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Subcommittee on the Western Hemisphere

Chairman Engel, Ranking Member Burton, and Members of the Subcommittee, I am honored by your invitation to testify today on the complex question of foreign aid reform as it relates to the Western Hemisphere. In this statement, I would like to discuss a proposal for foreign aid reform that I have developed jointly with Justin Muzinich, briefly comment on the legislation establishing a Social Investment and Economic Development Fund for the Americas, and make some recommendations on the Millennium Challenge Account.

Foreign aid has been the subject of vigorous public debate over the last several years. Among the complaints raised are that there is not enough aid to go around and that aid disbursements do not lead to enough development gains on the ground. Both critiques, though they usually come from different sides of the aisle, are to some degree correct. While the United States distributed $23 billion in 2006 — more than any other country — relatively little reached the billion people who live on less than one dollar a day. In Latin America and the Caribbean, the $1.8 billion disbursed amounted to just three dollars per person per year. And, according to a Brookings Institution report, for every dollar spent on aid worldwide, only 18 cents actually gets spent on real development in the recipient country.

Meanwhile an incredible phenomenon is occurring with comparatively little policy engagement from the development community. Worldwide, **the flows of private development finance have surpassed official aid**. In 2006, $380 billion of foreign direct investment (FDI) flowed to developing countries and $220 billion in remittances were sent home by developing-country migrants. These numbers far surpassed the $104 billion in official foreign aid flows, and the difference will only grow. This private-to-public ratio of six dollars to one, worldwide, is dwarfed by the same statistic measuring U.S. engagement with developing countries in the Western Hemisphere.

The $21 billion in FDI and $45 billion in remittances were over 35 times the amount of foreign aid sent from the United States to Latin America and the Caribbean in 2006. Private development finance is nothing to shrug off. Academic research has shown that FDI can raise wages and create positive spillover effects in the host country, and that remittances reduce poverty and child labor while insuring households against shocks.

A Proposal: Harnessing private development finance

Government policy can and should act to shape the size, direction, and attributes of private development capital rather than solely relying on the old model of government-to-government transfers. In so doing, we can leverage taxpayer dollars to provide more aid. And since the transactions are between private parties, the usual hole-in-the-bucket fears of losing aid to consultants or corruption are reduced.

So how can we use public policy to affect private transactions? Our proposal[1] borrows conceptually from two existing programs: the New Markets Tax Credit, which gives companies tax breaks on equity investment in poor communities inside the United States, and the Millennium Challenge Account, which rewards good governance through increased foreign aid to qualifying countries. What we urge are tax credits to businesses for good FDI in qualifying countries, and tax breaks to individuals for productive remittances to qualifying countries.

Some basic rules could be set up to make sure the private development finance encouraged by the tax breaks would get the most bang for the buck. Eligible FDI would be the kind that creates jobs and brings in technological and management expertise, providing the recipient country with much-needed links to the global economy. In fact, poor countries already spend their sparse tax revenue to attract this kind of foreign investment. Qualifying remittances would go directly towards post-secondary tuition, domestic microfinance loan pools, or some other private-sector engine of prosperity.

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[1] Muzinich, Justin, and Eric D. Werker. "A Better Approach to Foreign Aid." *Policy Review* 149 (June - July 2008). Muzinich, Justin, and Eric D. Werker. "A Global Tax Credit." Op-ed. *The New York Times*, October 20, 2007.

The political challenge of implementing this proposal would no doubt rest on framing it as a component of a new, 21st-century American strategy of exporting our values while fighting global poverty.

To make this work we should take a lesson from the Millennium Challenge Account. We propose that only those countries where—at the minimum—corruption is low, and governments are accountable to their people and respect human rights, should be eligible. This would help to ensure that the money would get used well, and it would offer a positive incentive for governments to reform. Of course, the incentive wouldn't work through the usual aid-conditionality mechanism that pushes reluctant governments to reform. Instead, it would motivate two huge constituencies to lobby their own government for meaningful change: capital investors, who are providing jobs, and the diaspora, who are sending money. So that the program wouldn't hurt American workers, we would limit the investment credits to those countries where existing private aid flows are minimal, and where per-capita income is very low.

As it turns out, our first pass of potential recipients did not turn up a single country in the Western Hemisphere. The reasons for that are twofold. One, relative to many underdeveloped countries in Africa and Asia, developing nations in the Western Hemisphere are richer. (Where they are not, like Haiti, corruption is too high.) Two, there are already relatively large levels of remittances and FDI flowing from the Unites States to developing countries in the Hemisphere. Tax breaks would likely end up subsidizing many transfers that would have occurred in the absence of the program.

Application to the Western Hemisphere

The challenge for foreign assistance reform in the Western Hemisphere then becomes how to harness decentralized aid in the presence of significant existing private development finance. The low-hanging fruit that I have advocated above may not be appropriate for the Western Hemisphere. Instead, a more targeted set of tax incentives could be used to increase the impact of private development finance in a way that addresses chronic foreign-policy dilemmas in the region. I offer two specific examples.

One, migrants living in the United States could be allowed to deduct remittances from their pre-tax income if the remittances were invested in special long-term business-development funds in

their home country. Qualified financial institutions could take the remittance deposits and make micro loans to small businesses. Migrants could commit to not withdrawing the money for a period of years. Not only would this provide credit through private channels, but it would leave the migrant a nest egg for her return to her home country.

