CSIS BRIEFS

Thinking Outside the Toolbox

Equipping U.S. Development Assistance for Modern Times

By Daniel F. Runde, Rafael Romeu, and Austin Hardman

DECEMBER 2024

THE ISSUE

The global development landscape has undergone profound changes over the past 30 years, with new players providing funding, the deployment of a variety of financing tools, and growing human needs and challenges in the Global South. However, nearly the entirety of U.S. ***foreign assistance*** *is still disbursed via grants—that is, money provided for development purposes without an obligation of repayment. The U.S. soft power toolbox has not yet fully adapted to this changed global reality and, as a result, remains behind the times. The development priorities of the Global South demand a level of resources that far exceed what grant funding can provide. The United States can be a better partner to developing countries by using non-grant tools to help unlock private capital and build up financial sectors, putting nations on a path toward self-sufficiency and away from dependency on China.*

INTRODUCTION

Geopolitical and global economic realities are not what they once were 30 years ago. China is now a competitor—a "near-peer soft power" that is willing and able to fill the void left by the United States and its allies. In addition to maintaining military superiority in pursuit of peace through strength, competition with China exists on two other fronts. One consists of economic competition through strategic technological and industrial sectors, such as **port infrastructure**, artificial intelligence (AI), the extraction and processing of **critical minerals**, telecommunications, **subsea fiberoptic cables**, and microchips. A related **front of great power competition** involves the Global South and the development aspirations of low- and middle-income countries.

China recognizes the reality of these three fronts of great power competition and has **invested accordingly.** With its Belt and Road Initiative (BRI) and subsequent Digital Silk Road and Maritime Silk Road, China is building and operating the energy, digital, and transportation infrastructure of the developing world. In this way, Beijing seeks to link the Global South back to the Middle Kingdom—a term derived from the concept of China being the cultural, political, and economic **center of the world**.

CHINESE VS. U.S. APPROACHES

China's approach in the Global South differs greatly from that of the United States. Although development finance data is not transparent, China primarily provides **debt financing** instead of grants. According to AidData, China committed **$3.4 billion** worth of grants in 2021. The Organisation for Economic Cooperation and Development (OECD) estimates that China allocated only **$3.1 billion** in the form of grants in 2022. Beijing's preferred method of meeting the development aspirations of the Global South has been a forward-looking investment strategy. From 2013 to 2021,

Global fiscal health and stability will be influenced by whether the United States meets this challenge with an intentional approach or merely continues with traditional forms of aid.

China provided **$679 billion** for infrastructure projects through its BRI, while the United States provided $76 billion in the same key infrastructure sectors. China now sits as the largest official lender to developing countries, with estimates of Chinese debt exposure reaching as high as **$1.5 trillion**. Debt levels, exacerbated by Covid-19 spending and pandemic-related economic contraction, are at an **all-time high**. Indeed, global debt continues to surge, with over **$15 trillion** added to the total in 2023, reaching a record high of **$315 trillion** in the first quarter of 2024. For developing countries, this problem is only expected to worsen. A June 2024 report by UN Trade and Development indicates that **48 countries** spend more on interest payments than on education or health.

Conversely, the United States prefers using grants to achieve development goals. Nearly the entirety of **foreign assistance** from the United States is disbursed in the form of a grant—that is, money provided for development purposes without an obligation of repayment.[1] To illustrate this point, in 2023, the U.S. government provided **$57 billion** in non-military aid via grants, while the U.S. International Development Finance Corporation (DFC)—which uses an array of instruments to support private sector development abroad, including through guarantees, political risk insurance, debt financing, and equity—committed **$9 billion**. The U.S. government is the **largest donor worldwide,** providing **29.5 percent** of all global foreign aid in 2023.

While charitable spending on aid and development programs reflects Washington's foreign policy interests and humanitarian priorities, the United States also has an interest in mitigating the effects of debt distress and protecting its foreign aid investments from China's debt traps. Being a part of the solution for debt distress is more important for the long-term economic prosperity of developing nations. Global fiscal health and stability will be influenced by whether the United States meets this challenge with an intentional approach or merely continues with traditional forms of aid.

Unfortunately, the current international financial infrastructure led by the International Monetary Fund (IMF), World Bank, **G20**, and Paris Club have been ineffective in addressing the aforementioned compounding debt levels because the current debt crisis involves a more diverse range of creditors than past instances of **debt forgiveness**. Private lenders and China's emergence as a bilateral creditor **complicate** the creditor landscape by limiting the relevance of IMF and Paris Club members. In addition, countries with higher levels of Chinese debt require more IMF **negotiating trips** during debt distress, underscoring China's influence on sovereign-debt dynamics and its engagement with multilateral institutions.

