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A NEW APPROACH TO FOREIGN AID

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The existence of cycles in economic thinking is nowhere better illustrated than in the related fields of economic development and economic aid from the advanced to the less-developed countries. If we go back 20 years to the end of the 1940's, we find that those who were then considered most knowledgeable about what are now called the less-developed countries believed that it would be long and arduous task to greatly increase the material standards of comfort in these backward parts of the world. They felt that the most effective way of assisting the economic development of these areas was through the provision of technical assistance and advice. They specifically warned against programs based on the transfer of large amounts of capital to the poor countries.

Thus, President Truman's famous Point Four called for a program of technical assistance to countries of Asia and Latin America. For a few years technical assistance was about all that we provided for most of the countries in these areas.

Of course, in the late 1940's and the early 1950's capital was badly needed for the reconstruction of Europe. And this received the highest priority. As European recovery progressed and agricultural requirements became less urgent, Marshall Plan assistance to Europe was phased out and the less developed parts of the world came to be viewed as appropriate targets for large-scale economic investment. The U.S. unquestionably had the resources to provide this investment, and we had the machinery through which it could be administered. There were some doubts about the wisdom of pouring large amounts of capital into countries that were predominantly agricultural, that were characterized by low levels of skill and high levels of illiteracy. However, the economists rose to the challenge and provided what seemed to be a convincing justification for large-scale programs of capital investment in these countries. One important element in this justification was Walt W. Rostow's theory of the stages of growth. First published in August 1959, this popularized the notion that we had discovered the secret of how to propel all countries into a state of self-sustaining rapid economic growth. Rostow overcame the doubts of those who were fearful that this would be a very long drawn-out process by his theory of the "take-off." The "take-off" was defined as a short stage, concentrated in two or three decades, in which the ratio of investment to population growth is high enough to transform the economy and make growth more or less automatic.

This was based in large part on a simple little formula which seemed to demonstrate that the key to growth was the amount of capital invested. It was known that the total amount of capital in the form of plant, equipment, infrastructure, etc. existing in any country in value terms is positively correlated with the value of the annual GNP. This led to the conclusion that you could control the rate of growth of a developing country by simply the raising or lowering the stock of capital. To illustrate this very crudely, if you had a country whose total investment was estimated at $100 million and whose total output was estimated at $50 million a year, and you wanted to increase the output by $5 million, or 10 per cent, you would have to make an additional investment of $10 million. Thus you would end up with an investment of $110 million, and an annual output of $55 million. The ratio of capital to annual output would remain at 2 to 1. It was recognized that new investment might produce either more or less output than the existing investment, and to improve the calculation, efforts were made to determine what recent experience showed the ratio between additional capital investment and additional output to be. But the calculation was still based on the assumption that investment more or less automatically produced output.

The Rostow idea of "take-off" and the concept of the capital-output ratio gave rise to a rather optimistic view of development prospects in the early 1960's. Rostow said in 1959 that India and China had already begun their take-offs. He thought Pakistan, Egypt, Iraq and Indonesia were about a decade behind. Mexico and Argentina, he said, had finished their take-offs, and the process was underway in Brazil and Venezuela. Rostow convinced a lot of people that if the amount of capital investment put in were massive enough, in a very few years a number of the backward countries would forge rapidly ahead and generate domestic savings in sufficient volume to eliminate or greatly reduce their dependence on capital from the outside.

What Went Wrong?

Things have not worked out as expected. At least half of the countries that Rostow said were in or near "take-off," have turned in disappointing economic performances in the last decade. The reason was not because they did not get the capital they sought from external sources, but because it is not true that investment automatically produced income.

In addition, political developments in many of these and other aid receiving countries have been disappointing as well.

We all know that an investment can go sour. The fact that investments are supposed to yield a certain income on the average is no assurance whatever that any particular investment or any set of investments will yield any income whatever. The fact that jute mills in India might be yielding 15 per cent would not give any valid indication what the return might be from an investment of several hundred million dollars in steel mills. What this means is that investment decisions are a little more complicated than just stuffing pork into a sausage machine and getting sausages to come out from the other end. It is possible to put in a lot of investment and get nothing out at the other end. However, the matter is a little more complicated than this. An investment can produce a high yield in financial terms and still be a disaster from an economic point of view. For example, an automobile manufacturing plant in a small country with high protection against auto imports may yield an excellent return from a financial viewpoint. The production helps boost the national growth rate, but in many cases this income is purchased at a crushing cost. The value of the protected product is overstated. An automobile which is comparable to an American car costing $3,000 may be priced at $6,000. This is the way that it is entered in the financial statement of the producing company, and this is the way it is entered in the national accounts.