Two, U.S. entrepreneurs could be eligible for a tax credit for all for-profit investment made in the social sector in qualified developing countries in the region. For instance, companies involved in village solar power for indigenous communities, or sustainable tropical forest eco-tourism, could qualify for the tax credits. Such a credit would tip the balance into profitability for a number of beneficial business ventures while stimulating American leadership in this emerging industry.

By involving private individuals and companies in market-friendly transactions between the United States and developing countries in the Western Hemisphere, such programs would offer a powerful alternative to Venezuelan-style assistance. And if country eligibility were tied to low corruption and strong democratic accountability, nations would get rewarded for their commitment to just reforms. Importantly, the pressure would not come from Washington (which can be complicated when anti-American sentiment is high) but instead from the diaspora, and investors with a stake in the ground.

Of course, tax incentives are not the only answer. Traditional aid can, and does, fund programs that can make it easier for migrants to send (and for their families to receive) remittances. It can fund consultants to study the competitiveness of a country's business environment. Or it can set up a fund to make grants and loans to encourage private sector development, as with the Multilateral Investment Fund. **What tax incentives do differently from other instruments is decentralize the aid, which strengthens the direct links between America and its potential constituencies abroad.** The countless transactions between individuals, or corporations, would contribute to the rich web of relationships between the United States and the rest of the world.

Evaluation of H.R. 3692

Three attributes of the legislation establishing a Social Investment and Economic Development Fund for the Americas stand out as highly desirable. First is the emphasis on rigorous evaluation and accountability. Too often, we spend taxpayer dollars on unproven programs without spending the small amount extra that it would take to actually learn whether or not the program

works. Advances in evaluation techniques make this omission even more inexcusable today. Second is the increased attention to Latin America and the Caribbean, which, given the threat of competing ideology in the region, is an important component of what should be a larger strategy. And third is the role given to the Inter-American Development Bank, and the payment of our Multilateral Investment Fund arrears. Multilateral aid offers a number of advantages over bilateral aid, and should receive a larger share of our development budget than it currently does. In today's geopolitical environment, strengthening international institutions that share our general worldview should be a priority. An increase in U.S. priorities getting implemented by multilateral or non-U.S. actors can only be a good thing. Sharing market development in Latin America and the Caribbean with the Inter-American Development Bank is in that spirit.

My reservations with the bill are a reflection of my view that the United States is due for a comprehensive foreign aid overhaul. The bill establishes an advisory committee and demands a different, higher level of accountability. This extra layer of oversight increases the cost of aid delivery and the complexity of reporting. It would be better if Congress could trust an executive agency to do its job and keep Congress informed, for *all* of its programming. Rigorous evaluation should also be a given for all foreign aid. And the thoughtful interpretation of this body of evidence, rather than specific earmarks, should inform the direction of all developmentally-oriented foreign assistance. Moreover, the $300 million per year that this initiative tops out at should be put in perspective. Compared to the $3 trillion in GDP in the region, this represents an injection of only 0.01 percent of the economy. In contrast, an African country like Tanzania receives nearly 15 percent of GDP in foreign assistance every year.

The Role of the Millennium Challenge Corporation

The Millennium Challenge Corporation (MCC), an organization with an important presence in the Western Hemisphere, embodies two distinct innovations in foreign assistance. One is in using the promise of aid as a "carrot" to reward countries that undertake their own positive reforms. The other innovation is the intense demand for accountability and measuring results. What I believe has occurred is that these two innovations have come into conflict with one another. But the correct response is not to back off on either innovation, which is the immediate political temptation.

Instead it is to double down. I offer a concrete step to do just that, building on the proposal for aid reform that I have discussed.

When a body like the MCC demands that every financed project undergo a rigorous economic and environmental assessment, top-notch fiscal responsibility procedures, and submit to a serious evaluation, that can be tough news for the recipient country. High standards can make the carrot of a $500 million aid package seem less alluring than a much smaller amount in free money. At the same time, the pressure to get money out the door—in order to keep the carrot out there—pushes the organization to shirk on rigor (which the MCC has admirably resisted). The easy solutions are to compromise on rigor, or to give up on the MCC being a serious catalyst for reform.

Let me offer a different take that can serve as a model for how U.S. foreign assistance might interact with market democracies in the developing world. If a country meets certain MCC-type criteria, it should be eligible for not only a large and well-thought out aid package, but also a host of other rewards. All these rewards should reinforce the nation's choice of market democracy and create the constituencies to lock it in. Tax breaks for remittances and good FDI should be extended to these countries in order to increase the flows of private development finance. In addition, as has been suggested by the HELP Commission, duty-free and quota-free trade access should be granted to eligible countries. Adding carrots like these to the MCC eligibility prize package would turn the existing, modest reward for reducing corruption or educating girls into a real jackpot. It could invigorate the MCC in the process, and give forward-looking constituencies in poor countries ammunition for their quest to pursue a model of development that is in our mutual long-term interest.

Summary

Private development finance has surpassed official aid flows, especially in the Western Hemisphere, and the dominance will only rise. As we conduct foreign assistance reform, it makes sense to think about harnessing those flows to benefit the developmental and foreign policy goals of the United States. **Using the domestic tax system is one such way to shape the size, direction, and nature of private development finance, in a manner that leverages taxpayer dollars while decentralizing aid and empowering reformers around the world.**