This new context has created both challenges and opportunities for the United States in its engagement with developing nations, necessitating a reevaluation of its approach to global development finance and diplomacy. Washington should think more creatively about its foreign assistance strategy so that it can mitigate the destabilizing effects of compounding debt and be a better partner to counties of the Global South.

RETHINKING THE PROMINENCE OF GRANTS IN THE U.S. DEVELOPMENT TOOLBOX

In recent decades, grants have been the default instrument of U.S. development aid, part of the country's soft power. There are good reasons for this. First, grants are a good tool for providing immediate relief, for example, in response to famines, pandemics, and other humanitarian disasters. Second, grants are an important development tool, particularly for activities that may not align with revenue-generating models or where broad public bene-

1 From the perspective of recipient countries, the vast majority of foreign assistance consists of grant funding in that the aid is fully concessional with no repayment required. The foreign assistance community also uses the word "grant," however, to allude to cooperative assistance grants, as opposed to acquisition awards or foreign aid contracts. Both contracts and cooperative assistance aid are grant-funded, meaning there is no repayment required for the lion's share of foreign aid regardless of whether this aid is administered through cooperative assistance or contract awards to the implementing partners.

fits make other financing mechanisms less suitable. They are often used for initiatives that strengthen institutions, enhance governance, and build local technical and managerial capacity–areas that are foundational for development but may not produce immediate financial returns. In addition, grants can address challenges where systemic barriers or capacity gaps exist, such as limited ability to deliver essential services or foster community resilience. Capacity-building efforts or programs aimed at improving public sector efficiency, for instance, often require upfront investment without direct monetary outcomes. Moreover, grants are often well suited for piloting and testing innovative development approaches or technologies. By funding these initial phases, they create opportunities to explore solutions that could later be scaled or adapted through other financing methods. While these are common applications, the flexibility of grants allows them to address a wide range of needs, including unanticipated needs, making grants a versatile and responsive tool in foreign assistance.

The United States should not abandon the use of grants, but it should also expand its of use other development finance tools such as concessional lending, guarantees, and equity. The excessive use of grants limits the opportunities for development paths driven by the private sector. More specifically, achieving sustainable outcomes in the sectors where national security interests overlap with development goals will require private capital. Grants should be more selectively and strategically deployed, focusing on areas where they can have the greatest impact and where other financing mechanisms may not be suitable or available.

The overreliance on grants in development finance presents several challenges that hinder fiscally sustainable and effective outcomes:

- **Potential to Crowd Out Private Investment:** Grants are often used to support initiatives that address clear market failures or provide public goods that the private sector is unable or unwilling to finance on its own. However, an overreliance on grant funding in some sectors may have **crowded out private financing** that could have been mobilized. A lack of transparency around how development funds are used and allocated can make it difficult to assess whether public funding is displacing or complementing private capital. In the case of HIV/AIDS relief, for example, what began as a necessary humanitarian aid program later suffered from **rigidity in structure**.

The excessive use of grants limits the opportunities for development paths driven by the private sector.

- **Overdependency:** As contexts evolve, with some countries becoming more prosperous, there is a responsibility to reevaluate the appropriate mix of financing tools. It is not in the donor's or the recipient's interest to allow foreign assistance to create a dependency or unhealthy expectation.
- **Supply-Driven Approach:** Grants are often administered and monitored by large non-governmental organizations (NGOs), consulting firms, or other **implementing partners.** The grant model is susceptible to **asymmetries in information** emerging between the donor and its implementing partners and between the donor and the recipient nation. When providing grants, the donor has ideas about how the money should be used, but the recipient may have different priorities. This can lead to a lack of local ownership and alignment. Grants and contracts do not inherently create a profit motive or market-based incentives for the recipient to ensure the long-term viability, local integration, and sustainability of development initiatives. Top-down development could stifle the entrepreneurship and innovation needed to **create prosperity**.
- **Lack of Sustainability:** Once a project concludes, implementers should then ensure that activities can continue without outside funding; that is, the project should either graduate into another vehicle or be self-sufficient, generating its own revenue. Development programs should have two objectives: (1) provide immediate relief and (2) establish the foundation for self-sufficiency and prosperity. The **collapse** of a program once the implementers leave is not a sustainable model that will meet the second objective. While donors have a responsibility to identify and mitigate elements of foreign aid that could interfere with self-sufficiency, there has been too little investment in understanding the most likely paths to sustainable outcomes for different designs and contexts.

