Africa were staggering, with Sierra Leone, Liberia, and Guinea estimated to have lost some \$2.2 billion in forgone economic growth in 2015. While traditional economic assistance before the outbreak would not have reduced the negative economic consequences later, health interventions might have (either long term support for health infrastructure systems or faster response to the initial outbreak).

Our own national security goals

In 2015, three countries received roughly 40 percent of US economic development funding: Jordan, Afghanistan, and Pakistan.¹⁵ From a national security perspective, the US has multiple goals for providing all types of assistance in these three countries, which not only affects the level of funding, but also the choice of aid vehicles through which the assistance is provided. When US goals around economic growth converge with goals around stability and national security, many of the best practices implemented in other purely economic development programs cannot be replicated.

This list goes on – urbanization, climate change, social accountability, demographic shifts – these are all intertwined with macroeconomic forces to affect the way US economic assistance programs function. In that context, the US must maintain a diverse portfolio of economic assistance tools while preserving other types of assistance which complement and deepen their impact.

Conclusion

I wish to thank the committee for this opportunity to provide testimony. InterAction's diverse membership strenuously and unanimously supports the United States' continued engagement in the world. To a person, our members recognize that that US global leadership must include assistance designed to lift people out of poverty – and the \$15 billion in charitable donations that citizens direct abroad every year suggests the American people do too. In that context, we believe both in the economic necessity of growth, and the human imperative of ensuring that growth is inclusive.

¹⁵ Based on data from the Foreign Assistance Dashboard at <http://beta.foreignassistance.gov/>