However, let us recall Abraham Lincoln's famous question to his son: "If you can call a tail a leg, how many legs does a dog have?" The boy said, "Five." Lincoln said, "No, four because just because you call a tail a leg, it doesn't make it a leg." Just because you call a

$3,000 automobile a $6,000 automobile does not make it a $6,000 automobile.

But little boys know that if they put a $1 value on a bottle cap that does not mean that it is worth $1 at the candy store. A country soon finds out that putting an overstated valuation on its automobiles or steel or fertilizer or anything else that it produces does not make the commodity worth that much in the world market. Just as little boys have to fork over real money when they go into the candy store, countries have to fork over real money when they go to the world market to procure their essential requirements. Of course, as economic development proceeds, those requirements from the outside world tend to mount.

One of the major mistakes frequently made by the planners of many countries in the late 1950's and early 1960's was to think that they could develop on the basis of reducing their import requirements, by producing for themselves things that they were currently importing. What was soon discovered, however, was that while they might produce automobiles or steel or many other goods that were formerly imported, other import requirements developed. They had to import more and more rather than less and less. The only countries that have actually reduced their imports are those that have gotten into serious trouble and whose economic growth has stagnated, such as Burma.

<u>What Must Be Done?</u>

The real money with which these imports are obtained has to be earned by exports or by selling services, or by obtaining foreign capital. This suggests that a country which wishes to develop must be able to count on expanding its export earnings in order to pay for the imports that it will require. If most of its investment is put into areas which do nothing to expand export potentialities, then the country is going to sooner or later find itself in serious trouble. It may for a time show rapid increases in output, but these increases will prove short-lived. It eventually finds that it cannot obtain the raw materials and the spare parts needed to keep its new industries operating. What is often forgotten is that just as you cannot keep a thermal electric plant going without an input of fuel, it is rather difficult to keep human beings going if they are not fueled with their necessary requirements of food, clothing, shelter and such other consumer goods as they crave. For some strange reason, many people have fallen into the habit of looking upon fuel oil which keeps machines going as being somehow noble and consumer goods which keeps human beings going as being wasteful.

What is very definitely realized now is that the provision of all of these inputs, including the necessary consumer goods, is a very important part of the development process. These can only be paid for on a sustained basis if a country develops steadily increasing export capacity. The development of export capacity requires the development of agricultural, industrial, mineral or service-types enterprises which will produce goods and services that can be sold on world markets in competition with other procedures. It is increasingly but not fully realized that this requires economic policies which make exporting financially attractive. This requires a realistic exchange rate which does not penalize exporters. It requires avoidance of burdensome taxes on exports and heavy taxes and other restrictions on imports needed by the export industries. It requires encouraging investment in modern equipment and techniques. Successful competition in export markets is generally based on imagination, flexibility, and a strong incentive to take the risks inherent in selling in distant and sometimes volatile markets. This is especially true when a country seeks to go beyond exports of raw materials or primary agricultural products.

What countries that want to speed their development must do is to re-examine their economic policies dropping those that inhibit exports and substituting policies that put a premium on efficiency and competitive strength.

What Can Foreign Aid Do?

Obviously foreign aid, to be effective, has to do more than merely pour capital into the less developed countries. Pouring in capital may have excellent results in some cases. But the results may be nil or negative in others. The key is the economic policies pursued by the recipient country.

Recognition of this fact led to the emphasis on "program" loans in the 1960's in some countries. The underlying idea was that the aid would be given in a flexible form to countries that adopted good economic programs. There was much to recommend this approach, but its execution left a great deal to be desired. One reason was that in some cases the assistance was provided even when the programs and policies being followed by the recipient country were not conducive to sound economic development. "Program" lending in these cases was used as a means of providing balance-of-payments support without insisting that the country put its economic their leverage to secure reforms that they knew were needed.

It appears that in both bilateral and multilateral aid donors have frequently failed to use the lever of withholding aid to persuade recipients to adopt policy changes. One reason may be that withholding aid from major recipients would make it difficult for the donor to achieve its commitment targets. Ironically the availability of a certain amount of aid for commitment each year may have been one of the reasons why the aid was not utilized to maximum advantage. In the minds of the administrators the maximization of commitments was a more immediate measure of success than was the efficiency in the use of the funds. The amount of commitments is easily measured and understood. The efficiency in the use of funds is difficult to measure. It cannot even be attempted until after the passage of considerable time.

However, if it is true that certain types of policies will tend to produce efficient use of funds, it is possible to assess the efficiency of aid in terms of its contribution to securing the adoption of good policies.