- **Lack of Scalability:** The grant-based model simply cannot scale up to meet global development needs. For example, the demand for infrastructure financing sits in the trillions, while aid is in the billions. There is insufficient government funding available to close the **$15 trillion** global infrastructure investment gap. Innovative development finance mechanisms that can attract private capital are more appropriate. This issue may be of particular concern in strategic industries affecting national security.
- **Use of Foreign Assistance to Pay Chinese Debt:** There are concerns that developing countries could indirectly use U.S. foreign assistance to **pay** their debt and interest owed to China. Recipient governments may implement budget cuts, devaluations, or inflationary policies to convert foreign aid into reserves. IMF financing arrangements explicitly recognize foreign aid grants as a (non-debt-creating) funding source to be sought out by governments needing to close an external financing gap. Foreign assistance funded by the U.S. taxpayer is thereby at risk of being leveraged for debt repayments, as are remittances and other non-debt-creating flows.

DEVELOPMENT TOOLS BEYOND GRANTS

Using other financing instruments—including first-loss guarantees, blended finance, enterprise funds, sovereign loan guarantees, and project loans—would allow the United States to address development needs in a more flexible and wider-reaching manner. These alternative tools could be a powerful agent of change, helping build out finance sectors in developing countries and allowing aid to achieve its intended impact. For example, project lending would increase the amount of funding available for development programs and broaden the pool of eligible countries. Moreover, the **frameworks** that support development lending can provide helpful financial checks and balances in nations where corruption or capacity limitations would disrupt the impact of a grant. Such checks contribute to the development of a stable, well-regulated, sound, and strong domestic financial sector—a nearly universally observed precursor to sustained material improvements in economic development. Finally, concessional lending (i.e., lending at more favorable rates than those charged by commercial actors) allows U.S. development institutions to have a voice and a vote during debt crises and restructuring.

The United States has valuable experience with a variety of non-grant instruments that it can use:

- First-Loss Guarantees: Under the terms of a first-loss guarantee, a third party agrees to cover some portion of a loss for an investor. These guarantees allow investors to fund riskier initiatives, including mining and environmental projects, because there is less liability placed on a lending bank. A loss-guarantee approach to development finance is consistently used by the World Bank, Asian Development Bank, and other multilateral development banks.

  The Development Credit Authority (DCA), formerly part of the U.S. Agency for International Development (USAID) but now absorbed under the DFC, is the primary source of U.S. first-loss guarantee loans. In FY 2016, **51 percent** of the value of DCA loans went to sub-Saharan Africa. Although concerns have been raised over investment risk, the likelihood of default is **very low**: Between 1999 and 2015, only 2.4 percent of the DCA loan portfolio defaulted.

- Blended Finance: The pooling of both public and private investment capital, blended finance has potential to meet development needs at a larger scale. Climate-resilient infrastructure projects have been a major beneficiary of this tool. Reports from the International Energy Agency indicate that to achieve net-zero carbon emissions by 2050, **70 percent** of clean energy investment must come from private sources. These estimates corroborate those of USAID, which found that **over half** of the money needed to close the development gap will come from private investments. Blended financing takes a synergistic approach to investment that has long-term positive impacts on local finance ecosystems. The **blended finance** model could be more heavily utilized to achieve other development priorities such as infrastructure. USAID has also explored blended finance in the context of **health** programs, **energy**, **education**, **economic development**, and other areas.

- **Enterprise Funds:** These funds were first introduced by Congress to help develop transitioning economies **after the fall of the Berlin Wall** by working in tandem with other aid sources to improve private sector engagement with the local economy. In 1989, USAID was given $1.2 billion to establish 10 investment funds that supported 19 of the 29 former Soviet states in Central and Eastern Europe. These Enterprise Funds had a clear impact. After **20 years of operation**, $1.7 billion had been invested in the funds, $6.9 billion in private capital had been raised from outside the U.S. government, and over 300,000 jobs had been created or sustained through these investments.

  More recently, Congress created Enterprise Funds for **Egypt and Tunisia** with the intent of developing the private sector and small- and medium-sized businesses in the wake of the Arab Spring. The funds awarded $120 million to Egypt and $60 million to Tunisia.

- Sovereign Loan Guarantees (SLGs): These guarantees allow financially stable countries to back borrowing countries, which can then access financing at a significantly lower rate—thus enabling direct and concessional support of developing country partners. Direct engagement with foreign governments via SLGs is also an avenue through which the United States can counter China's BRI. Since the BRI was launched in 2013, only **4 percent** of U.S. government assistance has gone directly to governments.

  The U.S. SLG program, as it exists today, has its roots in the 1990s, when President George H.W. Bush gave Israel **$400 million** to help finance the resettlement of Jewish refugees from former Soviet states in Israel. Since then, SLGs have been given out on an ad hoc basis to countries including Ukraine, Egypt, Tunisia, Jordan, and Iraq. Research conducted by the Center for Global Development estimated that expanding the SLG program could **generate $3.5 billion for partners for every $1 billion spent by the United States**, with this leverage growing over time. And unlike the BRI, U.S. SLGs are often designed to help a country reach economic and political stability by attaching **conditions** involving governance and economic reforms.

