



Aid, State Formation and the Missing Middle

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What is the connection between political and human rights and the role of the middle class in a country's economy? And what does that connection have to do with foreign aid? I will begin today by suggesting that there are powerful reinforcing links among political and human rights and democracy on the one hand, and economic “rights” in market economies and the middle class on the other. I want then to suggest the implications of those links for the management of foreign aid – both aid managed by the U.S. and other official government and international agencies, and aid managed and delivered by non-governmental organizations, which so many of you participating here today work with and work for. I conclude with a brief statement of what those of us in the development and humanitarian communities can do to minimize the potential for aid to undermine the growth and influence of the still small and fragile middle class in most of the world's poorest countries.

The state, the market and the middle class

Development economists are increasingly focused on the fundamental contribution of effective political, economic and social institutions to sustainable growth. The word institutions refers to a society’s habits, laws, and organizational arrangements – for example in the U.S. on the political side the separation of powers, the respective roles of the central government vs. the 50 states, and the rules governing elections at various levels; and on the economic side the judicial, legal, tax and regulatory arrangements that secure property rights, provide for effective contract enforcement, and ensure public access to basic education and health services. These political and economic *institutions* together represent and ensure various human and political “*rights*” such as the right to accountable government, the right to vote, and protection of civil and religious freedoms from the tyranny of the majority.

These political and economic institutions and the rights they undergird are associated in the advanced Western economies (the U.S., Europe, Japan) with a robust middle class. I will return to this point in a moment.

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Note that certain political rights are also central to sustaining a market system – a point emphasized by Hayek and Milton Friedman, and now close to becoming conventional wisdom among development economists. Where the political state is robust, we often put it mentally in opposition to the market. But where the state is fragile and political institutions are vulnerable (Congo, Liberia, Cambodia, Bolivia), note that economies and markets don't work very well either – and fewer people prosper. As it turns out, longstanding poverty, historically low rates of economic growth and weak states often go together.

Those conditions also tend to be associated with a small and weak middle class. The converse also seems to be true: political and economic rights (supported by solid political and economic institutions) are associated with a large middle class. In low-income sub-Saharan Africa, the 60 percent of households in the middle of the income distribution (excluding the 20 percent that are poorest and the 20 percent that are richest) captures less than 30 percent of total income on average. In contrast, in the OECD countries the middle 60 percent of households captures close to its share, i.e. close to 60 percent of total income (though for the U.S. that share has been declining in the last decade, as the share of the top 1 percent has multiplied).

Of course this is not a simple connection – between various economic and political rights and the middle class. Some economic rights can exist in the absence of democratic elections and can support development of a middle class. China entered its current growth period in the 1980s when the state returned to farmers the economic “right” to the fruits of their labor, and today it has a rapidly growing and prosperous entrepreneurial “middle”, at least in its urban areas. It is also the case that some apparent political rights, such as elections, do not guarantee in themselves key economic rights. In Zimbabwe, the state has created uncertainty (and worse) over property rights, and despite apparently democratic elections, the once emergent middle class has been virtually destroyed.

In addition there is the question of causation: Is it economic rights and sound institutions that help create a healthy middle class, or is it the middle class that provides the ballast for those institutions and for the protection of human and political rights? In the world's poorest countries, where the middle class is tiny and vulnerable, is the first task to build healthy state institutions (insisting for example on good governance and minimal corruption), or is the first task to provide economic infrastructure and opportunities (building roads and schools) in order to catalyze growth of an economically independent middle class? I don't think we know the answer to that question. If we did there would be less controversy over how to spend aid money -- but more on that point in a moment.