Foreign aid should be employed primarily as means of getting countries to adopt policies that are in their own best interest. Both theory and experience indicate that this means liberal economic policies which encourage private enterprise and initiative, emphasize encouragement of exports to bring to the country the advantages of the international division of labor, and induce the inflow of foreign investment and know-how. Developing countries that pursue proper policies should be able to generate and attract private savings and skills to carry their development forward. However, because of imperfections in the capital markets, lack of confidence in the stability of small or distant countries, and need for financing infrastructure projects which are not suitable for private financing, official capital should be available to countries that are doing the right things and are not mobilizing as much capital as they can efficiently employ. Less official capital should be provided to countries whose inability to mobilize private funds, either domestic or foreign, results from their own mistaken policies. The provision of official capital to such countries tends to finance the continuation of mistaken policies.

The success or failure of foreign aid should be measured in terms of the success observed in getting countries to adopt good policies. On this basis, we would say that foreign aid has achieved very little in a country that persisted in maintaining an overvalued exchange rate, a high degree of import and exchange controls, serious impediments to private investment, etc.

How Should Aid be Channeled?

If the success or failure of the program is to be measured by the kinds of policies the countries follow, the important thing is to find a channel that can best influence policy.

If the weakness of the program-loan approach was that the desire to meet commitment targets outweighed the desire to secure adoption of good programs, then we ought to try to avoid a channel that sets up commitment targets globally or bilaterally. The banking approach should do this, but unfortunately the official banking institutions have also tended to measure their success in terms of the volume of commitments. The IFC, which is intended to encourage the development of private enterprise, measures its success, in part, in terms of the profitability of its investments. This is good, except that it has a tendency to invest in projects that benefit from heavy protection. Protectionism is one of the policies that we ought to be discouraging, not encouraging.

What is needed is an organization whose purpose is clearly that of encouraging liberal economic policies in the world. It should have available a substantial fund that could be used for investment in countries that were pursuing acceptable policies. The investments could be made in a variety of ways. They could take the form of bank deposits, the purchase of bank debentures or the purchase of bonds, governmental or private, of the countries being aided. It would probably not be desirable to finance projects. There are enough institutions doing this already, and the scarcity of good projects available for financing is well known.

Channeling the funds through private banking channels, adding to liquidity, or through the public treasury, easing the tax burden, would serve the purpose of supplementing the investment funds available to the country. As long as the overall economic policies of the country were good it would not matter what specific economic projects benefited from the aid. This could best be left to the managers of the economy, both in the private and public sectors, who would be aided by the general increase in fund availability resulting from the actions of the overseas investment organization. This organization would therefore have no need of a staff to work up and evaluate investment projects. Its staff would instead devote its energies to evaluating the economic policies of the countries that were candidates for assistance. It would do what commercial banks and the Export-Import Bank do now with respect to assigning credit ratings to individual countries. But the ratings would be based on the quality of general policies, absorptive capacity and estimates of unfilled needs for capital.

It may well be found that in some cases countries which seem to rate high in terms of the types of policies they follow do not seem to be able to make use of large amounts of new capital. Others which are far from perfect in terms of policies may be experiencing rapid and apparently healthy growth which suggests that new capital from outside could be utilized very productively. The judgments about policies will necessarily have to be modified by estimates of capital requirements and absorptive capacity. Among the factors which should be considered are the rate of economic growth, the rate of growth of export earnings and the real rate of interest. Capital absorptive capacity should be measured in terms of the ability of the country to employ the capital in highly productive ways. If the productivity of capital is high, relative to other countries, the return on capital should be high, providing an inducement for capital inflow. The high productivity of capital should also be reflected in the ability of the country to expand both output and export earnings. It will frequently be found that a country that seems to have great need of additional capital but which seems unable to pay a reasonable return on investment suffers from serious policy defects which should be corrected if the capital is to be effectively utilized.

The Overseas Investment Corporation

I propose that a new quasi-public corporation, to be called the Overseas Investment Corporation, be established to carry out the channeling of our bilateral economic aid along the lines described above.

As already stated, the corporation should have as its primary goal the encouragement of sound economic policies in the developing countries with a view to creating a climate conducive to private enterprise and investment.

The corporation should have at its disposal, initially, a fund of about $1 billion for investment in countries that are pursuing appropriate policies and that are judged capable of utilizing additional capital inflow advantageously. The funds may be invested by the corporation in any way that it sees fit, including the purchase of stocks, bonds, government securities and depositing funds in banking institutions. It should be governed by consideration similar to those that would govern a prudent investor, considering the safety of the investment and the return. However, it should take a long-run view and establish as a prerequisite for investment that the country be pursuing economic policies conducive to private savings, investment, export growth and induction of foreign skill and know-how. This should not be a matter of actively dangling before the countries the carrot of its investments if they make policy changes. It should be a matter, rather, of refusing to invest in countries where policies were considered to be unacceptable.