- **Political Risk Insurance:** The DFC has already been using **political risk insurance** to support development in high-debt environments. According to DFC's chief operating officer, **Agnes Dasewicz**, the DFC plans to expand its use of this successful product. By providing businesses insurance policies for markets deemed too risky by commercial insurance companies, such as Ukraine, this mechanism is helping unlock private sector–led development in otherwise unstable environments.

To effectively deliver on helping other nations realize their development hopes and aspirations, every dollar the U.S. government spends on development should be stretched and scrutinized as much as possible. This begins with asking what the best financing approach is for a type of activity to produce the intended sustainable results in a given context. Can this development project be financed through some sort of market mechanism? Before a grant is issued, other options should be considered. While it is overly simplistic to categorize grants as purely altruistic, they certainly do not see the profits that to which the private sector is beholden. Not every development project will achieve market-rate returns, but many initiatives could generate returns in the 3–5 percent range and no potential revenue should go untapped. Even development initiatives with lower returns can still be viable and sustainable. Similarly, any opportunity to attract private capital should be pursued. Blending different sources of capital and aligning incentives can help unlock a wider range of development-oriented investments.

To accomplish the desired mobilization of private capital, there should also be efforts to optimize development finance institutions (DFIs) and multilateral development banks. Such institutions' past efforts to mobilize capital in support of development initiatives have been **underwhelming**. For example, from 2016 to 2022, DFIs managed to attract only about **33 cents** of private sector funding for every dollar disbursed into energy-related fields. Part of this struggle to catalyze broader private investments is due to **bureaucratic constraints**.

CONCLUSION

The future of U.S. foreign assistance rests on broadening the set of tools to help regional partners and developing countries meet their aspirations. This has been done

Entrepreneurship, market-creating innovations, access to private capital, and wielding the power of market economies are areas in which the United State can certainly outperform China and offer a better alternative to partners in the Global South.

before. For example, USAID's share of assistance in the form of loans or loan guarantees was much larger when the agency initially launched. From 1962 to 1988, loans accounted for **28 percent** of the United States' total foreign assistance portfolio. However, this figure began to decline in response to the debt problems of developing countries. By 2001, loans made up just **1 percent** of total aid appropriations.

Incorporating added instruments to the U.S. development toolbox will not only result in better stewardship of the **1–2 percent of the federal budget** allocated to foreign assistance, but will also advance strategic interests by mitigating the influence of China's BRI across the Global South. Dual-mandated development vehicles have a record of promoting prosperity for partner nations while seeing returns—precisely what will ignite private sector investment and local ownership.

Development in the Global South, though a crucial theater of great power competition, is not being properly addressed by the United States. Although the United States does not lack the resources needed to gain a competitive advantage over China, the current U.S. development tool kit fails to operationalize the most advantageous elements of American economic and soft power. The use of grants to the exclusion of all other forms of foreign assistance makes the U.S. posture more rigid and less adaptable to changing circumstances compared to market-based financing mechanisms. Entrepreneurship, market-creating innovations, access to private capital, and wielding the power of market economies are areas in which the United State can certainly outperform China and offer a better alternative to partners in the Global South. The default use of grants as foreign aid for all circumstances and at all times does not always represent the best U.S. offer.

If the ultimate goal of foreign assistance is for developing countries to graduate to stable, sophisticated economies with dynamic private sectors, the United States should rethink how it uses its mix of development tools. The financial stability of the Global South is at risk while actors such as China, commercial creditors, and well-connected domestic bondholders solidify their strategic position and come to dominate the set of policy options for indebted nations. It is not in the United States' interest to remain on the sidelines, ceding influence and economic opportunity to its strategic, commercial, or military competitors. ■

Daniel F. Runde *is a senior vice president, director of the Project on Prosperity and Development, and holds the William A. Schreyer Chair in Global Analysis at the Center for Strategic and International Studies (CSIS) in Washington, D.C.* ***Austin Hardman*** *is a research assistant with the Project on Prosperity and Development at CSIS.*

This report is made possible by general support to CSIS. No direct sponsorship contributed to this report.

CSIS BRIEFS are produced by the Center for Strategic and International Studies (CSIS), a private, tax-exempt institution focusing on international public policy issues. Its research is nonpartisan and nonproprietary. CSIS does not take specific policy positions. Accordingly, all views, positions, and conclusions expressed in this publication should be understood to be solely those of the author(s). *© 2024 by the Center for Strategic and International Studies. All rights reserved.*
Cover Photo: amixstudio/Adobe Stock