We don't understand causation but we can be clear that there can be a vicious circle -- in which bad government undermines the prospects for an economically prosperous middle class, and the absence of a middle class deprives society of the ballast that helps secure good government. In the case of Africa, where the official donor

community currently spends \$15 to \$20 billion annually on aid, and is committed to doubling that amount in the next few years, there are signs that the circle is indeed vicious. Africa seems to be stuck not in a “poverty trap” of the kind described by Jeffrey Sachs (in which people are too poor to save and invest, so there is no basis for growth). The evidence is that many countries in Africa have experienced at times in the past 10 or more years of reasonable growth – Cote d’Ivoire, Zimbabwe for example. But these and other once economically successful countries subsequently succumbed to political problems and growth collapses. Africa seems to be subject to a different kind of trap – that created by the lack of a healthy middle class and the institutions that support and reinforce the middle.

The aid industry and the missing middle

What has the likely vicious circle and the lack of a robust middle class in many poor countries of Africa got to do with foreign aid? Consider first official U.S. government aid to Africa. In 2005 the U.S. provided about \$5 billion in bilateral aid to sub-Saharan Africa for development, triple that provided in 2000. More than half was spent on two large aid programs begun by the Bush Administration: the President's Emergency Fund for AIDS Relief (PEPFAR) and the Millennium Challenge Account (MCA), which targets a small number of countries that meet relatively high standards of governance, attention to health and education, and economic policy. The remainder went for traditional aid projects mostly financed by the U.S. Agency for International Development (USAID) in such sectors as health, education, agriculture, infrastructure, and judicial reform.

Only exaggerating slightly, it is fair to characterize the combination of U.S. programs as highly fragmented, minimally coordinated with each other (though USAID sometimes administers MCA projects), and largely uncoordinated with the dozen or so other large donors (Japan, the European Union, the United Kingdom, France, Germany, the Netherlands, the four Nordic countries and so on). The result for a recipient country government like Mali or Mozambique is a relatively high administrative burden in terms of negotiating, budgeting and accounting, procurement, auditing and other monitoring and supervision, and overall management of the aid relationship.

With its three separate programs, the U.S. is worse than many other donors. But the fact is that foreign aid in many of Africa's poorest countries is best thought of as a highly fragmented, inefficient, noncompetitive industry, despite much enlightened resolve among aid officials to do better. There are simply too many players. In highly aid-dependent countries such as Mozambique, Tanzania, Ghana, and Burkina Faso, where aid constitutes as much as 10 percent of GDP (and finances virtually all new public investment), the players include not only a dozen or more official government programs, but the various United Nations agencies (United Nations Development Program, UNICEF, World Food Program, World Health Program, Food and Agriculture Organization, and more), the World Bank, the African Development Bank, special programs such as GAVI (the Global Alliance for Vaccines and Immunization) and the

Global Fund to Fight AIDS, TB and Malaria, and such large international NGOs as CARE, Oxfam, and Save the Children. Some donors (but not the U.S.) provide some aid in the form of budget support to capable but poor governments, so that the financing is fully aligned with the recipient government's own planning and priorities. But total budget support to any country very rarely amounts to even a third of all annual aid transfers.

The burden is sufficiently large and visible that the government of Tanzania several years ago was seen as fully justified in declaring an annual three-month "holiday" from donors, a period during which it will not accept donor visits -- in order to provide time to manage the other 90 percent of its spending. Though it is an exaggeration, in one year that government was purportedly providing more than 2000 separate reports to its various donors. Similarly, it was no doubt concern about the administrative burden and the accompanying minor but penetrating humiliations that led countries such as India and Sri Lanka to reject overtures of additional aid after the 2004 tsunami.

Besides the administrative burden on government itself in poor countries receiving aid, other aid practices may adversely affect growth of the private sector and of an independent middle class in poor countries. One likely problem is diversion of talented, educated citizens from government and from small businesses to work for donor and UN agencies and international NGOs, where salaries are higher and more secure. The former minister of finance in post-Taliban Afghanistan was particularly frustrated at his inability to keep talented staff at salaries of \$100 a month who could earn \$1000 (or more) a month working for the UN, the World Bank, or USAID. The pressure to leave government was all the higher because the presence of so many external actors led to increases in housing and other costs in postwar Kabul. To the extent that aid and aid workers' salaries lead to increases in the costs of housing and other nontradable goods and services, aid will also contribute to pressure on a country's own currency, making its exports less competitive on global markets and overall management of its macroeconomic policies more difficult. That may mean one less new business started up in food processing or flower exporting.