I propose a radical new method of financing this corporation. Taxpayers, both individuals and businesses, would be permitted to invest an amount equal to, say, one per cent of their income tax payments in shares of the OIC. They would be given a tax credit for this investment. Federal receipts from income taxes, personal and corporate, are estimated at about $122 billion in FY 1972. If every taxpayer elected to invest one per cent of his federal income tax payment in the OIC, $1.2 billion in capital would be raised. However, it would be advisable to establish some minimum that might be invested simply in order to eliminate uneconomic record keeping for very small investments. Something in the order of a one per cent tax credit with a minimum investment of $10 might yield around $1 billion for the OIC. This would not cost the Treasury anything on a net basis, since foreign aid appropriations would be correspondingly reduced.

The shares acquired by the taxpayers would be marketable. The stockholders would be entitled to elect half of the directors, with the other half being appointed by the Secretary of the Treasury. The board of directors would elect the officers of the corporation, but the president of the corporation would have to be approved by the Secretary of the Treasury. Dividends would be limited to 8 per cent of the capital, with earnings in excess of this retained to be invested by the corporation.

The corporation would be chartered for a specified period of time. Congress could decide annually whether or not the capital should be augmented by the same method used initially. If the investment policy were successful, it would be difficult to wind up the corporation, but once its mission was accomplished, it might be converted to a purely private investment corporation, giving up its quasi-official character.

The private involvement in the corporation would minimize political influence on the corporation's decisions. The public participation would serve to keep its orientation from becoming purely one of profit maximization without regard for the goal of encouraging the development of sound economic policies in the developing countries.

The corporation should command wide support in the business community. If well managed, the value of the shares could not only be maintained, but might appreciate. The investment would be costless to the investors, since the funds would otherwise go for taxes. The corporation, if successful, would help create a climate favorable to private enterprise which would be beneficial to American as well as other investors, including nationals of the aid-receiving countries.

The corporation would permit the elimination of most of the foreign aid machinery and would therefore permit a net saving to the taxpayers. The management of foreign assistance would be largely removed from any connection with out diplomatic machinery, which would have several advantages. We could get away from wasteful political use of aid, which benefited neither the recipient nor the donor. We would get away from the present tendency for some countries to consider our aid as their right. We would establish an entirely new and far more healthy relationship with these countries. Substantial capital would be available to them if they met the required conditions, but we would not be in the position of negotiating terms and conditions on a government-to-government basis.

In the initial stages some of the largest aid recipients would clearly have difficulty qualifying for investments from the corporation. There will be strong opposition to the proposal by those who think we should give assistance to countries regardless of their economic policies. To soften this opposition, it might be desirable to provide for a graduated reduction of assistance from present levels for countries that cannot meet the required conditions. However, it should be clear that this is a transitional arrangement to give the country time to decide whether it wishes to adjust its policies or adjust to getting along with little or no official capital from the United States.

The new corporation would differ fundamentally from the already existing Overseas Private Investment Corporation (OPIC). OPIC is designed to induce greater transfers of U.S. private capital, technology and management know-how to the developing countries. It insures investments against loss due to specific political risks of currency inconvertibility, expropriation and war revolution or insurrection, and it guaranties private loans to developing countries against loss from both commercial and political risks. The OPIC guaranties and insurance are backed by cash reserves derived from earnings and appropriated funds, but OPIC has the authority to seek additional appropriations from Congress if its cash reserves should be inadequate to meet its liabilities. OPIC is under a Congressional mandate to consider "the possibilities of transferring all or part of its activities to private United States citizens, corporations or other associations." It is conceivable that the insuring and guaranteeing functions of OPIC could be merged with the new corporation that I have proposed, thus carrying out this Congressional mandate. Such a combination might even serve to help marshall sentiment in the developing countries against those countries that expropriated American property without paying compensation, since the payment of expropriation claims by the OIC would directly diminish the amount of funds available to the corporation for direct investment in other developing countries.

The principal advantage of the OIC approach to foreign aid is that it would offer a powerful inducement to the developing countries to pursue overall policies conducive to self-sustaining economic growth. This would insure against aid funds being used to perpetuate economic policies inimical to development and to private investment and enterprise. The mechanism would be relatively simple and inexpensive. Moreover, the taxpayers who were financing the program would enjoy some very direct, tangible benefits from it in terms of the possible benefits from their ownership of equity in the OIC.

If this approach proved successful after a trial period, it might increasingly substitute for other means of transferring official capital to the developing countries. However, as the experts recognized back in the early postwar years, direct technical assistance to the developing countries is of great importance. Institutions capable of providing such assistance on a substantial scale along with financial assistance for economically justifiable projects will continue to play an important role. However, the OIC approach could founder if the borrowing countries that could not qualify for OIC investments were able to satisfy readily all their needs for external capital from other official international lending institutions. This can be avoided if there is general acceptance of the idea that economic aid must encourage and not frustrate efforts to adopt sound economic policies in the recipient countries.