Less tangible but potentially even more problematic is the potential for governments dependent on aid to end up lacking any real democratic accountability to their own citizens. When the key financing for its new equipment or its monthly allotment of medicines is coming from outside and not through local government taxes, those managing the village health clinic system will be more concerned with their relationship with the outside funder than with the views of local mayors let alone the citizens dependent on clinic services. Perhaps most pernicious is the risk that aid inflows allow a government that is already instinctively hostile to an independent business sector -- which, were it to thrive, might provide healthy political competition to those now in power -- to remain hostile, stifling rather than encouraging the non-state dependent entrepreneurial class.

What can you do?

Obviously less aid to poor countries is not the answer -- not when the government of Ethiopia is able to spend less than \$5 per person annually on health care. Many of you are yourselves in the aid business as humanitarian workers. You know that more is needed. But you can lobby not only for more aid but for better aid -- for substantial improvement in the quality as well as the quantity of aid.

You can urge the Bush Administration to experiment with using its new MCA program to directly support government budgets. Countries eligible for the MCA have, after all, already been deemed to meet a minimum standard of financial management. That would imply less hiring of local staff, fewer projects, fewer reports, automatic "coordination" with the European governments and the World Bank, which already provide such support, and much greater alignment with recipient government priorities. In more fragile states, where governments are less capable or responsible, you can lobby for greater use of official aid in programs that provide cash directly to the poor -- of the style initiated in Mexico and now being imitated right here in the city of New York, under which cash is transferred directly to poor mothers on the condition that they keep their children in school and bring them in for periodic health examinations. These programs provide the poor with the beginnings of consumer power in the form of "voice" about the quality of their schools and health services. You can lobby for USAID to purchase consulting and training services at the local level instead of importing much higher cost American consultants -- thus helping to create a market for instead of destroying local capacity. In some circumstances it may make sense to push for U.S. leadership on what is now a virtual taboo among official aid donors -- the temporary "topping up" of senior government staff salaries to help bring back the skilled diaspora of countries such as Liberia to serve and rebuild their countries after conflict.

There are also implications for private giving -- by traditional and new foundations, by the many international NGOs now in the aid business, and by private multinational firms now increasingly getting into the aid business as a part of their corporate social responsibility programs. You can urge Gates, Google and Care to not only provide services but to take responsibility for coordinating with the large official donors to minimize bureaucratic and administrative burdens in recipient country settings. In particular you can use your own organization to push them to minimize local as well as international hiring, for example by pooling their funds with official donors and/or each other rather than running their own projects. You can urge Exxon/Mobil, de Beers and Coca-Cola not only to use their resources to do good at the village level, but also to use their influence in "benign lobbying", i.e. in pushing government officials where they operate to honor human rights, to encourage competition, and to resist the temptations of corruption and favoritism -- which hurt most the small businesses and the incipient middle class that cannot afford to buy privileges and favored access. You can urge multinational firms, particularly in small economies where they are influential, to back up the needs and demands of the fragile, business-friendly middle class in poor countries, by

demanding honest and competent government that honors economic, political and human rights for all.

A concluding note

Many of you are Americans. Many of you grew up taking for granted the role of a robust middle class -- as the bulwark of a healthy private economy and an accountable state. Where the middle class is too small or too dependent on the state itself to play that role, you cannot take for granted a country's ability to sustain political and human rights, or to sustain long-run, broad-based economic growth. But as powerful members of the humanitarian community, you can insist that those who aim to help with development aid do no harm to that small middle class, and you can yourselves do what is possible to support the middle -- doubtless in ways that each of you working at the ground level will know best.

Thank you very much.